

Analyst Insight – Long Short Manager Diligence

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Source: iStock

Key Points

- We note that the GameStop shorting squeeze frenzy is making individual stock shorting a lot riskier for managers.
- We draw that switching from shorting stocks to shorting ETFs is not an ideal solution.
- We conclude that it pays to understand your managers approach to managing unconventional risks and any impact it may have on their ability to deliver the promised alpha.

Risks are real but too early to say it's a structural issue.

The GameStop shorting squeeze frenzy is forcing many long-short managers to re-think about their strategy. While this herding behaviour from 'main street' investors is a real risk for long-short funds, it remains to be seen whether it will eventually impose a structural threat. The risks are much greater in small and mid-cap names and particularly in a narrow equity market like Australia. This point is noted from the data presented in the table below where many of the top 10 highly shorted stocks are sub \$1 billion in market cap. While the shorting rules in Australia are different to the US (for example the maximum allowable short on a ASX listed company is 20%), material moves (up or down) in the short interest can cause significant move in prices.

Top 10 Most Shorted Stocks on ASX for January 2021

Ranked based on percentage shorted of the total shares outstanding

Stock	Market Cap	Industry	End of Month % Short	% Change over month	Monthly Return (%)
WEBJET LTD	\$1570M	Retailing	14.52	-0.73	-2.93
TASSAL GROUP	\$703.74M	Food, Beverage & Tobacco	12.17	1.46	-4.31
SPEEDCAST INT LTD	\$189.40M	Telecommunication	9.27	-3.63	NA
MESOBLAST LTD	\$1520M	Pharmaceuticals, Biotechnology & Life Sciences	9.16	-6.30	8.82
INGHAMS GROUP	\$1300M	Food, Beverage & Tobacco	8.61	1.31	6.38
AVITA THERAPEUTICS	\$673.56M	Pharmaceuticals, Biotechnology & Life Sciences	8.37	7.21	-6.03
WESTERN AREAS LTD	\$673.91M	Materials	7.75	8.98	4.70
NORTHERN STAR RESOURCES LTD	\$14030M	Materials	7.66	132.37	-6.15
METCASH LIMITED	\$3590M	Food & Staples Retailing	7.37	-4.16	2.92
MYER HOLDINGS LTD	\$258.70M	Retailing	7.28	-8.95	1.61

Source: Foresight Database and ASIC

While our diligence work on long-short funds certainly shows that many managers have good risk controls around their single short positions, investors need to keep a few important points in mind.

Substitution of single short names with an ETF has two potential issues.

Firstly, this is most likely a style drift for a fundamental stock picker. Instead of making money from falling stocks prices for fundamental reasons, they (who are they?) are switching to an ETF shorting which has many other types of risk. Does their mandate allow this? Do they really understand the risk reward? How will this dilute their future alpha potential? Should your active manager capitulate and stop shorting at all? Is it true that they make a lot of money from long side anyway? Chances are likely.

There is asymmetric risk from short positions.

Shorting a stock or security exposes one to an unlimited risk. How high can a stock price can go? This risk is asymmetric to 'long only' investing as the maximum you can lose from buying a stock is 100%. That is why, pragmatic managers use stop loss mechanisms, but this approach may not be that scalable if stock prices move up very quickly like it happened in GameStop case.

Position exposure of a short stock increases when prices go up.

This is a hidden risk that has caused issues for some of the hedge funds in this GameStop saga. Due to funds being forced to limit their stock exposures, attributed mostly to rising prices (they must buy stocks at a much higher prices), we see further price raises as they are forced to buy stocks to close short positions and maintain single stock limit exposure.

The issues raised in point 2 and 3 above are what amplifies a short squeeze. We see, then, that it pays to understand your long, short manager's strategy on managing risks.

About the Author

Jay Kumar is an independent analyst and founding director of Foresight. He has over 25 years of experience in investment research, analysis and management. Jay gained his investment specific experience at the Reserve Bank of Fiji, Morningstar, ING Investment Management and ANZ Wealth.

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