Restrictions on Short-Selling will muzzl e the Markets

What exactly is short-selling? If we pay attention to business television entertainers and, alas, to the U.S. Secretary of Treasury, we are led to believe that short-selling is evil and culpable for the recent market routs. I don’t believe this. Instead, I claim that the current restrictions on short-selling are against the best interests of investors and of the American people.

Short-selling means that: (a) you tell your broker that you want to sell a stock which you not own; (b) the broker arranges for a buyer, (c) the transaction is made at the market price. After that, your broker must deliver stock to the buyer within a reasonable amount of time. To deliver the stock you must buy it at a later time or “rent” it from stock from a stock-loan desk. This may sound complicated but, in essence, is simple: you initiate a transaction by selling, not just by buying. Short-selling means selling what one does not own, just like buying means buying what one does not own.

Why does short-selling exist? Is it a “dark practice” done by evil people? The answer, as you suspect, is no. Short-selling is essential for the functioning of markets. If you were only allowed to sell stock that you owned, non-shareholders would not be allowed to have an opinion on the value of companies. This is not the way that public markets are supposed to function, and certainly not the way that the New York Stock Exchange, NASDAQ and the European bourses have worked for decades.

Once a company decides to “go public”, i.e. to list itself in the stock market, its value is no longer decided by its directors or its shareholders. It is decided by investors. If some investors think that company will increase its profits, they will buy the stock. Conversely, if the company is deemed too expensive in relation to its business outlook, shareholders might sell (or not) and non-shareholders can go short. The fact that price contains as much market information as possible is a cornerstone of healthy equity markets.

If short-selling was not allowed, shareholders and directors would be able to manipulate the stock price in several ways, consciously or unconsciously. For example, the company would only put out good news and rosy forecasts. This would drive up the stock artificially and shareholders can sell to make a profit. Once the stock dropped, they would buy it back if they want. Short-sellers prevent that by researching the company and shorting as the stock if it rises for fictitious reasons. The market keeps listed companies honest, in a sense; short-selling is an important element in making this happen.¹

Some television entertainers vilify “short-sellers”, as gangs of wild prowlers set on destroying value (Notice that this happens mostly when markets go down). These entertainers always recommend buying stocks that have already gone up or are about to. I bet you never saw a television show where the host recommended shorting a stock. This

¹ A forthcoming paper by Mike Lipkin and me introduces a model that describes how restrictions on short-selling can lead to asset bubbles (lecture by Lipkin at Columbia University, September 12, 2008).
optimistic bias tends to give rise to bubbles, i.e. to behavior in which investors, observing a rise in stock prices, also buy the stock, pushing the price even higher. The whole thing ends by a significant drop once all buying ends. Usually, what prevents bubbles from forming in the stock market is that short-sellers are allowed to profit from bouts of unjustified optimism and excesses, by shorting. More importantly, there is no real sociological division between shareholders and short-sellers. Often the same investor has a short position in one stock and has bought another stock; one can be long today and short tomorrow! Although it is true that there exist professional short-selling hedge funds, these cannot be unequivocally blamed for price drops. If a stock price is too low, then the company, its insiders, or other investors may buy the stock. If they are right, short-sellers will lose.

Let us focus on the case of U.S. financial stocks. The message of short-sellers, in essence, is: your company has too much debt for the business that it is running. Reduce the scale of the debt by selling some assets. By lowering the stock price, or shorting the stock, they are indicating that the company has too much debt for the equity (like in the case of a homeowner, too much outstanding mortgage for income).

Financial institutions have revealed over the past year, in a very piecemeal way, the extent of their subprime/mortgage losses. Because of the protracted way in which the losses were revealed (alleging, for example, that the instruments were difficult to value), the market got alarmed, voted with its feet and sold or, in some cases, shorted the stock. Special financial instruments, like the Financial UltraShort ETF were made available to the public so that individual investors could short financial stocks. This was sending a very clear message to Wall Street.

Unfortunately, since March 2008, and even before that, the US government and the Fed have decided to assist specific financial institutions, essentially intervening in the markets and changing the rules as the game was being played. Last July and again yesterday, September 17, the US Treasury introduced additional restrictions on short-selling. These are explicitly directed to supporting financial stocks and the most recent “targets”, Morgan Stanley and Goldman Sachs. This looks particularly bad because the Secretary of Treasury is a former executive of Goldman Sachs.

One more thing: among all the financial institutions of Wall Street, Goldman Sachs was a heavy short-seller of mortgage-backed securities. This means that, while Bear Stearns, AIG Financial Products and others suffered losses from mortgage-backed securities because prices dropped, Goldman profited because they had shorted the same market, betting that the mortgage market would collapse and buying protection against default of mortgage issuers. Yet, this trade was touted as pure genius by Wall Street and television entertainers. However, as the fall of 2008 begins, the market seems to be forming a bleaker opinion of brokers. This has led to the latest share drops.

It would be naïve, in my opinion, to dismiss the latest developments as being caused a short-selling axis of evil. More likely, the market is beginning to realize that, given the current environment, the leverage ratios of independent broker-dealers such as Morgan
Stanley and Goldman Sachs are too risky. Therefore, they should either (a) shrink in size by selling businesses, or (b) increase their cash reserves, something they cannot do unless they merge with banks that have large deposits and limited mortgage exposure. But timing is everything. The short-selling restrictions that have been recently put forth by the SEC are there to buy time, at the expense of investors and the public.

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