EQUUS
POINT CAPITAL

Advantages and disadvantages of short selling

Short selling is the act of borrowing stock and selling it in the market in the expectation that the price of the stock will decline, before buying the stock back (hopefully at a lower price) and returning the stock to the lender. The borrower pays the lender a fee for this service, typically a margin above a risk-free interest rate.

For a 'long-only' portfolio the manager is limited to holding positions deemed favourable and under-weighting or having no weight in positions deemed unfavourable. Including short selling broadens the potential opportunity set for a manager to take both positive and negative views on stocks with the expectation that this will lead to additional return.

We find meaningful returns can be derived from shorting stocks, although the process does carry potentially greater risk.

The advantages of short selling include:

- Provide liquidity to the markets which may lower prices of stocks, improve bid-ask spreads and assist in price discovery
- Ability to hedge an existing portfolio's long-only exposure and reduce the overall market exposure of a portfolio
- Short selling allows a manager to use capital proceeds to overweight the portfolio's long-only component of the portfolio
- An exposure to both long and short positions can reduce a portfolio's overall volatility
- Ability to add meaningful risk adjusted returns

There are, however, issues with short selling that need careful consideration:

- Shorting stocks can be inherently volatile. While it is possible for a stock to go to zero (think Arrium, Slater and Gordon or more recently Ten), this tends to be a rarity. Stock prices tend to mean revert, and this turn around can be both quick and significant on the back of some event (for example, a change in management, or a takeover offer)
- While the maximum potential gain on shorting a stock is 1x, should a stock's price appreciate there is in theory no limit to the potential losses from being short
- Short sellers run the risk of borrowed stock being recalled by their broker when the short seller has limited control on the price of covering their position
- Short squeezes, where rapid and significant upward price moves cause short sellers to cover in mass, can push prices against short sellers
- Borrowing stock can be difficult in less liquid names or if the amount of available stock in the market is limited
- Less liquid stocks may be expensive to borrow
- The exchange may limit or ban short selling during volatile market conditions, such as the GFC when the ASIC banned short selling on concerns about market stability

There is also the view that short selling works against the interest of 'long' investors. While we would prefer to not to get into the merits of short selling, as an investment option it can provide meaningful excess alpha to a portfolio's returns.

At Equus Point Capital our risk management process recognises the potential pitfalls around shorting stocks by:

- understanding the universe of candidates to short sell is limited,
- shorting stocks can be inherently volatile and we limit exposure to any single position,
- we limit the total exposure to short positions within the portfolio, and
- we incorporate a clearly defined stop loss strategy to limit potential losses on any position.