McKenzie's Insight – Short Selling During Crises

Trading & Hedging

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Short selling is a trading strategy designed to profit from falling asset prices.

It involves the sale of an asset that the trader either does not hold at the time of the sale (a '*naked*' short sale) or has borrowed in order to fulfil his or her settlement obligations (a '*covered*' short sale).

Where the asset is vested, the loan typically is collateralised with either cash or some other form of asset.

It takes backbone to pursue short positions, such volition best summed up by US Hedge Fund Manager, Jim Chanos, "*If you're a short-seller, that's a cacophony of negative reinforcement. You're basically told that you're wrong in every way imaginable every day. It takes a certain type of individual to drown that noise and negative reinforcement out and to remind oneself that their work is accurate and what they're hearing is not.*"

Beyond the individual long or short seller, a market that embraces long and short price actions often also celebrates more meaningful, '***Price Discovery***', the be-all and end-all of stock and bond market investing.

Cite:- **A Short History Of Our Most Maligned Trading Technique**, 27 August 2016

More dangerous than any nefarious individual short seller has been the worrying tradition of regulators and governmental agencies crowding into open markets during times of economic and financial crisis and either banning (prohibitions) or threatening to ban the utility of shorting, without any rationale other than shorts lower asset prices.

Today marks the birthday of our Posthumous Patron at Australian Standfirst, Professor Michael McKenzie and he was recognised as leading the world in research and the understanding surrounding the impact of naked short selling on the securities lending and equity markets, here on the ASX and globally – his work and findings led to regulatory and legislation changes to market rules in Hong Kong, London and some US bourses.

Cite:- **Vale: Michael McKenzie Brought Pragmatism To Investing**, 18 April 2015

Mike's work dissected the nature of the relationship between share price volatility and traded volumes, observations that negative shocks elicit a greater response in volatility than positive shocks of an equal magnitude and importantly, strong evidence of time variation and asymmetric

response to shocks in the variance-covariance structure of asset returns.

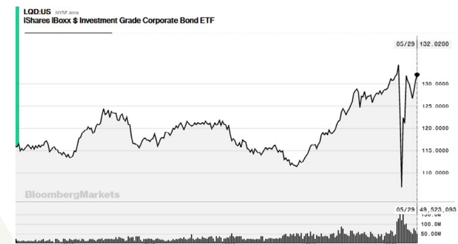
Nothing though that he investigated before his passing five years ago, would prepare for the enlargement seen during this new era when the US Central Bank and others following would, without notice, entering entire new market segments, as seen in late March of this year with the US listed ETF, LQD [LQD:US].

Cite:- **Australia Begins Quantitative Easing**, 17 March 2020

Cite:- **Australian REPO Operations, March 2020**, 22 March 2020

Not only does these unprecedented and alarming steps threaten a broader reckoning in and of themselves, they call into question how shorting and the government confrontation of short sellers, via what's dubbed, "***short squeezes***" plays into any of our calculus's moving forward.

Before the market open on Monday, 23 March, the US Federal Reserve announced not only unlimited Quantitative Easing, but in an unprecedented move, Powell said he would also start buying loans and bonds in the secondary market, as well as the LQD.



What happened next was also unprecedented, explained JP Morgan, "*Looking at credit ETFs, the short base collapsed in spectacular fashion from LQD, the biggest HG ETF after the Fed's credit backstop programs.*"

All those traders who naïvely expected that the Federal Reserve would not nationalise virtually every market were wrong – and they suffered the largest ***short squeeze*** in human history.

The fact that a wing of the US Government, entered into public markets, without legislation or even forewarning to or from US Congress, and bought listed Exchange Traded Funds with the explicit intent to prop up US Corporate Bond markets and squeeze private investors is wrong – as an advisor or global investor, how does one now prepare or mitigate the advent of such an event? Financial markets are deteriorating from science-driven places of Price Discovery and exchange to glorified punting pens, where even the most informed cannot predicate Government's, '***Crowding In***'.

But what McKenzie taught us to confront this menace is that the most commonly cited argument against short selling is that it exacerbates stock price volatility.

The logic behind this view is fairly straightforward: when there is bad news for a stock, short sellers increase their positions, i.e. they sell. Of course, the reverse is true for good news. Thus, short sellers' trading activity is seen as adding further pressure to prices, resulting in increased volatility.

This view was commonly advanced by regulators to explain the motivation for the 2008 short selling bans. A second argument commonly made against short selling takes a more macro view that short selling destabilises the market. For example, in 2010, the Chairman of the SEC, Mary Schapiro, stated that the SEC was concerned that unconstrained short selling could "*destabilise our markets and undermine investor confidence*".

Michael's work not only proved this assumption to be wrong, his calculus actually demonstrates the inverse, that ***short squeezing*** has likely contributed to volatility in a wide variety of investment strategies.

Short interest is widely regarded as a leading indicator for underperformance in stocks among quantitative investors and institutional investors tend to make up the majority of the short interest in any given name, therefore not only does the allowance of shorting aid ***Price Discovery*** – beneficial to all, atleast all who wish to play the game straight – it buttress the destructive forces championing short squeezing (for whatever motivation they may be led by).

The advent of shorting has allowed short-term market dislocations to be corrected whilst having a constructive and accelerated positive impact on the long-term fundamental value of assets. ■

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