AURORA FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

By Hugh Dive

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Short selling….

Eye of newt, and toe of frog, Wool of bat, and tongue of dog, Adder's fork, and blind-worm's sting, Lizard's leg, and owlet's wing, For a charm of powerful trouble, Like a hell-broth boil and bubble. Double, double toil and trouble; Fire burn, and caldron bubble. Shakespeare's Macbeth

The financial press frequently paints the picture of hidden cabals of short sellers conspiring together to drive down a stock, causing unrealised losses to retail investors and pain to executives whose company's stock have been sold short. Whilst short-sellers are frequently derided as vultures, criminals, pessimists or un-Australian (or un-American), in reality shorting stocks is a hard, stressful and lonely way to make money in the market. Short selling allows an investor to profit from taking a contrarian view. In this week's piece we are going to look at short-selling shares a hot topic given the offshore shorting in February of the Australian banks.

How it works

Unlike long only investing where you seek to own good quality companies with honest management teams, clean balance sheets and solid future prospects, when selecting a stock to short sell the characteristics to look for are companies with low or negative growth, high and increasing debt levels, a weak business model, over-valued by a market and possessing a shaky management team. Short sellers will then borrow stock from a stockbroker and sell it, essentially betting that the price of the target company will decline before they have to replace the borrowed shares by buying the stock back. The short seller is both required to return the shares to the owner when requested and pass on any dividends paid.

Additionally if the short stock rises sharply, the lender may require additional collateral or require the short seller to close out your short sale transaction before your planned timeframe. **This gives rise to the skewed payoff ratio from short selling where the maximum gain is known (the stock falls to zero), but the maximum loss is theoretically infinite.**

When borrowing shares to short sell an investor has to look closely at both the rate per annum that they are required to pay to borrow the stock and where the owner is located geographically. The rate reflects supply and demand and for most stocks is currently 0.5% per annum. For stocks where the shorting demand may be higher than the supply such as Fortescue the rate may be 15% or higher, or in the case of small capitalisation or tightly held companies such as Blackmores, the short seller may be unable to borrow stock and thus cannot short sell.

We also strongly prefer to borrow stock from foreign owners such as large index funds like Vanguard or State Street, as if we borrow stock from a domestic owner and a dividend is paid we are required to compensate for both the dividend and any associated franking credits.

For example in July 2015, we shorted ***Slater & Gordon*** at \$3.70 per share, paid the lender the rate of 0.5% per annum and then bought the stock back at \$1 to close out the position in December 2015. Whilst the stock has continued to fall in 2016 and our profit would have been greater had we held onto the stock; we were concerned in December that the bulk of the gains in shorting the stock had already been made. Further due to the precipitous fall, Slater & Gordon had moved out of our investible universe.

Short selling to Arbitrage prices or reduce risk

Another less risky way in which we utilise short selling at Aurora is to try to take advantage of price discrepancies in different markets by short selling a product in one market (where its value is higher) and buying it in another (where its value is lower). An example of this is ***Henderson Group*** a fund manager with dual listings on the ASX and LSE. Where a price discrepancy exists between the two markets we may look to short sell Henderson on the ASX (where it tends to be valued more highly) and purchase the same amount in London, using short selling to generate arbitrage profits. Similarly in takeover situations where a component of the offer comes in stock, short selling can be used to lock in today's price without being exposed to the risk of a prevailing market fall.

Bans on Short Selling

In September 2008 during the GFC, financial regulators worldwide moved to ban short-selling on financial stocks (such as ***Westpac*** and ***QBE Insurance***). This occurred as short-selling of financial stocks globally had dramatically increased due to investor concern about the underlying stability and solvency of many financial institutions after the U.S. government takeover of the housing finance corporations ***Fannie Mae*** and ***Freddie Mac*** and the failure of investment bank ***Bear Sterns*** earlier in March 2008. The objective of the ban was to enable a more orderly functioning of the financial markets and to avoid extreme share price movements and in Australia this ban lasted until the end of May 2009.

However a review by ASIC in 2012 concluded that the ban actually reduced trading activity of Australian stocks; increased bid-ask spreads; reduced liquidity; increased price volatility; and contributed to a decline in the number of settlement failures. Additionally, ASIC were unable to establish a causal relationship between the measures and stock prices[1]. Whilst these moves were initially lauded in the press, they were insufficient to prevent the demise of highly levered companies with unsound business models such as ***Centro*** and ***Babcock & Brown*** as ultimately the selling pressure returned even with the bans.

Pain Points

Where short selling hedge funds have been rumoured to have worked together like a coven of witches was during the GFC in targeting shaky companies that had debt covenant clauses tied to their market capitalisation. For example in June 2008 Babcock & Brown was aggressively shorted after analysts drew attention to a clause in an A\$2.8 billion loan that would allow bondholders to require the company to repay the loan within 90 days if Babcock's market capitalisation fell below A\$2.5 billion.

The Market can remain wrong longer than you can remain solvent

It would be wrong to view that short selling risky stocks is a smooth path to outperformance. The father of modern macroeconomics Keynes once famously said that "*markets can remain irrational a lot longer than you and I can remain solvent*''. This quote particularly resonated with me after an unprofitable short selling of ***Fortescue*** prior to the GFC due to concerns about the over-valuation and debt situation of the company. This trade was put on at \$50 per share late 2007 and then was closed out at \$70 four months later as the price continued to rise with no signs of slowing momentum. It was very painful to lose 29% in a short stretch of time; however Fortescue peaked at \$120 in June 2008 before falling back to \$20 in December 2008. Whilst our investment thesis was ultimately correct, we were unable to handle the pain of a steeply rising stock and the associated losses and increasing margin calls.

A "*short squeeze*" occurs when a heavily shorted stock rises sharply, forcing sellers to close out their position by buying back stock, thus causing further upward price momentum. Often when the market appears to overreact to a small piece of positive

[1] https://ris.govspace.gov.au/files/2012/11/Short_selling_PIR.pdf

news, this is a short squeeze and it is similar to too many people trying to fit through a door. It is conceivable that the impact of many short sellers closing out their positions in Fortescue around early 2008 contributed to a "short squeeze" in the stock and pushed the company's share price even higher.

Our Thoughts

While short selling is often criticized and retains a negative connotation in a securities industry that is inherently biased towards being optimistic, we see that it serves a valid role in financial markets. Short sellers provide an alternative view and can aid both liquidity and price discovery in stock markets.

Short selling remains a hot topic in the market at the moment after the Australian banks saw extensive offshore shorting in late February on the back of a flawed US report that suggested Australian property was poised for a 50% fall. Investors that bought the bank shares being sold by the offshore short sellers will have had a profitable March with the major banks gaining on average 10%. Conversely the offshore short sellers have had a rough March to date, though their losses will have been cushioned by a 5.5% gain in the AUD against the USD, click to view our piece the widow maker trade.

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