“The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk”
U.S. House of Representatives,
Committee of Financial Services,
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
May 22, 2003

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I am pleased to have this opportunity to testify about the state of the hedge fund industry and the role of short sellers in capital markets.

As an economist, I am concerned with prices. It is important that we get the prices right. When security prices are wrong, resources are wasted and investors are hurt. In order to get prices right, we need to allow all information, both positive and negative, to get into the market. Short selling is one way that negative information gets into the market. Without short selling, stocks can become overpriced because only optimistic opinions are reflected in the stock price.

Our current financial system is not set up to encourage short selling. We have well-developed institutions, such as mutual funds, to encourage individuals to buy stocks, but few institutions to encourage them to short. As events of the past few years have made clear, the infrastructure of our system, such as analysts, underwriters, and some elements of the media, have had an overly optimistic bias. In addition to this optimistic bias, there are technical issues with short selling related to our system of lending equities. Simply put, our system is not designed to facilitate short selling of equities, and it can be difficult or impossible to short some stocks.

Constraints include various costs and risks, such as the expense and difficulty of shorting, legal and institutional restrictions, and the risk that the short position will have to be involuntarily closed due to recall of the stock loan. If these impediments prevent investors from shorting certain stocks, these stocks can be overpriced and thus have low future returns until the overpricing is corrected. The mechanics and institutional details of short sales in US equity markets have changed little in the past century. Unlike the Treasury market and the derivatives markets, the equity shorting market has actually regressed in some respects, a point discussed

further in Jones and Lamont (2002).

To be able to sell a stock short, one must borrow it, and because borrowing shares is not done in a centralized market, finding shares can sometimes be difficult or impossible. In order to borrow, an investor needs to find an institution or individual willing to lend. These lenders receive a daily lending fee from the borrowers, determined by supply and demand in the lending market. Brokers have the ability to lend shares of their customers, provided customers have given written permission. Once a short seller has initiated a position by borrowing stock, the borrowed stock may be recalled at any time by the lender. If the short seller is unable to find another lender, he is forced to close his position. This possibility leads to recall risk, one of many risks that short sellers face.

Generally, it is easy and cheap to borrow most large cap stocks, but it can be difficult to borrow stocks which are small, have low institutional ownership, or which are in high demand for borrowing. A somewhat paradoxical description of the stock lending market is that it usually works very well, except when you want to use it, in which case it works terribly. By this I mean that it can be difficult or expensive to short stocks that many people believe are overpriced and many people want to short. Of course, this point is the essence of the overpricing hypothesis: stocks are only overpriced when informed investors are unable or unwilling to short them. No one would want to short them if they weren't overpriced, and they wouldn't be overpriced if they weren't hard to short.

In addition to the problems in the stock lending market, there are a variety of other short sale constraints. Regulations and procedures administered by the SEC, the Federal Reserve, the various stock exchanges, underwriters, and individual brokerage firms can mechanically impede

short selling. Legal and institutional constraints inhibit or prevent investors from selling short. Most mutual funds never go short.

Evidence for overpricing

A variety of evidence suggests that when stocks are difficult to short, they get overpriced. One example I have studied is battles between short sellers and firms (Lamont, 2003). Firms don't like it when someone shorts their stock, and some firms try to impede short selling using legal threats, investigations, lawsuits, and various technical actions. Consistent with the hypothesis that short sale constraints allow stocks to be overpriced, firms taking these anti-shorting actions have in the subsequent year very low abnormal returns of about -24 percent per year. The negative returns continue for up to three years. What appears to be happening is that these companies are overpriced, either because of excessively optimistic investor expectations, faulty products or business plans, or just plain fraud on the part of management.

Firms (either management or shareholders) can take a variety of actions to impede short selling of their stock. Firms take legal and regulatory actions to hurt short sellers, such as accusing them of illegal activities, suing them, hiring private investigators to probe them, and requesting that the authorities investigate their activities. Firms take technical actions to make shorting the stock difficult, such as splits or distributions specifically designed to disrupt short selling. Management can coordinate with shareholders to withdraw shares from the stock lending market, thus preventing short selling by causing loan recall. These battles between short sellers and firms can be extraordinarily acrimonious. The following statement from the sample I used gives a flavor of attitudes toward short sellers: "Your activities are mean, shameful and loathsome. They are motivated by appalling avarice and greed, and they will not be permitted to

go unanswered."

An example of the various anti-shorting strategies used by firms is provided by Solv-Ex, a firm that claimed to have technology for economically extracting crude oil from tar-laden sand. Short sellers claimed that Solv-Ex was a fraud. On 2/5/96, the management of Solv-Ex faxed a letter to brokers and shareholders: “To help you control the value of your investment…we suggest that you request delivery of the Solv-Ex certificates from your broker as soon as possible.” This suggestion, entirely legal on the part of Solv-Ex, was essentially an attempt at market manipulation. The letter was an attempt to orchestrate a short squeeze using the stock lending system.

Any shareholder heeding Solv-Ex’s suggestion would have withdrawn his shares from the stock lending market, potentially forcing short sellers to cover their positions. On 2/2/96, before the letter, Solv-Ex’s price was at $24.875. By 2/21/96, the price had risen to $35.375, perhaps due to Solv-Ex’s attempted squeeze. Solv-Ex took other action against short sellers as well. Later in 1996, Solv-Ex said that it had hired private investigators to find out who was spreading misinformation about the firm, and subsequently it filed suit against a well-known short seller, claiming he had spread false information. However, in this case it was Solv-Ex which was engaged in illegal activities, not the short sellers. Solv-Ex delisted at 7/1/97 at $4.25, amid an SEC investigation of whether Solv-Ex had defrauded investors. It entered Chapter 11 bankruptcy in 1997, and in 2000 the court ruled that the firm had indeed defrauded investors.

In this case, the evidence is consistent with the idea that Solv-Ex was overpriced in February 1996, since it subsequently fell sharply. My study, Lamont (2003), looks at long-term returns for a large sample of 270 similar firms who threaten, take action against, or accuse short

sellers of illegal activity or false statements. It turns out that (as in the Solv-Ex case) sample firms have very low returns in the year subsequent to taking anti-shorting action. Returns relative to the overall stock market are approximately -24 percent per year. The evidence is strongly consistent with the idea that short sale constraints allow very substantial overpricing, and that this overpricing gets corrected only slowly over many months.

While the underperformance of -24% per year is very large, it is similar in magnitude to the range found in other studies of stocks with very high short sale constraints, such as Jones and Lamont (2002), Lamont and Thaler (2003), and Ofek, Richardson, and Whitelaw (2002). Jones and Lamont (2002) find data for six years (1926-1933) while Lamont and Thaler (2003), and Ofek, Richardson, and Whitelaw (2002) studied data for a few years around the year 2000. Each one of these four data sets has unique characteristics, and it is conceivable that any one result reflects chance or an unusual sample period. But taken together, the evidence shows that in extreme cases where short sellers want to short a stock but find it difficult to do so, overpricing can be very large.

A notable feature of the data is that many of the sample firms are subsequently revealed to be fraudulent. A variety of other evidence suggests that short sellers are good at detecting and publicizing fraud on the part of firms (Dechow, Sloan, and Sweeney 1996, Griffin 2003). Again, recent events have emphasized the need to reward whistleblowers. The SEC and other regulators cannot be our only line of defense against corporate fraud. To protect investors, we need a vibrant short selling community.

Tech stock mania

Even absent corporate fraud, though, short sellers play an important role in protecting

individual investors from overpriced stocks. When informed traders are not able to go short, it will be small investors who unwittingly buy the overpriced stock, while the smart money stays away. For example, during the tech stock mania in 2000 there were some stocks that though clearly overpriced were not shortable for technical reasons. The victims were the individual investors who bought these stocks and suffered substantial losses. An example, documented in Lamont and Thaler (2003), is Palm, Inc. Palm was irrefutably overpriced in March 2000, but was difficult or impossible to borrow in the stock lending market, and thus could not generally by sold short. Institutions avoided owning Palm, and individual investors who blindly bought Palm suffered as it subsequently declined.

More generally, suppose we consider the possibility that Internet stocks were priced much too high around 1998-2000. Perhaps many investors thought that Internet stocks were overpriced during the mania, but only a small minority was willing to take a short position, and these short sellers were not enough to drive prices down to rational valuations. As a result, billions of dollars was wasted on uneconomic enterprises, millions of investors suffered losses, and hundreds of thousands of workers switched jobs only to see their new companies fail. It seems to me that the problem was not enough short selling in 1998 to prevent stock prices from reaching untenable levels.

Historical pattern

There is a natural tendency to feel that short selling is somehow inherently malevolent or un-American. To the contrary, it is quite positive for our economy to correct overpricing and detect fraud. And nothing could be more American than free speech, free markets, and a healthy competition among ideas and firms. If we are to have liquid markets that properly reflect

available information, investors must be able to buy and to sell.

Governments often restrict short selling in an attempt to maintain high security prices. Meeker (1932) reviews the attempts by a colorful cast of characters (from Napoleon to the New York state legislature) to ban short selling. Unfortunately, short sellers face periodic waves of harassment from governments and society, usually in times of crisis or following major price declines as short sellers are blamed. Short sellers are often thought to be in league with America's enemies. The general idea is that short selling is bad, and when bad things happen (such as war) it probably involves short sellers in some way. For example, the New York Stock Exchange imposed special short selling regulations during World War I (in November 1917), in response to both a substantial market decline and a fear that the Kaiser would send enemy agents to drive down stock prices. Jones and Lamont (2002) discuss another historical episode following the crash of 1929. The anti-shorting climate was severe in October 1930. President Herbert Hoover met with the president of the NYSE to discuss the situation and to curtail possible bear raids implemented via short-selling. The FBI's J. Edgar Hoover was quoted as saying he would investigate the conspiracy to keep stock prices low. Numerous anti-shorting regulations stem from this period, such as the uptick rule and the Investment Company Act of 1940 which placed severe restrictions on the ability of mutual funds to short.

This historical pattern has continued in recent years, as press reports indicate that authorities in Japan have sought to discourage shorting. Thankfully, in the past few years, Congress and the SEC have shown admirable restraint in not succumbing to the temptation to blame short sellers for the recent market decline.

Manipulation

It is of course appropriate for the SEC and other authorities to investigate possible manipulation involving short sales. But in general, there is no reason to believe that short selling is more likely, compared with other trading activity, to be used to manipulate stock prices. In fact, there are reasons to believe that short selling is less likely to be involved in illegal manipulations. There are even certain types of manipulation (such as "cornering" the stock) in which short sellers are the desired victims of manipulation.

Certainly, the big story from the past few years has been questionable behavior on the part of issuing firms, analysts, accounting firms, and underwriters. The short sellers have been the heroes of the past few years, alerting the public and the authorities to corporate fraud. And it has been the hedge funds which have simultaneously preserved investor capital and corrected mispricing.

Mutual funds vs. hedge funds

I believe that it would benefit both the efficiency of prices and the welfare of investors if more investors were to allocate their capital to strategies involving short selling, for example market neutral long-short funds. One way to channel more capital to short selling is to make hedge funds available to retail investors. It is sometimes thought that hedge funds are too risky for individual investors. Although risk is a complicated concept, I do not believe it is generally correct to say that hedge funds are more risky than mutual funds. Certainly, the experience over the past few years is that a long-short hedge fund was far less risky than a traditional long-only mutual fund that invests in tech stocks. Academic studies generally show that as a class, hedge funds can serve to reduce overall volatility in a diversified portfolio.

But the retailization of hedge funds is not the only way to accomplish this goal, since recent changes in the law have made it possible for mutual funds to go short. The Investment Company Act of 1940 placed severe restrictions on the ability of mutual funds to short, but the law changed in 1997, allowing mutual fund managers greater freedom to use derivatives and short sales. There are now mutual funds that have hedge fund-like attributes, such as the ability to go short and use leverage. These funds come with the full array of regulation, disclosure requirements, and investor protection.

In terms of policy, what should be avoided is a new set of regulations that subject hedge funds to the same rules as mutual funds, thereby limiting the freedom of hedge funds to exploit and correct mispricing. I fear that any new regulations might have the unintended consequence of making short selling harder than it already is, and consequently increase the level of mispricing and fraud in our economy. If policy makers feel that hedge funds are being inappropriately marketed to retail investors, the appropriate response is to raise the threshold for individuals to become an accredited or qualified investor in hedge funds. Individual investors who fall below the threshold can always invest in hedge fund-like mutual funds.

Recommendations

My opinion, therefore, is that we need to change the current lopsided system that discourages short selling. First, in the narrow technical arena, we should consider ways to make the equity lending system work better. It seems particularly unhelpful that (sometimes fraudulent) firms are able to abuse various aspects of the system in order to prevent short selling. Second, in the broader arena, we should continue to encourage the development of institutions that channel capital into short selling. Happily, there are signs of progress on both fronts, and as

more capital is devoted towards short selling it is likely that market forces will help improve the efficiency of the equities lending system.

Congress and the SEC will continue to hear complaints from companies about short sellers. As I mentioned earlier, the evidence shows that when companies and short sellers fight, it is the short sellers who are usually vindicated by subsequent events. For example, in 1989, the House Committee on Government Operations (Commerce, Consumer and Monetary Affairs subcommittee) held hearings about the alleged evils of short selling, featuring testimony from supposedly victimized firms. Officials from three firms testified. Subsequent to this testimony, the presidents of two of these three firms were charged with fraud by the SEC. Thus when you hear companies complain, keep in mind that short sellers are often the good guys.

Thank you for this opportunity to testify, and I would be happy to answer any questions.

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