

## **Opinion: Implications of Short Selling and the Credit Crisis.**

With so much negative media about short selling, particularly by hedge funds, it's time to step back and take an objective look at how short selling works in the market.

What is this? 'An absolute return strategy using a portfolio of debt securities leveraged 10 to 1 or more – where the investment style seeks to realise a consistent spread on the assets in excess of the cost of leverage.<sup>i</sup> It could be describing a tricky hedge fund or some highly geared derivative product, but in fact it describes the activities of any commercial bank.<sup>ii</sup>

All of those regulators and media commentators who have devoted so many column inches to the subject of short selling and securities lending, should read what David Rule, CEO of the International Securities Lending Association (ISLA) recently said on the topic.

As part of his foreword in the 2008 Review of ISLA, he quoted past Chairman Richard Steele as saying in 2007, 'securities lending is at the heart of the financial system, providing liquidity to the equity, bond and money markets. The ability to borrow securities underpins the services that securities dealers offer their customers and the trading strategies of dealers, hedge funds, and asset managers'<sup>iii</sup>

Rule went on to explain that "as far as short selling of stock is involved it is important to understand that short selling of stocks does not in itself drive equity prices lower, as short selling will have no long-term effect on share prices.

"If short sellers cause a share price to fall below its fair value, other investors will be quick to take the opportunity to buy such shares. Academic research has shown that placing restrictions on short selling reduces the efficiency of price formation."<sup>iv</sup>

It is also a fact that only a small proportion of lent securities are used to cover directional short sales. And it is true to say that securities are borrowed for other reasons including; to avoid settlement failure; by market makers in order to provide liquidity to buyers, and to enable arbitrage-related activities. For example to go short, individual shares versus an index-based basket'.<sup>v</sup> Institutional investors such as Super/Pension funds and the like earn additional revenue at low risk by lending shares. If this was to stop, not only would Super/Pension funds have lower returns but the market would have reduced liquidity which is the last intention of any regulator in any market.

It is becoming extremely apparent that globalisation of financial markets continues to afford an opportunity for all investors to better diversify and reduce domestic and overall portfolio risk; all attempts to improve such mechanisms via the formation of smart derivatives, short selling, stock lending and the like will only enhance the flexibility and ability of investors to diversify portfolios and reduce risk.

With that in mind we probably need to think what the implications of the current credit crisis mean to investors. In January at the World Economic Forum on Financial Services it was reported that, 'The crisis has also highlighted the danger of focusing regulatory attention in the wrong areas, based on perceptions of risk that may be misplaced.

'For example, recent years have seen repeated calls in the US and the EU for tighter regulation of hedge funds and private equity. Yet the sub-prime losses have been most heavily concentrated in the most heavily regulated entities in the system – the commercial and investment banks'<sup>vi</sup>

So what can be described as systemic financial risk and how should we manage such risks? '

In general terms, the manifestation of systemic financial risk involves a system-wide financial crisis, typically accompanied by a sharp decline in asset values and economic activity. In all cases, systemic financial risk involves the spread of instability throughout the financial system as a whole with results that are sufficient to affect the real economy. Manifestations of systemic financial crisis are relatively rare: In the past 20 years, systemic financial risk events have included the equity crash of October 1987 ("Black Monday"), the Japanese asset price collapse of the 1990s, the Asian financial crisis of 1997 and the Russian default of 1998 (which led to the demise of the Long-Term Capital Management (LTCM) hedge fund).

Each of these episodes was characterised by an abrupt loss of liquidity, discontinuous market moves, extreme volatility, sharp increases in correlations and contagion across markets, and systemic instability. While the pathways of contagion of systemic financial risk are often well understood in retrospect, and the conditions for a systemic financial risk event may be well identified ahead of crisis, the precise triggering event is rarely predicted. Systemic risk is an inherent element of the global financial system.<sup>vii</sup>

So perhaps we need more regulation or maybe we should ask Governments to ban such activities? Roger Ferguson Chairman of Swiss RE America Holding Corporation, disagrees, saying recently, 'Derivatives allow for the spread of market and credit risks. Most economists say that the world economy looks pretty good, and I say that derivatives are one of the reasons for that'.<sup>viii</sup>

Now that we have a clearer view of these issues we can see how hedge funds that engage in stock lending and short selling of equities specifically impact on this apparently fragile and churlish global financial system. They improve and facilitate equity market liquidity by these activities. It may be that the impost of additional regulation will further spook the markets as it could indicate a system in crisis and an

economic system hanging on to power by imposing further band-aid solutions for a fundamentally flawed system.

If an economy is fundamentally shaky and potentially in transition, perhaps even at a turning point in history, then the paradigm shift will create great friction as it changes direction, which may be the experience today of the US economy.

According to recent comment by Dominique Strauss-Kahn, Managing Director, International Monetary Fund (IMF) Washington, DC, low interest rates, high liquidity, a breakdown in credit and risk management practices, and a shortcoming in US financial regulation and supervision had produced an economic 'perfect storm' in the financial world.

"I think we have to recognise the failure of this system and the overall regulation," he said in January this year.

After all there is a danger that the rest of the world is losing confidence in investing in the US market. However in India it is business as usual, as it is in China, because they rely on economies driven by investment, consumption and exports. Their economies are fuelled in part by internal savings, foreign direct investment, central banks reserves, Sovereign wealth funds, and nations with surplus cash as a result in high oil revenues.

Additionally we should remember that nations like Japan are sitting on underutilised pools of cash estimated to be up to USD \$14Trillion; it is estimated that half that sits in cash on deposit accounts.<sup>x</sup> This is money that will eventually be applied to more productive investments, potentially via rapidly expanding global financial products that use derivatives and hedge fund techniques to provide investors with strong risk adjusted returns.

So with that in mind please stop bashing the short sellers and security lenders and seek out investment professionals that understand your investment policy requirements as you would seek out professional medical advice and remember that 'the innovative idea of today is the accepted policy of tomorrow.'<sup>x</sup>



Scott A J MacDonald  
VanMac Group.  
[scott@vanmac.com.au](mailto:scott@vanmac.com.au)  
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- <sup>i</sup> Ed. Easterling, *'Perspectives on Hedge Fund Investing'* p33-34 Crestmont Research Jan 2007 [www.crestmontresearch.com](http://www.crestmontresearch.com)
- <sup>ii</sup> Ibid.
- <sup>iii</sup> D Rule, *'Forward - Investor Services Journal- Securities Lending Review 2008'*. Investor Intelligence Partners London.
- <sup>iv</sup> Ibid
- <sup>v</sup> Ibid
- <sup>vi</sup> Ed's; M Agius; C McCreevy, D Neiderauer, J S Turley, *'Regulation and Capital Market Competition'* Jan 2008 World Economic Forum – Financial Services Switzerland.
- <sup>vii</sup> World Economic Forum Report in Collaboration with Citigroup; Marsh & McLennan Companies; Swiss Re; Wharton School Risk Center; Zurich Financial Services, *'Global Risks 2008- A Global Risk Network Report'* Jan 2008 World Economic Forum Switzerland.
- <sup>viii</sup> Ed's; R W Ferguson, R J Shiller, D D. Wall, *'Derivative Markets, Mounting Worries'* Jan 2008 World Economic Forum - Financial Services Switzerland.
- <sup>ix</sup> Ed's; P Chidambaram, C Lagarde, D Strauss-Kahn, L H Summers, J A Thain, Y Watanabe, *'The Global Economic Outlook 2008'* World Economic Forum – Financial Services Switzerland.
- <sup>x</sup> Quote by Scott A J MacDonald adapted from web site [www.vanmac.com.au](http://www.vanmac.com.au)