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Is It A Fraud?

Those who are brave enough to short stocks and other asset classes garner a lot of bad press, but they serve an invaluable function for markets. How exactly does short selling work, and why would an investor want to do it?

September 25, 2020

Falling Short

Nikola is a startup that plans to make electric and hydrogen-powered trucks. Its founder resigned this week after Hindenburg Research published a scathing report accusing the company of being an "intricate fraud"[1]. This caused Nikola's stock to lose more than a third of its value[2], and the Securities and Exchange Commission (SEC) even launched an investigation shortly after it was published.

Hindenburg isn't attempting to perform some public service by trying to protect investors from what they believe to be fraudulent activity. Instead, they clearly disclose early in the report that they have a short position in Nikola (ticker: NKLA) and stand to profit if the stock price falls.

Short selling is one of the most controversial topics in investing. It's also one of the most confusing, so let's walk through the mechanics, the risks involved, and the role it serves in well-functioning markets.

It's A Scam

Let's assume that Stacy wants to short a fictitious company called Scam Corporation (ticker: SCAM) because she believes that it's a fraud. She logs into her online brokerage account and submits a trade to short 1,000 shares of SCAM at $50/share.

This is an order to sell stock that she doesn't own, so the broker facilitates this trade by looking in other client accounts for 1,000 shares of SCAM. The broker finds the shares in Mark's account and then lends them to Stacy to sell. The proceeds of the sale (1,000 shares x $50/share = $50,000) are placed in Stacy's account.

Mark is unaware that his shares were sold, but that's ok. Brokers keep track of short positions to ensure Mark is not affected in any way. For example, if he entered an order to sell his shares seconds after Stacy borrowed them, the broker would simply find shares elsewhere for Mark to sell.

Then one day, news breaks that Scam Corp is under investigation by the Justice Department and key executives have been arrested. The stock price falls to $5, and Stacy decides to "cover" her short position.

She places an order to buy 1,000 shares of SCAM at $5/share for a total of $5,000 (1,000 x $5/share = $5,000). The broker takes the shares purchased by Stacy and puts them back in Mark's account to close out the trade. Stacy is left with a nice profit of $45,000 ($50,000 - $5,000 = $45,000).

To summarize, a short position is a loan. Stacy borrowed shares from Mark and then sold them for cash. After the share price fell, she used a portion of that cash to buy back the shares at a lower price and return them to Mark to close out her liability to him. Her profit is the leftover cash.

Strong Stomach

While it may appear that Stacy just made some easy money, maintaining a short position is not for the faint of heart. There are three considerations worth discussing.

The first is the cost. Brokers charge a fee called the "borrow" to facilitate short sales. The borrow is based on supply and demand and changes daily. Heavily shorted stocks or those that trade infrequently can easily exceed 50% annually. Meaning, a stock would have to fall more than 50% over the course of a year to yield a positive return for the short seller.

Dividends are another cost. For instance, if SCAM paid $2/share in dividends, the broker would take $2,000 (1,000 shares x $2/share = $2,000) from Stacy's account and place it into Mark's account to cover the dividend payment.

The second consideration is the direction of a stock's asymmetric payout. Mark is "long" SCAM, so he can only lose what he put into the position (excluding transaction costs). He also has unlimited upside since a stock can theoretically rise forever.

The situation is reversed for short sellers. Stacy's upside is capped at $50,000 (SCAM cannot fall below zero), but the downside is unlimited. For example, if SCAM surged from $50 to $350 in a week on news of a pending acquisition, she stands to lose six times her initial investment (in addition to the borrow paid to the broker and dividends paid to Mark).

This asymmetry can often fuel a "short squeeze." This happens when a heavily shorted stock receives unexpected positive news. That's not good for someone who is exposed to unlimited downside, and it can quickly ignite panic buying (the opposite of panic selling) as short sellers cover their positions. The ones who can't get out first get squeezed as the stock soars higher.

Back in 2008, Volkswagen's short squeeze was so massive that it briefly propelled it to be the world's most valuable company[3]. During the financial crisis, the company encountered challenges that inspired shorts to pile into the stock. Porsche then began buying a larger stake in Volkswagen, which caused shorts to cover their positions (buy back the stock). This created a vicious cycle seen in the chart below.

The third consideration is exogenous forces that have nothing to do with the investment thesis. For example, brokers have full authority to force short sellers out of their positions if a stock becomes too hard for them to manage. This can result in a loss for no reason other than operational challenges at the brokerage.

Margin requirements can also cause problems. Since short positions have unlimited downside potential, brokers require short sellers to keep account levels above thresholds. Meaning, if Stacy's short in SCAM is working but the rest of her portfolio is losing money, her broker may close out her short position because the account value falls below the required level.

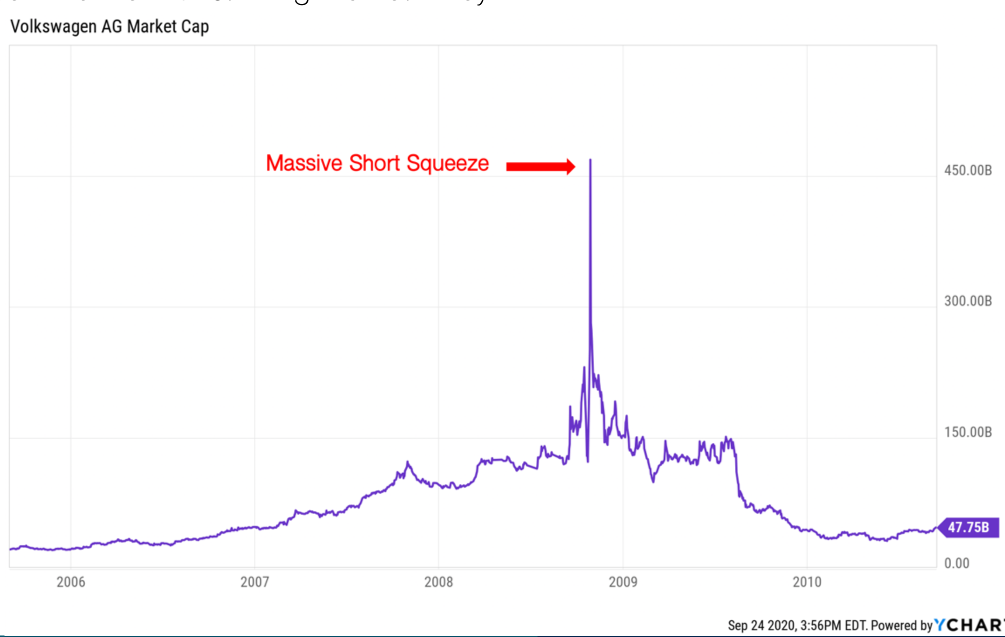
There have also been instances where the short thesis is correct, but the fraudsters received protection from regulators. One of the largest of such scandals collapsed back in June, when Wirecard's auditors refused to sign off on their books. For over a decade, there had been accusations of fraud from prominent short sellers across the globe. However, German authorities apparently refused to take these seriously[4].

The Bottom Line

It's hard to think of a group of investors that is despised more than short sellers. They are often demonized by the press, sued by their targets, and even vilified by regulators. But this brave cohort serves an invaluable purpose for a well-functioning market. They are the watchdogs that sniff out bad things that can hurt investors. They also serve as a reminder to management that someone is analyzing their every move.

Think about it this way. Try to name a single major fraud unearthed by regulators over the last two decades. I can't. The big ones all seem to have come from short sellers and/or journalists. But journalists tend to rely on intel from whistleblowers and other sources. The real skill lies with professional short sellers. They are the ones capable of digesting mountains of financial data and connecting the dots.

Furthermore, show me a market that cannot be shorted, and I'll show you one that is poised for trouble. It's happened too many times in the past. Think about the housing market in the U.S. before the invention of products that allowed short sellers to bet against it. That market ran wild because



there was no way to express a negative view on it. More recently, WeWork lit billions of capital on fire for years leading into their failed IPO in 2019[5]. Maybe they would have been smarter if the market for venture capital offered a way for short sellers to keep it in check.

That being said, the ends don't always justify the means. Not all short sellers are saints, and the opportunity for profit is often so powerful that it can coerce short sellers to do other bad things like publish phony data and/or blatant lies.

Short sellers aren't always successful either. There have been countless short campaigns led by prominent hedge funds with deep pockets that died on the vine. This is why investors should never assume a research report like the one Hindenburg published to be accurate on face value (this saga has most likely just begun).

The bottom line is that short sellers are integral to markets, but leave it to the professionals. The requisite skill and ability to manage risk are traits that are often too hard to acquire on your own.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer

Sources

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