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Short selling isn’t a dirty word: investors can profit from falling stars

TIM BOREHAM THE AUSTRALIAN 12:00AM October 8, 2016

It’s a sobering reflection on Myer Holdings’ perceived prospects that short sellers account for 16 per cent of the retailer’s share register. It’s the single most shorted stock on the market.

Over at contractor Worley Parsons, 15 per cent of the shares are held by parties betting the strife-prone contractor’s fortunes will continue to be, well, strife prone.

Other stocks with large shorted positions comprise an intriguing selection such as nickel producer with a lively history, Western Areas (13 per cent), retailer — controller of the IGA supermarket brand — Metcash (12 per cent) and China-focused infant formula producer, Bellamy’s (11 per cent).

Shorters have also targeted three of the big four banks (CBA excluded) ahead of their full-year results, with the shorted component of the registers ranging from 1.9 per cent for Westpac to 1 per cent for NAB.

Overall, though short selling accounts for only about 1 per cent of the market and is deployed far less here than in the US. During the GFC the practice also gained a “shorting and distorting image” and was blamed for everything from individual stocks going bust to the global recession.

Critics of short selling often argue that shorters delight in spreading negative rumours about a stock, and there’s probably a kernel of truth in this.

These days, though, short selling is becoming a more accepted tool to preserve capital, especially among older investors scared of losing their duds a la GFC just ahead of retiring.

“There’s also an improving knowledge of strategies at both the individual and adviser level,’’ says Mark Burgess, a portfolio manager with absolute return fund manager Kardinia Capital.

‘Easier picking losers’

Montgomery Fund founder and Wealth columnist Roger Montgomery says share investors have enjoyed 30 years of asset growth with low interest rates — but the times are a changin’.

"With disruption affecting every industry from energy to television it is often easier to pick the losers than the winners," he says.

"Investors can profit from the inevitable decline of some industries as they are replaced by automation, substitution, or faster rivals."

Short selling entails borrowing and then selling stock from an institutional holder, usually an index manager who are holding rather than trading the shares.

This is done via a so-called prime broker, which accesses the requested stock via a pool of shares. In the case of big companies there's usually more than enough stock to cover requests for both the borrower and a lender fund wishing to redeem the shares.

Index fund managers — who passively sit on their holdings — are willing participants. Offshore institutions are popular as lenders, because they can't use their franking credits and thus don't need to be compensated for the loss.

The borrowing fee is surprisingly low: usually 0.4-0.5 per cent of the face value of the shares. But as with the heavily shorted Fortescue Metals Group a few years ago, this can rise to as high as 10-15 per cent if there is scarce stock available. While half a per cent or so seems derisory, it makes a big difference to the returns of a low-fee index manager.

"The end of story is that hopefully the share price tanks to a level that reflects all our information and is fairly valued," Burgess says.

"We look to buy back in, lock in a profit and return the stock to the prime broker."

If the stock defies expectations and rises in price, a squeeze occurs as shorters scramble to buy stock to square off their positions (typically, they set a 15 per cent share appreciation as a stop-level at which they buy back in).

Because of this, the likes of Myer and Worley Parsons are candidates for sharp share spikes on any unexpected good fortune.

Montgomery dubs short selling as a foil against earnings manipulation (boards will be found out) and the buy recommendations of conflicted brokers.

"A band of researchers happily lifting the hood of companies to find flaws is a necessary counterweight," he says.

Of course, individual investors can't lob up to a prime broker (most investment banks have this function) to bot a handful of shares.

But they can access managed funds that employ "long-short" strategies, although the choice of products is far more limited than in the 'long-only' sector.

Tall stories

Like Tim Tams, long-short funds come in different flavours.

The market-neutral funds will have an equal short and long component, with performance dependent on the manager's stock tipping ability.

An "active extension" variant, known as a 130/30 fund, short sells 30 per cent of the value of the portfolio but then reinvests the amount in a long position. This way, the fund is 100 per cent exposed to the market's movement (beta).

As its name suggests, a variable long-short adjusts its market exposure according to the prevailing conditions.

According to research house Zenith Investment Partners, the Bennelong long-short equity fund (market neutral) has returned 16.75 per cent over the last ten years, compared with the ASX 300 accumulation index's 4.76 per cent increment.

Other stars are the Regal Tasman market-neutral fund (16.74 per cent), the Bennelong Kardinia absolute return fund (11 per cent) and the Smallco Investment Fund (10.5 per cent).

Another way of "shorting" a stock is to take out a contract for difference, which compels a buyer and a seller to pay the difference between the current value of a share and its worth at an agreed date.

In a sense, CFDs are the purest way for investors to take a position, but they are also a winner-takes-all device akin to plonking it all on the black at Monte Carlo.

As the corporate watchdog intones: "The complex structure of CFDs and the risks associated with them mean that they are unlikely to meet the investment needs and objectives of most retail investors."

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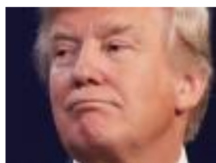

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