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Short selling: looking beyond obvious shorts, short shorts

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Shorting in today's market is challenging. Whether it be co-ordinated short squeezes from Reddit traders, tweets from Elon Musk or an unsympathetic media, short sellers aren't having

a great time. To compound this, interest rates at record lows are fuelling speculation-driven asset bubbles. But who will ultimately be the real winners and losers?

Being involved in short selling for over fifteen years requires a thick skin. When markets are roaring, your clients ask why on earth would you try and short anything. When markets are falling, you are blamed for all the ills in the world. Share prices are supposed to go up for ever and CEOs never lie. The only feasible explanation for falling share prices must be those darned short sellers ... or so the narrative goes. As a contrarian and a short seller in today's environment, I can feel the pain!

Recently we saw the press, Reddit retail traders, US politicians from both sides and CEOs all over the world jump on the bandwagon to vilify the practice of short selling. A poster child for the anti-short-selling witch hunt also emerged: one Elon Musk. The irony of this is that short sellers lost over $40bn trying to short Tesla in 2020 and the combination of short sellers being stopped out and forced to cover and passive investors contributed to making Musk the richest man in the world (on paper at least). To his credit, Musk has shown good humour by launching a range of red satin short shorts, which is a swipe at the short sellers who have tried and failed to short Tesla. Musk has said that short selling "should be illegal" and described short sellers as "jerks who want us to die". Coming from the richest man in the world, that hurts.

Through January 2021 this hatred moved from tweets and short shorts jokes to real money losses for short sellers through some of the most extreme short squeezes I have observed. The foundations for these short squeezes arose due to over-leveraged hedge funds shorting over-leveraged structurally challenged companies, which they believed were heading to bankruptcy and were a sure bet. These were companies like GameStop, Blackberry and AMC Entertainment. Unfortunately for these hedge funds, it was not a sure bet and we witnessed the mother of all short squeezes when GameStop soared 20x in a few weeks. A new army of investors called the Reddit crowd identified some stocks which were heavily shorted and started buying.

Obvious shorts are dangerous shorts

What it showed is how powerful social media can be in coordinating large numbers of people to all push in the same direction at the same time. The identification of both the stocks and the weakness in the entities which were short the stock, was in some respects brilliant. The risk return of heavily shorted stocks where the angle seems a bit "obvious" is, in my opinion, poor. Obvious shorts are usually very dangerous shorts. Combine this with the excessive amount of leverage being used by these hedge funds and this was an accident waiting to happen. The more puzzling narrative is that this was a win against the establishment, against the evil short sellers. Unfortunately, the real losers in all this were (and continue to be) retail punters who have come late to the trade and bought GameStop at $US300/share.

Adding to the hatred being directed towards short sellers has been the recent spate of short reports on popular local stocks like Bingo Industries, Tyro Payments and Nearmap. Short reports were unheard of in Australia until Glaucus wrote a short report on Quintis claiming that it had overstated the valuation of the trees, overstated its earnings and overstated the value of some of the contracts which had been announced by the company. It presented evidence-backed opinion to support its claim. Quintis (and most market participants) dismissed the report. They claimed that the author of the short report had self-interest and its research was riddled with errors. This is a common response to any short sale report. As it turned out the report was excellent, most of the predictions came to fruition and shareholders lost all their money. This is despite the company, shareholders and the press attacking the motives and veracity of the short report.

Since that time, the frequency of short reports being issued has increased dramatically while the general quality of the short reports has deteriorated markedly. Despite this, my view is that if someone releases a short report which is in fact accurate, then I really need to sit up and take notice and stress test my investment thesis. Someone has, free of charge, alerted me to something which may change my investment thesis on a stock. A reminder that there are nuggets of wisdom to be heard in even the noisiest marketplace.

Read our case study about a recent short report on Bingo Industries or find out more about Perpetual's SHARE-PLUS Long-Short Fund.