

Shortselling Revisited.

In today's news there were several items about shortselling, notably that the ASIC (the Aussie regulator) was considering extending the short selling ban, and that short selling was responsible for market weakness in various markets.

At a time when public opinion and emotions run high against hedge funds, this is dangerous; because banning short selling is misguided, counterproductive and harmful.

Reference an earlier post I made on 25 September: Short Selling and Market Efficiency.

All these were academic studies based on sophisticated reasoning and hypotheses.

But think of things simply for a moment. As an industry, hedge funds have always run net long. This net long exposure is chronic and stable. It tends to range around 30% to 50% net long. By the way that means that on average, an equity long short fund would be, for example, long 100 dollars and short 50 to 70 dollars for every 100 dollars of capital.

A ban on shorting would mean that they would be constrained from shorting and would therefore have to run a short position of say 20 to 30 dollars. In order to maintain their net positions at around 50% say, they would have to reduce their long positions to around 50 to 80 dollars.

The point to take is that a ban on shorting has resulted in hedge funds reducing their long exposure as well as their short exposure. The net impact on the market is unclear. What is clear is that the hedge fund would be buying stocks it considered low quality, thus propping them up, and selling stocks it considered high quality, thus threatening their funding and viability. Loans and bonds can have market size covenants which could get triggered. This is when it can get

entertaining and amusing, if it wasn't so worrying. Imagine a ban on shorting that triggered a wave of short covering driving up the prices of companies which should not exist, and the selling off of companies which are perfectly fine, but for the shrinkage in their market size end up triggering debt covenants resulting in technical default.

To the regulators I say, please guys. Take a deep breath. Put the safety back on. Holster the gun. Before you shoot the market in the foot.