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Why short-sellers are good for the economy

PAUL KERIN

Who said this? "It's a typical short-seller trick. Take a short position, then send someone to ask a question which suggests we're hiding something." No, it wasn't Gerry Harvey at last week's Harvey Norman annual meeting. It was Enron chief executive Jeff Skilling in 2001, seven months before Enron went bankrupt.

Gerry Harvey is no Jeff Skilling. He's a business legend and deservedly so. But his call last week to ban short-selling is dangerous. It's not the first time he's made that call. He made it in 2008, when he also said he was "yet to find anyone to give me a good reason why they (short-sellers) exist" and that personally, he'd "line them up against the wall and shoot them".

No doubt he was joking about the last bit, but even banning short-sellers would be like shooting the canaries in the coal mine. Of course, short-sellers exist purely to make money. But the Enron example illustrates what substantial economic research demonstrates in spades: there's some very good reasons why we should want them to exist.

Short-sellers acting in their own self-interest perform very valuable public services. Yes, Adam Smith's invisible hand even applies to short-sellers! They expose fraud and earnings manipulation (think Enron), identify poor underlying performance (think Arrium and Dick Smith), reduce the incidence of each of these and make share markets more efficient.

Short-sellers sell shares they don't currently own, hoping to buy more cheaply in future. They're betting on the share price falling.

A recent US study found that short-sellers were the first to discover 14.5 per cent of all corporate frauds — more than double the 6.6 per cent discovered by the financial regulator (the SEC); short-sellers also outperformed both auditors (10.5 per cent) and analysts (13.8 per cent).

Short-sellers have exposed many instances of earnings manipulation. But research shows that they also reduce its incidence by imposing discipline on companies' earnings announcements. The greater the market's ability to short, the less likely are companies to engage in earnings manipulation.

Short-sellers are also early identifiers of deterioration in companies' real underlying operating performance. A recent study showed that the 10 per cent of companies that experience the biggest increases in short interest in a quarter subsequently experience an average 21 per cent decline in operating performance (cash flow return on assets) over the following three years. The greater the increase in short interest, the larger the subsequent performance decline.

Most importantly, short-sellers make sharemarkets more efficient. They improve market liquidity, reduce overpricing and speed up price discovery (the incorporation of new information into share prices). In efficient markets, share prices truly reflect companies' intrinsic (fundamental) values. This helps us maximise economic growth by channelling capital to businesses that generate the best returns. And by bringing share prices closer to intrinsic values, short-sellers actually help protect less sophisticated investors, who are most at risk of buying overvalued shares.

Investors inevitably assess intrinsic values differently, but their "votes" — buying/selling shares — usually generate reasonably efficient prices if buy/sell decisions are unconstrained. By definition, those wanting to short are less optimistic than current shareholders and buyers. If short-sellers were banned, only optimists' votes would count, overvaluing shares.

Short-sellers only profit if — by superior information, analysis or judgment — they "vote" better than others. They won't always be right, but it's in the public interest to let them vote.

Numerous studies of short-selling bans implemented around the world after the GFC have provided rich evidence of the downsides of such bans. Those studies consistently show that the bans failed to support share prices and reduce volatility, but they did reduce market liquidity (bid-ask spreads) and slowed down price discovery, especially where bad news was concerned. That is, the bans reduced market efficiency and increase the incidence of overvalued shares.

Last week, Norman accused short-sellers of spreading incorrect information about Harvey Norman to drive its share price down. However, with very few exceptions (thinly traded, tightly held stocks), short-sellers can't manipulate prices below intrinsic value. Hundreds of potential short-sellers exist for almost every stock. Most are equally willing to buy or short, depending on whether they think shares are under/overvalued. Even if some short-sellers spread false information or colluded, others

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would quickly step in if prices dropped below intrinsic value. Short-sellers help prevent overvalued shares rather than create undervalued ones. In any case, spreading false information and/or collusive shorting are both illegal and substantial penalties apply.

Chief executives and chairs never like short-sellers. The list of chief executives who blamed short-sellers before their companies imploded extends way beyond Skilling. Australian examples include ABC Learning Centres' Eddie Groves and Bond Corporation's Peter Beckwith. The short-sellers were spot-on: the shares were overvalued.

Most chief executives don't act inappropriately, of course.

If companies don't want to be shorted, the best solution is to institute good governance mechanisms that prevent fraud and earnings manipulation, drive strong operating performance and ensure prompt and full public disclosure of all relevant information. If you do all that, your company's share price will reflect its intrinsic value and there'll be no point in shorting. If you don't, you get what you deserve.

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