Short Sellers: Villains or Visionaries?

Paper: “How Are Shorts Informed? Short Sellers, News, and Information Processing”  Authors: Matthew Ringgenberg, Assistant Professor of Finance, Olin Business School, Washington University in St. Louis; Adam Reed, University of North Carolina; and Joey Engelberg, University of California–San Diego


Link to video on Olin Business School
Short sellers may not be the villains of the 2008 stock market crash after all. New research suggests that short sellers—traders who profit from stock trades when the stock price falls in the future—may actually be well-informed visionaries, with a knack for interpreting company news and the underlying value of a company’s stock. By examining trading activity and the release of news stories involving a broad selection of companies on the New York Stock Exchange over a two-year period (2005–2007), researchers discovered surprising evidence on the role short sellers play in the financial markets. A longer version of this interview with Professor Ringgenberg is on YouTube.

Did a recent insider-trading scandal or the 2008 market crash inspire your research into how short sellers are informed and make their trading decisions?

A: The financial crisis focused a lot of attention on short sellers and blamed them for the crisis. We really wanted to investigate whether or not that blame was to some extent correct or not. What our research actually found, somewhat surprisingly, was that short sellers can actually play a beneficial role in the market.

What are the benefits of short selling?

A: One of the things we found was that short sellers tend to be really good at processing publicly available information. So, if a news article comes out about a firm, it usually contains a lot of complex information. And what we found is that short sellers tend to interpret—kind of do more homework—and do a good job of understanding what that information means for the value of the firm. So, in that sense, short sellers actually provide a benefit because they help prices represent the fundamental information about a firm.

Does this ability to interpret company news give short sellers an unfair advantage over other people who play the market?

A: On average, I don’t think it creates an unfair advantage. The evidence suggests that short sellers do their homework and get rewarded fairly for doing their homework. If you look back at the history of short sellers, they were some of the first vocal critics of Enron. Short sellers looked through the financial statements, they questioned the accounting practices, and in that sense it was something that they profited from by selling Enron short.

What are the implications of your research for short sellers and other investors?

A: One of the big implications has to do with market regulations. In 2008 and 2009 the SEC [Securities and Exchange Commission] here in the United States and other market regulators around the world imposed short sale bans as a result of the financial crisis. Regulators, at the time, were arguing that a ban would help stabilize prices.

So, in some cases, short sellers actually provided benefit to the market, and locking them out could make things worse.

Have you shared your research with professional stock traders including short sellers? What do they think?

A: We talked to a number of short sellers. We talked to hedge funds, pension plans, regulators, the Federal Reserve, and the SEC. In general, I think market practitioners—the hedge funds, the investors—are largely not surprised. A lot of them do believe that short sellers play a beneficial role in markets.

Is there a way to know which stocks short sellers are trading, or is that something that you can only find out long after the transaction in archival data?

A: Thanks to a relatively new database created by the people who are lending their shares to short sellers, you can see which shares were borrowed, and that gives you a much better idea of who’s shorting and what they’re shorting. That’s data we didn’t really have access to 10 years ago.

If short sales data is available in real time, could it be a valid market indicator?

A: I think it already is becoming an indicator. A company called Data Explorers gathers this data for clients who study the trends to see which stocks are being shorted. Active short-sale trading of a particular stock might be a signal that you should go and do your homework about that firm.

“Short sellers are often the villains of financial markets, or at least they’re portrayed that way. Our research suggests that’s not necessarily a fair characterization. I think the source of their bad reputation is that they profit when prices fall. If they’re not making the prices fall, they’re basically revealing the bad information [about a stock’s underlying value] faster.”