

Are Hedge Funds Good Short Sellers?

Stockholm (HedgeNordic) – Hedge funds are supposed to be good short sellers. If not hedge funds, then who else? Recent research, however, provides some evidence that hedge funds struggle to generate alpha on short trades.

Robert Kosowski, Pasquale Della Corte and Nikolaos Rapanos of Imperial College Business School joined forces to test the performance of hedge funds' "best shorts" using data collected under the EU Short Selling Regulation. "We use publicly disclosed short positions for EU stock markets from 2012 to 2018 to show that short positions for which hedge funds have high conviction ex-ante outperform other short positions that account for a smaller proportion of the funds' short positions," writes the abstract of the study. Higher conviction short bets do outperform lower conviction shorts, but that does not imply hedge funds' short-selling activity is profitable.

The researchers formed a portfolio that mirrored the highest conviction short positions and went long a basket of lower conviction shorts. Whereas the strategy outperformed a benchmark six-factor model by seven percent per year, the outperformance was mainly attributable to the basket of long positions rather than the performance of the best short ideas. Clarifying the results, Robert Kosowski, associate professor at Imperial College Business School, says "you are making money by going long the stocks that people have low conviction on, and those stocks go up as opposed to going down. The short position on the high conviction stocks doesn't actually do very well."

Although the data history is relatively short to reach a convincing conclusion, Kosowski reckons that "funds overweight positions in stocks they are not really informed about and eventually they lose money." Furthermore, "on the low conviction side, they lose even more money because they've not researched well enough." One should keep in mind that some of the short positions may serve as hedges rather than directional bets, which makes the process of assessing a manager's conviction more ambiguous. "Our findings are consistent with investors not having an informational edge as far as shorts are concerned, and you can trade against that," concludes Kosowski.

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