Demystifying Short Selling

Stockholm (HedgeNordic) – Short selling has always been a tough job, and the Reddit-fueled GameStop trading frenzy at the beginning of the year may have made the job even more challenging. Videogame retailer GameStop has been in trouble for a long time, and thereby, a classic target for short sellers in the hope of profiting off the company's worsening fundamentals. The short squeeze triggered by retail traders through an avalanche of small trades – stirred up on Reddit's WallStreetBets forum – has often been cast as a triumph of merry men over the big bad hedge fund managers, putting short sellers in the spotlight again. So is short selling an evil, a necessary evil, or a much-needed necessity? In this article, two short sellers from the Nordics are sharing their views on shorting and its role for financial markets.

Why Short?

"With a financial ecosystem that is driven primarily by one thing, stocks going up, we believe it is healthy for the market to have short sellers expressing a different view from the crowd," argues Carl Rydin *(pictured left)*, a portfolio manager at long/short equity fund **Origo Quest 1**. "The supportive view is that short selling provides additional market efficiency through better price discovery and greater liquidity," continues Rydin. "With a market moving further towards passive investment vehicles with no price sensitivity, this argument supporting short sellers as part of the market becomes even stronger."

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Anders Palmqvist, the CEO and CIO of Archipelago Investments – which runs market-neutral equity fund **Chelonia Market Neutral**, corroborates Rydin's arguments. "The main benefit of shorting, also supported by academic studies, is a more efficient market with improved liquidity, but also higher returns for long term pension funds and investors, as they are lending their large equity holdings against interest to the market via stock lending desks," Palmqvist tells HedgeNordic. "With regulators and others strongly advocating passive funds tracking an index solely on the back of low fees, the resulting massive flows into passive investments are very much like what we witnessed in synthetic asset-backed CDOs in 2008 in that price-setting in the market is not done by fundamental security analysis, but massive capital flows based on models of risk that proved untrue." Magnus Angenfelt, the fund manager running Chelonia Market Neutral, adds that short selling "makes the market more perfect and takes away valuation anomalies driven by passive index funds."


Magnus Angenfelt, Portfolio Manager – Archipelago Investments

"Another role for short sellers in the market has been spotting wrongdoing and company frauds," further argues Rydin, who joined Origo Fonder back in 2017. "One would think the understaffed regulator will be there to detect misconduct, money laundering and accounting irregularities, but history shows that short sellers or investigative journalists have demonstrated they were able to find some of these issues before the regulators," the portfolio manager tells HedgeNordic. "Investment bankers or talented sell-side research analysts typically won't be the ones identifying them, as they are too incentivized not to."

Palmqvist shares the same line of thought, saying that "shorting also gives a more balanced view on some hyped stocks or potentially fraudulent companies." According to Palmqvist, who founded Archipelago in 2016, "cases like Wirecard show why bans on short-selling are badly misguided, and at the time the short sellers faced relentless criticism even from the German regulator." Palmqvist goes on to add that "hopefully, shorting can also result in smaller losses for less-informed investors, if they are made aware that an investor is short a stock, they could see this as a potential red flag or alarm signal." "If someone dares to take unlimited risk by going short, maybe they buy less of the next Wirecard or Nikola in the future?" Palmqvist is pondering.

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Profiting off a company's demise is just one of the many reasons for engaging in short selling, argue both Palmqvist and Rydin. "Like market makers or stock option traders delta-hedging on behalf of pension funds wanting downside protection or general equity market hedging, relative value trades, ESG or Sustainability reasons," says Palmqvist. "There could be several different reasons for market participants to sell short a security, including hedging reasons and profit reasons," adds Rydin.

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"If a large long-term investor in a stock is worried about the short-term market impact related to Covid-19, he or she can decide to hedge the investment for downside protection for a short period of time and without necessarily limiting – all or part of – the potential long-term upside in the stock," argues Palmqvist. "There are also many different strategies that include short selling, such as fundamental research-driven investors thinking a stock is overvalued, a quantitative computer-driven fund trading on signals, or an investor simply hedging a part of the portfolio and not necessarily looking to outright profit from the short position," further adds Rydin.

Fundamentals-Based Shorting

The teams running both Origo Quest 1 and Chelonia Market Neutral rely on fundamental analysis to find their shorting candidates. "Since we are fundamentally research-driven at Origo, our short-thesis often requires equal (if not deeper) fundamental analysis compared to our research in potential long positions," Stefan Roos *(pictured right)*, the founder and CIO of Origo Fonder, tells HedgeNordic. "In order to contradict conventional opinions and thereby identify companies with unsustainable business models, accounting irregularities, balance sheet risk, and/or companies operating in industries with structural declining characteristics, short sellers typically deploy deep fundamental research and look beyond CEO comments or investor presentations."

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Anders Palmqvist believes that fundamentals-based shorting is "of particular importance in bull markets like today where we see many new investors, perhaps less informed, entering the market." Instead of investing based on "old fashion fundamental stock analysis, investing has become some sort of "gamification," argues Palmqvist. "Regulators should also actively inform retail investors about the potential risk that these passive index products involve no security-level analysis whatsoever that is normally required for true price discovery."

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"The shorting approach is very individual, and should be so. It must fit with your personality," argues Chelonia Market Neutral's fund manager, Magnus Angenfelt. "At Chelonia, we try to follow two rules: Newer short on pure valuation. Be sure you have time on your side." The Origo team appears to be following the same rules when shorting. "Another aspect we focus on is the timing of when to put on a short," explains Roos. "Valuation itself is never enough to short a stock for us as it can always go from expensive to super expensive and beyond," he emphasizes.

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“Further, evolutionary trends, disruptive opportunities and threats impacting companies negatively play an important role when we short,” explains Angenfelt. “We believe it is easier to identify losers than winners, with potential winners often being too expensive,” he continues. “It is also less competitive as most long-only active managers primarily focus on winners. Passive funds obviously own everything in the index regardless of valuation and disruptive threats, and as a result, broken business models are often valued as business as usual. A rising tide lifts all boats,” argues Angenfelt.

Is Shorting Ethical?

“In its essence, it is certainly not unethical,” answers Roos. “Just simply because short sellers have a monetary motivation doesn’t mean it’s unethical,” he argues. “There are obviously short selling participants that do not follow the rules and regulations by using naked short selling or very aggressive activist short campaigns. We certainly do not support this behavior,” Roos tells HedgeNordic. “Having said that, our view is that short selling as a concept is not only ethical but healthy for the market as a whole.”

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“Most shorting in the market fills the primary purpose of risk mitigation, which is an important function in the market, and maybe even more so in strong bull markets,” argues Anders Palmqvist. “So yes, shorting is not only ethical, it is a prerequisite for investors, pension funds, insurance companies, hedge funds, being able to hedge market risk.”

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Palmqvist also believes the practice of shorting can be used to drive and encourage sustainability awareness at targeted companies. “If you believe the companies are not delivering on relevant ESG metrics, are too slow in the transition, are green-washers, or worse are taking no action and are environmental polluters, hedge funds can short their stocks and bonds,” says Palmqvist. “The polluters’ access to capital markets and financing conditions are then indirectly worsening, and longer-term, this shorting or risk of becoming a short target will potentially – or hopefully – force these companies to take necessary climate action sooner rather than later.”

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