KEY POINTS

- Whether long or short, investors need to understand the impact of trading mechanics.
- Borrowing fees and other costs (as well as the threat of a buy-in) can make short positions cost prohibitive.
- In some cases, borrowing rates can lead to toxic security prices and a no-win situation for both the buyer and the seller.

Short It and Forget It?

The trading mechanics of shorting can be costly

BY DENNIS DICK, CFA

The recent Groupon IPO has garnered a lot of analyst attention. Some analysts have said the stock isn't worth the $15 billion market cap and is a no-brainer for shorting. Groupon's business has few barriers to entry, and the stock is eventually going to fall as competition intensifies—or so goes the argument. Well, Groupon might be overvalued, but the case is not as simple as short it and forget it.

A lot of factors must be considered when shorting a stock. Can the stock even be shorted? Is the stock easily borrowable? If not, how much is the borrowing rate to short the stock? How great is the risk of a possible buy-in if the stock becomes hard to borrow after I have shorted it? All of these questions need to be answered before initiating a new short position.

Take a closer look at the mechanics behind shorting a stock like Groupon. The first step is to find out whether the stock can actually be shorted. In order to short a stock, the stock has to be borrowed from an investor who is long. Many stocks that are highly traded can be shorted easily if the customer's broker has ample inventory. Other stocks are "hard to borrow," and the trader must call the broker's security lending desk to obtain a "locate" on these shares. The broker will charge the trader a fee for lending these shares. For less-liquid stocks, such as Groupon, the broker's lending desk may have no inventory, and the trader may have to go outside of the brokerage to locate the stock.

This situation is where a company such as Locatestock.com can get involved. Locatestock.com operates an electronic platform that brings lenders of stocks and short sellers together and specializes in locating hard-to-borrow stocks for traders.

"Large institutions who would like to lend their stock populate our inventory and advertise a rate that they would like to be paid on the stock they lend," says John Tobacco, CEO and founder of Locatestock.com, explaining the mechanics behind his business. "We then advertise that rate to traders who would like to short the stock. We charge a transaction processing fee to the trader for facilitating the transaction."

The rate that lenders demand for borrowing their stock is a factor of supply and demand. If ample supply exists and the demand is relatively low, the rate may be as low as a fraction of a percent. But in the case of a stock like Groupon, the demand is very high (because many investors feel the stock is overvalued). The supply is also limited because the float is small. In addition, underwriters of new IPOs are restricted from lending their shares for the first 30 days of trading, which limits the supply further. In such cases, an institution holding the stock long will demand more compensation for loaning its shares.

In the case of Groupon, three days after the IPO, the daily borrowing rate at Locatestock.com was 9 cents a share. Keep in mind that this rate changes continuously, so the rate may fall later as the stock becomes easier to locate and the demand to short the security drops. But if Groupon stayed at this borrowing rate for over a year and a trader held the stock short the entire time, the trader would pay a total of US$32.85 a share ($0.09 x 365). With Groupon currently trading at US$24 a share, the stock could potentially fall to zero and the short trader would still lose money.

In other words, the short trader has a considerable amount of risk. For short-term traders, this fee is feasible because Groupon can have excessive intraday moves. But for traders that want to short the stock for longer time periods, this fee would make that short position cost prohibitive.

In some extreme cases, these borrowing rates can actually lead to toxic security prices that cause both the buyer and the seller of the security to lose.

For example, Ford Motor Company has an exchange-traded debt note ("Ford Motor Co., 7.50% Notes" trading under ticker symbol F.PRA on the NYSE) that pays quarterly distributions of US$0.46875 a share. The next distribution was due on 15 December. The security traded on 15 November for a price of US$27.00 when the security was callable

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at the issuer's option at a price of US$25.00. Considering the high rate of the coupon (7.5 percent per annum) and the fact that Ford recently called in a similar security back in March, Ford logically might have called this security early, a move that would have made the price of US$27.00 look like an attractive short because a trader could have banked US$2 if the security was called the next day.

But significant fees were associated with shorting this security. The borrowing fee on 15 November was 7.1 percent per annum at Interactive Brokers (a retail brokerage firm). Thus, an investor shorting this security would have paid US$1.917 per annum in borrowing fees to stay short the security (assuming the borrowing rate remained the same throughout the year). The investor also would have been required to pay the distributions of $1.875 per annum. The total annual cost would have been US$3.972—or $0.010389 a day.

If the short trader was banking on the security being called, the call would need to have happened in the next 192 days for the short trader to make money (US$2 potential gain divided by daily cost of $0.010389). In other words, for the short to be profitable, Ford would have to call the security by 26 May 2012. If it was called after this date, the short trader would lose.

Now take a look at the other side of this trade—the investor buying the security. The investor can currently buy the security at US$27. Considering the US$27 purchase price and the potential callable price of $25, a long investor would stand to lose US$2 if the security was called the next day. But the investor would continue to receive quarterly distributions of $0.46857 each quarter if the security was not called. The next quarterly payment was due on 15 December 2011. The interest would continue to accumulate on this security after this date at the rate of $0.46857 each quarter. The investor would need to receive a minimum of four more quarterly distributions plus an additional 24 days of interest in order to make money at the US$27 purchase price. The breakeven date for this would be 9 October 2012. If the security was called before this date, the investor going long would lose on the investment.

Therefore, if the security was called between 26 May 2012 and 9 October 2012, the current price of the security would be toxic—because both the investor going long and the investor going short would lose. As can be seen, these borrowing costs are a very important consideration when shorting a security.

Not only should investors consider the borrowing costs when initiating a short position, but they also need to consider the possibility of a potential buy-in, especially if illiquid issues are being shorted. If the brokerage's clearing firm is unable to locate a previously shorted stock, that short position may become subject to buy-in so the brokerage can stay in compliance with restrictions on naked short selling.

Typically, a notification is sent to the trader who is short, stating that the security has become hard to borrow, and if new shares cannot be located, the security may be bought-in. Buy-ins usually occur on less-liquid securities,

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which often have a very small float. The lack of liquidity in these securities can pose some substantial risks to traders who are short.

"It is dangerous to short an illiquid stock because at anytime the clearing firm can buy you in," says Jeff Goldman, managing partner at JC Trading Group. "Sometimes, they give you a warning that you have so much time to cover the position, but other times, they give little or no notification at all. They just buy-in the position. If the security has little liquidity on the sell side, these buy-in prices can get pretty ugly."

To compound problems for the short traders, stocks often become difficult to locate in multiple brokerages simultaneously. Other shorts may be subject to buy-in at the exact same time, putting a further demand on sell-side liquidity, which can press the buy-in prices even higher.

In any event, it is important for traders looking to initiate a new short position, to analyze the costs of putting that position on as well as the costs and risks in holding that short position for longer periods of time.

But understanding these costs and risks can be valuable information for long-only traders as well. Excessive borrowing rates and potential buy-in risks are two serious deterrents in shorting illiquid securities. With fewer shorts to keep the prices in check, these deterrents could possibly lead to over-inflated prices. A stock such as Groupon could remain at lofty prices for quite sometime, even if the fundamentals of the company are hurt by increasing competition.

Whether you're a long trader or short trader, it is important to consider the overall trading mechanics when making an investment decision. Being right on the fundamentals can still result in being wrong in the P&L.

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RECOMMENDED RESOURCES

"Short Arbitrage, Return Asymmetry, and the Accrual Anomaly"
Summarized in *CFA Digest* (November 2011)
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