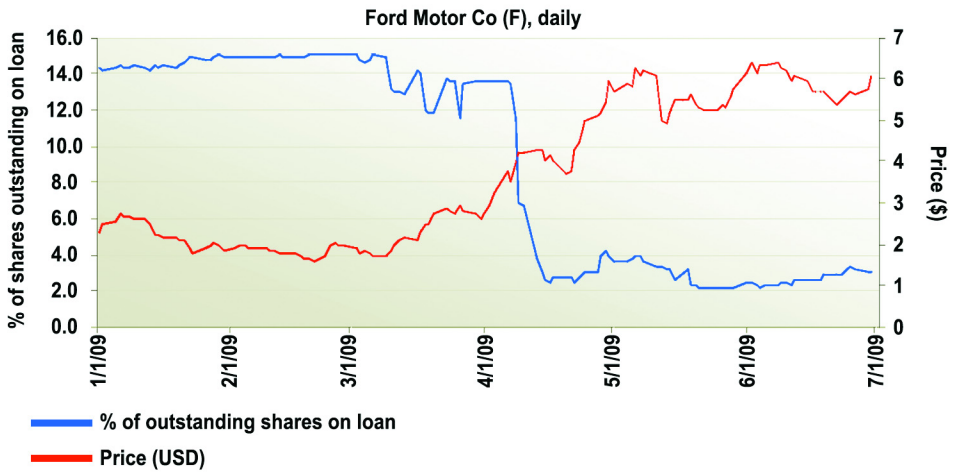
The hidden risks of short selling

The crowds aren't always wise when trading from the short side.

BY JAMES CLUNIE

FIGURE 1: FORD — SHARES OUTSTANDING ON LOAN



Short sellers preyed on Ford in early 2009 but were caught off guard when the stock rebounded by April. Its percentage of outstanding shares on loan plunged as Ford peeled away, a classic sign of a crowded exit.

Source: Data Explorers and Thomson Reuters

Unlike long-only investors, short sellers attempt to profit from falling prices. As a directional approach, short selling is straightforward: sell stock and then buy it back to exit, or cover, the position. However, short sellers must first borrow the shares of stock they wish to sell.

Short sellers are often regarded as sophisticated market players — traders who can identify stocks that are likely to underperform their peers, and who act aggressively to exploit that outlook. Roughly 20 years of empirical evidence supports this perception: Heavily shorted stocks lag the market, on average, earning profits for short sellers.

However, these same heavily shorted stocks rise sharply in price more frequently than normal. Timing is also crucial, in light of the cost of borrowing stock to sell short.

Short sellers face unusual risks. A stock can theoretically increase 1,000 percent or more as losses on a short position multiply. The situation can become dire if large numbers of short sellers attempt to exit at once, pushing up price with their buy orders. "Short selling and crowded exits," (*Active Trader*, October 2009) explored this phenomenon, and showed how European stocks in these circumstances rallied approximately 27 percent, on average, within 60 days. The following describes how crowded exits formed in several heavily shorted U.S. stocks as the broad market bounced back in 2009.

Don't follow the crowd

A crowded exit occurs when short positions in a stock are large relative to its normal trading volume and a catalyst then triggers an exceptional degree of short covering. Short sellers rush to cover their positions, but elevated demand for stock creates an updraft.

At the start of 2009, market conditions were perfect for short sellers — stock prices were falling and cyclical stocks with weak balance sheets were easy tar-

gets. As some firms bordered on bankruptcy, their stock prices descended toward zero. However, concerted government intervention in the global financial system eventually led to a strong market rebound in March 2009. As traders realized governments would ultimately support the banking system, their appetite for risk returned with a vengeance.

Short sellers now faced entirely different market conditions. The stocks that appeared most vulnerable in February 2009 were now crowded with short positions, and some of the riskiest stocks were rallying sharply. Shorts needed to cover their positions, but liquidity was poor compared to the increased demand for stock. This was classic crowded-exit territory.

Crowded-exit examples

Researchers measure short-selling activity by "short interest," which is the closing number of borrowed shares in a stock. By comparing short interest to volume or the number of tradable shares outstanding (the "float"), you can identify stocks most likely to develop crowded exits. The stocks most susceptible to crowded exits are economically sensitive, possibly leveraged, and heavily shorted relative to normal trading volume.

Take Ford Motor (F) — a cyclical firm with more than $100 billion of debt in 2009. Figure 1 compares a daily chart of Ford to the percentage of its shares outstanding on loan, a proxy for the proportion of shares that are shorted. In January 2009 Ford had roughly 14 percent of its shares outstanding on loan, an above-average percentage indicating heightened short interest.

Figure 2 compares Ford's price to its days-to-cover ratio (DCR), which is the short interest divided by average daily

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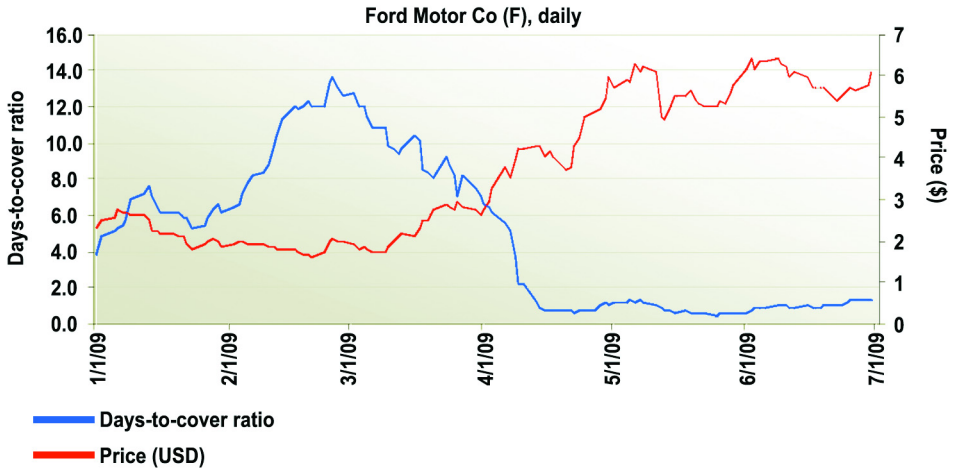
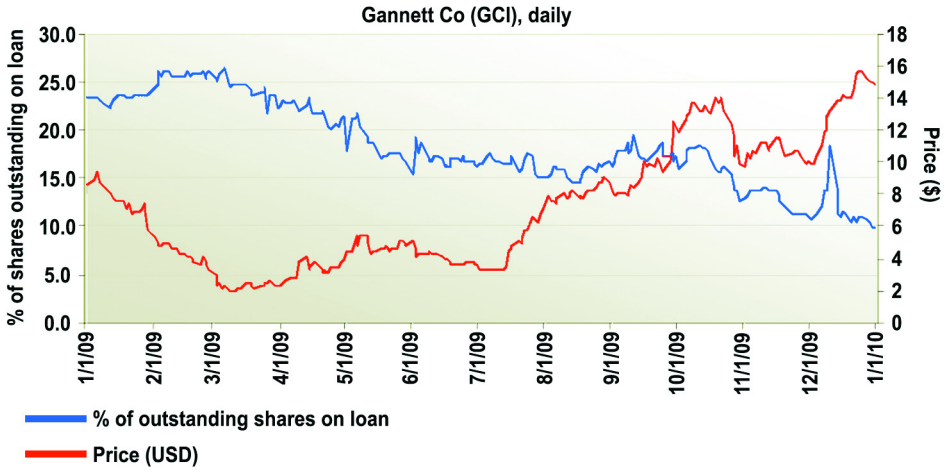
FIGURE 2: FORD — DAYS-TO-COVER RATIO



Ford's days-to-cover ratio, a measure of short interest, peaked at 14 in March 2009 before dropping sharply over the next two months.

Source: Data Explorers and Thomson Reuters

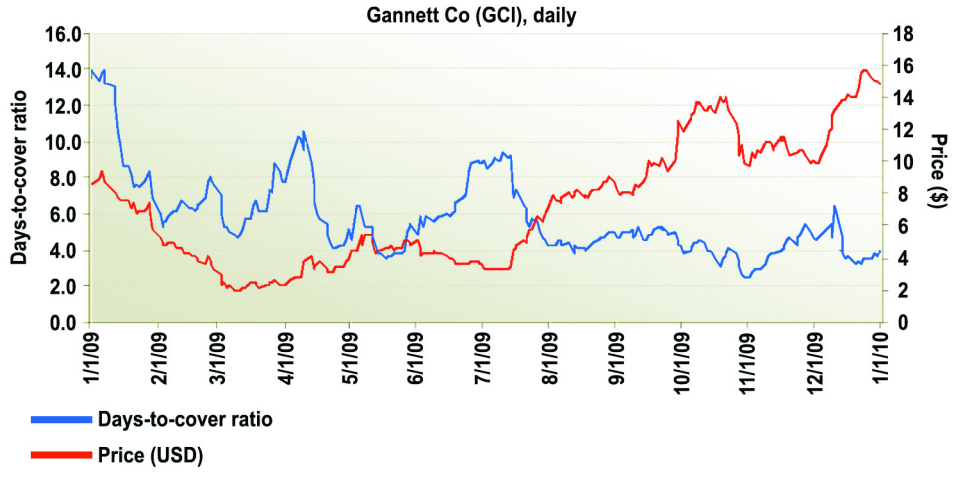
FIGURE 3: GANNETT — SHARES OUTSTANDING ON LOAN



Like Ford, Gannett had a high level of short interest in January 2009. Short sellers exited their positions as GCI rebounded, but they didn't panic as they had with Ford.

Source: Data Explorers and Thomson Reuters

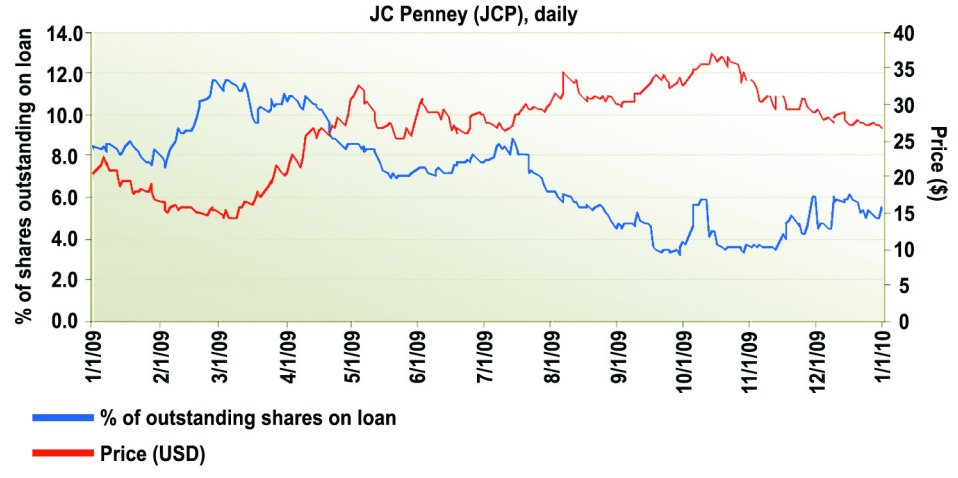
FIGURE 4: GANNETT — DAYS-TO-COVER RATIO



Gannett's days-to-cover ratio fell from 14 in January 2009 to 4 in May 2009.

Source: *Data Explorers and Thomson Reuters*

FIGURE 5: JC PENNEY — SHARES OUTSTANDING ON LOAN



As the stock price doubled, short positions in JC Penney declined from roughly 12 percent in March 2009 to less than 4 percent within six months.

Source: *Data Explorers and Thomson Reuters*

volume. The DCR represents the number of days of "normal" trading volume that would be required for all short positions to be closed. The ratio rose to almost 14 days by February 2009. Figures 1 and 2 clearly indicate short sellers had crowded positions in Ford relative to liquidity.

By early April, Ford had risen 50 percent from its low, at which point short sellers capitulated en masse, creating even more buying demand. By early May, Ford had tripled in price from its March low.

Media firm Gannett (GCI) was another example of pain for short sellers in 2009. Like Ford, Gannett was an indebted firm facing tough business headwinds.

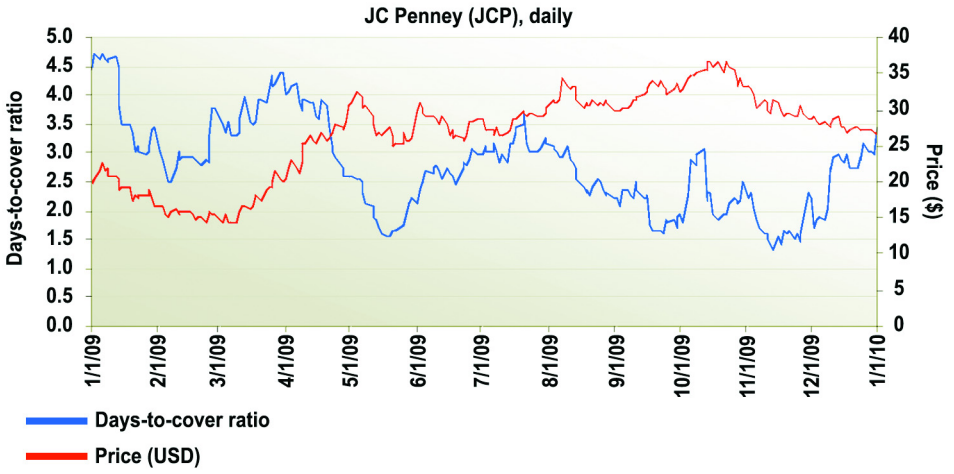
Figure 3 (p. 41) shows its short interest was exceptionally high — the percentage of shares outstanding on loan hit 25 percent in February 2009. Figure 4 shows its days-to-cover ratio was elevated (around 14 days) in January 2009.

As GCI rose from roughly $2 in March to $14 by December, its proportion of borrowed shares dropped by more than half. But unlike the speed in which Ford's short sellers fled their positions, Gannett's short sellers retreated gradually (compare Figure 3 to Figure 1). GCI's short sellers weren't really caught in a crowded exit; instead, they slowly realized market conditions had changed.

Figure 5 shows the percentage of shares outstanding on loan for retailer JC Penney (JCP) in 2009. Short sellers began borrowing increasingly more shares in February 2009. However, short positions never got too crowded: JCP's days-to-cover ratio varied between 2.5 and 5 in early 2009 (Figure 6).

Nonetheless, as the stock rebounded, short positions collapsed from almost 12 percent of outstanding shares on loan in February 2009 to less than 4 percent by September, at which point JCP had doubled. Short sellers didn't face a liquidity problem; they simply miscalculated by building large

FIGURE 6: JC PENNEY — DAYS-TO-COVER RATIO



JC Penney's short positions never got too crowded in early 2009, but its days-to-cover ratio fell as JCP bounced back in April 2009.

Source: Data Explorers and Thomson Reuters

short positions in February and failing to cover quickly enough.

Disappearing crowds

In September 2008 the Security and Exchange Commissions (SEC) temporarily banned new short positions in financial stocks, an emergency measure designed to prevent short sellers from driving down stocks.

Although the SEC's ban arguably hurt short sellers by limiting trade opportunities, it also lowered the risk of crowded exits; short sellers in mid-2009 faced fewer crowded exits in financial stocks than if the SEC hadn't acted.

Short sellers also retreated in other markets during 2009. As was the case in the U.S., the most crowded short positions on the London Stock Exchange were in cyclical and heavily leveraged stocks. Crowded exits abounded and some short sellers suffered large losses in these instances.

Arguably, this washout contributed to lower market-wide short interest in early 2010 compared to early 2009. Following their recent losses, shorts generally lack capital, and stock-lending data available from the exchanges and research firms such as Data Explorers and SunGard, has found surprisingly few new short setups.

But just as crowded exits are rare and capital is generally less available, short sellers with good information can trade with fewer liquidity problems. Ultimately, crowded-exit risk will return, but for now, conditions are ripe for selective, well-researched short selling.

For information on the author see p. 8.

Related reading

James Clunie article:

"Short selling and crowded exits"
Active Trader, October 2009.
How should short sellers handle situations in which the number of borrowed shares, or short interest, in a stock jumps?

Other articles:

"The short syndrome"
Active Trader, August 2009.
New research uncovers solid relationships between short interest and stock prices over the past 20 years.

"Bear raids"
Active Trader, November 2008.
Integrating Wyckoff analysis in a short-selling approach.

"The short view"
Active Trader, April 2008.
What does the level of short interest reveal about the market? Analyzing how the NYSE Composite index behaved when short sellers flooded or fled the market since 1984 provides some insight.

"Short interest and relative strength"
Futures & Options Trader, January 2008.
Short sellers aren't always right about a stock's future direction. This technique identifies opportunities to buy calls on stocks that are popular with the short-selling crowd.

"Short selling basics"
Active Trader, December 2007.
From a regulation standpoint, selling short is easier now than it was a year ago, but there are still things to consider before shorting a stock.

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