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# Industry Perspective:

*The mechanics & merits of short positions*

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## Introduction to shorting equities

In light of recent market volatility and the heightened focus on short-selling, the team at Changebridge would like to share their perspective on the mechanics of short selling, the investment rationale for short positions, as well as the importance of research diligence, accessibility & transparency in the process of shorting equities.

*The goal of fundamental analysis is to arrive at an estimate of a company's fair value and to compare that estimate with the current price to see whether the security is undervalued or overvalued.*

Taking a long position in a security which is believed to be undervalued is the most common and widely embraced form of investing in the capital markets. However, when an investor believes a company's share price is overvalued and likely to fall, the markets also provide sophisticated investors with tools to express that view. These tools include derivatives, inverse-notes, and short-selling. The practice of short-selling has recently garnered a lot of attention amongst investors, politicians, and society-at-large, but has actually been in existence since the 1600's[1]. It is both common and controversial - worthy of our understanding.

In essence, short-selling is a form of speculation in which investors attempt to profit from the anticipated decline in a security's share price. The inverse of traditional "long" investing, "short" investing is an effort to identify mispriced securities where the risk/reward trade-off is skewed to the downside.

## Mechanics of short-selling

Short-selling is a fairly simple concept; the investor generates a profit when the stock price declines (net of costs associated with the position) and the investor will incur a loss if the stock price increases while short the underlying security.

If an investor believes a stock is overvalued and likely to decline in the future, the investor can borrow shares of the company from a broker, then quickly sell them in the market. The short-seller enters into this arrangement knowing it will eventually need to buy those same shares back in the market (in order to return those shares to the lender) but does so with the expectation that the shares can be purchased in the future at a lower price, thus earning a profit.

While the concept is simple and the mechanics of establishing a short position in the capital markets are well-refined and highly regulated, consistently taking a short position in stocks and achieving desired outcomes is a challenging practice. Markets tend to rise over time, lifting most securities with them. Transaction costs and borrowing costs associated with shorting individual equities also raise the hurdle for a short-seller to generate a profit. Selling short is a demanding strategy that requires skill and practice, but it has a place in the capital markets.

## Market benefits of short-selling

Responsible short investing provides several benefits to the equity markets. It contributes to efficient price discovery, helps mitigate market bubbles, increases market liquidity, facilitates hedging and other risk management efforts, and shorting equities provides limits to upward market manipulation. We discuss some of these in more detail below.

*Contribution to efficient price discovery:*

The role of a fundamental analyst is to assess fair market value. While one might presume that everyone who transacts has assessed intrinsic value, many market participants trade for other reasons. In fact, JP Morgan estimated in 2017 that only 10% of trading comes from "fundamental discretionary trades." Meanwhile, 60% of trading activity

[1] https://www.npr.org/2015/01/29/382463501/the-spicy-history-of-short-selling-stocks

was believed to come from passive and quantitative strategies[2].

Fundamentally driven investing (both long *and* short) contributes to the price discovery process by facilitating a relationship between a stock's price and an analyst's assessment of a company's business prospects and future cash flows. The passive indices that many investors rely on are counting on active, fundamentally-motivated investors to perform the function of estimating fair value. This perspective was well-articulated in the Howard Marks memo, "Investing Without People."[3]

*Mitigating market bubbles:*

Market bubbles are characterized by rapidly rising market values and prices of assets. They are generally followed by a similarly speedy decline in prices, known as the "popping" of said bubble. By identifying areas where stock prices exceed intrinsic value, and selling short those securities, short sellers participate in mitigating rapid price acceleration and the ensuing crashes that often occur[4].

*Increasing market liquidity:*

Market liquidity refers to the ease with which buyers and sellers can transact, without meaningfully impacting underlying prices[5]. With a finite number of investors willing to go long or short a security at different prices, short sellers are one of the constituents able to serve that role of providing market liquidity as stock prices become volatile. Further, short sellers eventually become fundamental buyers of securities when they cover (buy back) their short positions.

*Facilitating hedging and other investment management activities:*

Hedged strategies (which often include short positions) generally seek reduced market exposure, lower correlations, and lower volatility than the broader market. Short-selling offers the potential to provide a negative correlation with broader indices, meaning profits can be made during periods of price declines. During such market corrections, or when a short thesis comes to fruition, these positions can improve overall portfolio risk metrics and help investors participate in the capital markets.

## Controversy around short-selling

An important consideration regarding short-selling is the risk/reward profile of the investments themselves. Since returns are inversely correlated with stock prices, it is possible for an investor to lose an amount greater than their initial investment. This contrasts with a long position, where losses are effectively limited to 100% of the initial investment. While neither of these "worst case" outcomes is desirable, the rational fear of losses greater than the initial investment is one of the reasons shorting stocks requires active oversight by experienced investors, and the practice is perhaps best utilized within a strategy that integrates fundamental research and risk mitigation policies.

Short selling is also controversial because it is not universally accessible to all investors. Currently, investors who seek to add short exposure to their portfolio have few options, which might include Limited Partnerships (LP's), Separately Managed Accounts, and Long/Short Mutual Funds. These structures might require investors to be "accredited" with the SEC, subject to minimum investment levels, and encumbered by liquidity restrictions. The perception that short-selling exists only in the domain of institutions and high net worth investors provokes a call for either restricting short selling or democratizing the practice with greater oversight. This creates an imbalance between investors based largely on wealth, asset level, or access.

Lastly, short-selling strategies often lack a level of transparency and holdings disclosure that might otherwise make the practice more mainstream and open to consideration. Specifically, open-end mutual funds are only required to publish holdings on a quarterly basis, with a 30-day lag[6]. This means for an entire quarter, a mutual fund can short

[2] https://www.cnbc.com/2017/06/13/death-of-the-human-investor-just-10-percent-of-trading-is-regular-stock-picking-jpmorgan-estimates.html
[3] https://www.oaktreecapital.com/docs/default-source/memos/investing-without-people.pdf
[4] https://www.investopedia.com/terms/b/bubble.asp
[5] https://www.investopedia.com/terms/l/liquidity.asp
[6] https://www.etf.com/sections/features-and-news/etf-education-how-transparent-are-etfs

securities without disclosing their holdings. Limited Partnerships are only required to disclose their *long* positions quarterly and may do this 45-days after a quarter-end[7].

Insufficient transparency, lack of access, and the risk of asymmetrical loss are amongst the reasons why short-sellers may be providing the market with critical functions, but do so under a degree of scrutiny and cynicism. Changebridge believes there an opportunity exists to improve both access to shorting and transparency. With more frequent disclosure, much of this skepticism can be mitigated.

*Does the practice of shorting add to market volatility?*

Market participants have also posited that short-selling techniques can be the cause of (or at least amplify) market volatility. Using prior market sell-offs as a gauge for the impact of short sellers, Hamid Mehran, a Fed economist, and two finance professors from Notre Dame, Robert Battalio and Paul Schultz, produced a research paper which did not indicate that shorting stocks played a major role in market turmoil during the periods observed.

"As a whole," they conclude, the evidence indicates "no harm in the aggregate from short-selling during market downturns and no benefit from banning short-selling. There are likely to be other ill effects of short-sale bans besides decreased liquidity and higher trading costs. Short-sellers restrain management malfeasance by rooting out fraud and earnings manipulation. The evidence does not suggest short-sellers are the problem. They are the messengers with bad news about companies' prospects. They are unpopular because they deliver messages that people would rather not hear."[8]

## Changebridge Capital's approach to shorting equities

With the merits of short-selling inexorably linked to our institutional commitment to research diligence, risk mitigation policies, accessibility & transparency - Changebridge embraces the role of short positions within a portfolio, for suitable investors.

*Research diligence*

Changebridge employs a "quantamental" (quantitative + fundamental) approach to investing. The quantitative system identifies inefficiencies, opportunities for fundamental analysis to add value. The quantitative elements of the process reduce behavioral biases, while fundamental analysis aids in determining a view on intrinsic value. Sometimes the process reveals intrinsic values below market prices, and sometimes the process reveals security prices trading above the firm's opinion of intrinsic value.

*Risk mitigation*

Changebridge uses sizing restrictions to prevent excessive security-specific risk. All positions are fully reassessed should a 20% loss occur (long positions *or* short positions). These positions are re-examined from the bottom-up to reduce anchoring bias. The team also utilizes a position-sizing formula that takes into consideration conviction, upside, downside, and liquidity to assess appropriate allocations.

*Accessible & transparent*

The Changebridge team believes investors have the right to see their holdings daily, and our investment philosophy is published openly on our website. An investors' capital is theirs and they have the right to access it without liquidity restrictions. This commitment to *transparency*, *accessibility* and *liquidity* is central to engendering trust in the investment process and it is paramount in our relationship with clients.

If you would like to learn more about Changebridge Capital please visit: www.changebridgecapital.com.

[7] https://www.barrons.com/articles/hedge-funds-holdings-reports-13f-out-of-date-51589833524
[8] https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr518.pdf

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