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can short selling ever be ethical?

Mike Scott asks investors, both in the mainstream and SRI fields, whether the practice of selling short on stocks is always a bad thing – or might actually serve as a responsible investment tool.

Short selling – profiting from price falls by selling stocks you do not own and buying them back at lower prices before returning them – is the ultimate counter-intuitive activity to most people.

It hit the headlines towards the end of 2008 as the meltdown in the financial markets caught up with high profile banks around the world.

Regulators in markets including the UK, the US, Australia, France, Belgium and Switzerland temporarily banned short selling in financial services companies after claims that the practice was unsettling markets and artificially driving prices lower.

There was, and is, a general feeling – particularly among the public at large – that short selling is a 'bad thing'. But can it actually be compatible with being an ethical investor? Michael Levas, founder of Florida-based fund Olympian Capital Management, which specialises in working with high net worth individuals, says there is no question that it can be. 'Short selling has been around for a long time and it's an integral part of the market place,' he says.

As markets fall, Levas argues, investors with a bearish view of the market want to profit from their belief that prices will go down, just as people who believe the market will go up want to profit by buying or 'going long'. It is also useful for investors wanting to hedge a long position to ensure that if their bet is wrong they do not lose too much money.

Levas is a mainstream investor, but short-selling also receives an endorsement from a leading governance activist. 'It's a very good way for the market to send a signal that a company is in trouble or there are issues that might not have been spotted otherwise,' says John Wilcox, chairman of Sodali, a US-based corporate governance consultancy.

Wilcox cites the case of US fund manager Bill Ackman at Pershing Square Capital Management, who shorted US municipal bond insurer MBIA. 'He was going public with his concerns about the company based on very deep analysis. He had concerns about its AAA credit rating and the value of its assets, and he was proved right.'

Because short sellers stand to lose a lot of money if they are wrong, their analysis is often heralded as being superior to that of other investors, although the case of Volkswagen, whose shares soared to more than ?1,000 when short sellers were caught out by Porsche's covert share buying, proves they do not get it right all the time.

Supporters of short selling, including the Financial Services Authority (FSA), the UK regulator, say it increases market liquidity, lowers transaction costs and helps to ensure efficient pricing. A consultation document from the FSA following the ban on short selling concluded that the practice had not been responsible for the collapse in bank share prices. 'The FSA has not found conclusive evidence to support the hypothesis that short selling was in fact a major contributory factor to the recent price volatility in financial stocks,' says Carmen Reynolds, a partner at law firm White & Case. 'However, it did recognise that the market conditions last autumn made the markets much more susceptible to abusive behaviour attributable to short selling.'

Short selling plays an important role in the market in terms of increasing liquidity and based on the FSA's analysis, reducing volatility, says Rory Sullivan, head of investor responsibility at Insight Investment, part of the HBOS group that has been taken over by Lloyds TSB. He says it can also have a role to play in certain types of long-term investment strategy, such as long-short funds looking for sustainable long-term returns. Insight both short sells and lends its stock, another vital component of short selling.

Insight uses short selling as part of a long-short strategy, whereby it buys one share but shorts another. For example, it might buy a power company on the basis of its good record on cutting carbon dioxide emissions and short a rival group that has a poor record, on the basis that the cleaner company will outperform the more polluting one. In this way, it should be able to make money on the basis of the differential between the two share prices, irrespective of the general performance of the markets.

Despite the apparent benefits of short selling, most market observers agree that there are issues to be dealt with. One charge levelled at short sellers is that they create false rumours to drive down the price of shares they have shorted. 'But this is not a short selling issue, it is fraud,' argues Wilcox. In such cases, he says, short selling is merely the tool used for illegal behaviour.

'Short sellers need to be transparent about it and investors need to be transparent about what shares are being lent and when,' says Stephen Hine, head of international affairs at the UK-based Ethical Investment Research Service.

'Naked' short selling, where investors sell shares without having borrowed them, is a problem, says Olympian's Levas, and indeed it is now banned in the US – although that ban has not been strictly policed, he adds.

'Covered' short selling, where the sale is covered by borrowed shares, imposes natural limits on the amount of shorting because there is a limit to how many shares investors will lend.

Because, in theory, naked short sellers can short more than 100 per cent of a company's stock – especially in small cap companies – it is overly speculative, adds Wilcox. 'It allows gambling without facing the full economic consequences of your actions.'

Levas therefore calls for the return of the 'uptick' rule, whereby investors can only short a stock if the previous movement in the share price was upward. 'The uptick rule would have prevented the bear market raids we saw on Lehman, AIG and Bear Stearns,' he says.

It is easy to characterise short selling as bidding against the market, especially as some short sellers do not play by the rules, says Wilcox. But if a company believes it is being unfairly victimised by short sellers, 'the obvious strategy is to reveal more details about its strengths. If it really is strong, that will put the short sellers out of business'.

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