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The verdict is in on short-sellers of stocks: They greatly benefit all of us

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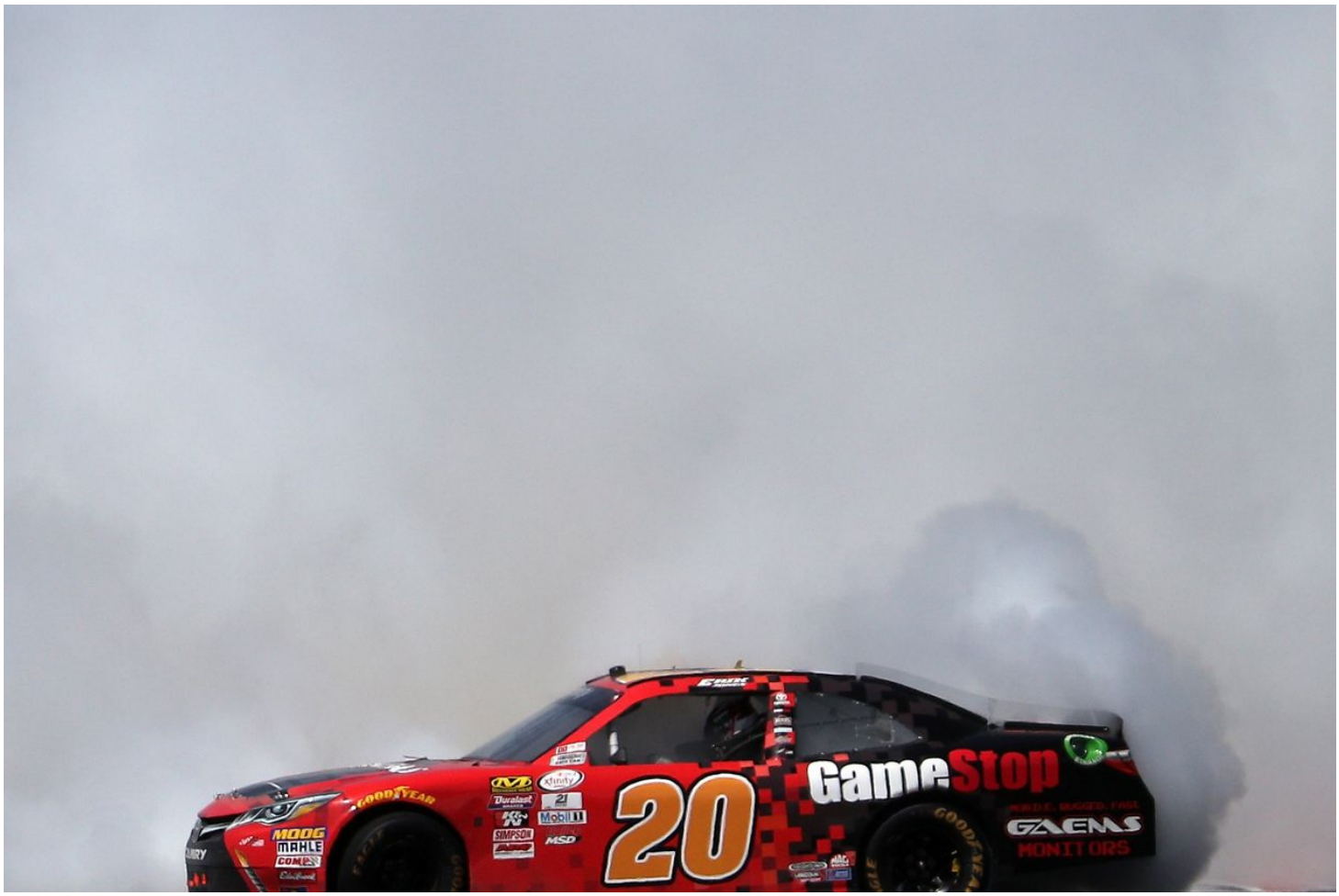
By Mark Hulbert

Short-selling, which has become controversial because of the GameStop saga, keeps company management honest and improves stock-price efficiency.



(Photo by Chris Graythen/Getty Images)

GME -0.25%

At great career risk, I want to put in a good word on behalf of the research that short-seller firms conduct.

My career risk springs from the highly polarized environment that has prevailed in the aftermath of the GameStop Corp. **GME, -0.25%** saga, which has pitted small investors (the good guys) against short-selling hedge funds (the bad guys).

I'm not kidding. When three weeks ago I suggested that short-sellers are not all bad, and that they in fact have a role to play in a well-functioning market, I received more vitriolic email than I had in years.

As a double check on whether my arguments were as misguided as these e-mailers alleged, I am devoting this column — my regular monthly focus on the latest Wall Street research — to interviewing a number of finance professors who have studied the roles that short-sellers and their research play.

Would the world be a better place if the short-selling firms closed their doors?

The professors' answer is an unequivocal "no."

Why? Short-sellers have an enviable record of identifying overvalued companies.

One revealing study focused on research reports published as part of 124 short-sale campaigns launched in the U.S. over a five-year period by 31 short-selling firms. The research, published in the Review of Financial Studies, was conducted by Alexander Ljungqvist, a finance professor at the Stockholm School of Economics, and Wenlan Qian, a professor of finance at the National University of Singapore.

The professors found no indication that any these 31 firms were "bear raiders intent on manipulating share prices by disseminating falsehoods (a strategy sometimes called 'short and distort')."

That's an important finding, since one of the charges leveled recently is that the short-sellers were manipulating prices. On the contrary, the professors found that the firms in their sample were far more right than wrong: A total of "50% of the targets are later delisted, 47% replace their auditors or see their auditors resign, and 23% restate earnings. Investigations by third parties such as the SEC [Securities and Exchange Commission], the Department of Justice, or a stock exchange come to similar conclusions as the reports in fully 90% of the cases."

If these firms were simply manipulating share prices to realize a short-term gain, then we would expect that those prices would eventually recover. But that's not what the professors found. On the contrary, they found after the targeted firms' stocks fell 7.5% on the days the short-sellers' research reports were published, their stocks proceeded to lag behind the market by at least another 20% over the subsequent three months. And over the nine months after that, they trailed the market by almost 30% more.

The professors conclude that "financial markets need short sellers to function well …. The short sellers in our sample are information producers who help correct mispricing and thereby help make markets more efficient."

The average investor benefits from short-sellers

Another revealing study found that short-sellers can identify and publicize financial misconduct more quickly than government regulators can. This study, which appeared in the Journal of Finance, was written by Jonathan Karpoff, a professor of finance at the University of Washington, and Xiaoxia Lou, a finance professor at the University of Delaware.

The professors focused on 454 firms that at any point over a 17-year period were disciplined by the SEC for financial misconduct. They found that there was an unusually large jump in short interest in these companies' stocks well in advance of when the SEC's disciplinary actions were made public — 19 months in advance, on average.

Karpoff told me in an interview that these results suggest that not only are "short-sellers good at rooting out financial misconduct," they "accelerate the time to discovery" relative to the SEC.

This conveys a huge benefit to long-only investors, since it dampens the price inflation that would otherwise occur when companies misrepresent their financials. The consequence is that long-only investors lose less money than they otherwise would. And not by a small amount, either: The professors report that the average benefit to those investors is equal to 1.09% of the firm's market cap.

Short-sellers reduce earnings exaggeration

Karpoff published another study in the Journal of Finance that is also relevant to the debate about short-sellers. His co-authors for this additional study were Vivian Fang, an accounting professor at the University of Minnesota, and Allen Huang, an accounting professor at the Hong Kong University of Science and Technology.

The professors focused on an experiment the SEC conducted between 2005 and 2007 in which some of the barriers to short-selling were removed for a third of the stocks in the Russell 3000 index. Compared to the remaining two-thirds of stocks, there was significantly less "earnings management" among these

more easily shorted stocks. (Earnings management occurs when companies manipulate their books so as to report more favorable earnings.)

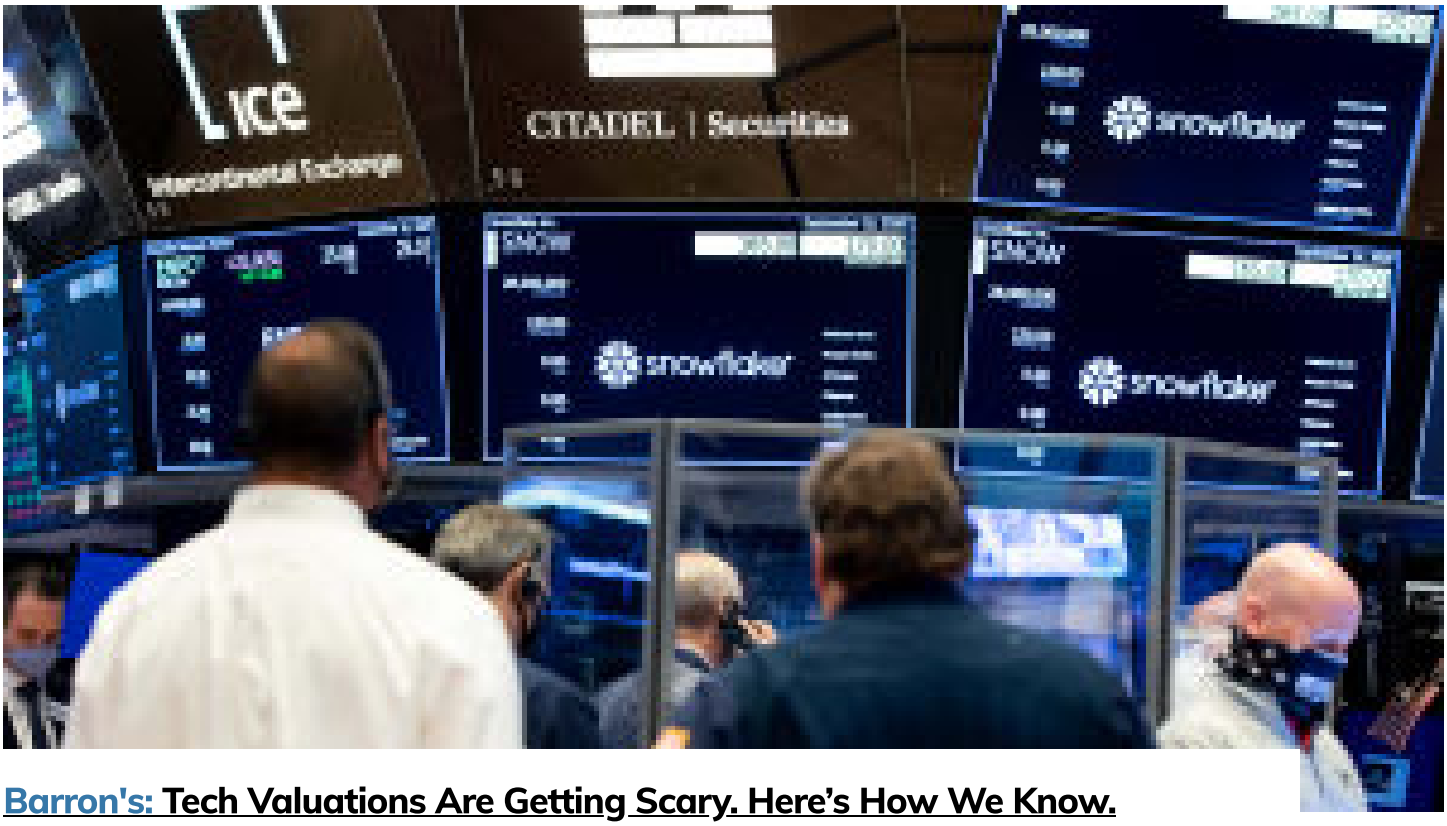
Tellingly, Karpoff told me, this reduction in earnings management disappeared at the end of the experiment. That's when the one-third of Russell 3000 stocks once again traded with the same barriers to short-selling as the other two-thirds.

The bottom line

Not all short-sellers are upstanding citizens. No doubt some engage in unethical or even illegal behavior. But, then, the same can be said about some analysts and investors who focus only on the long side, as well as those corporate officers and directors who manipulate earnings reports. So, please, let's stop writing the history of the GameStop saga as a polarized one between good and evil.

On balance, according to the professors with whom I spoke, we're better off because many short-sellers are keeping companies honest and trying to keep some stocks from becoming overvalued. At a time when some believe the overall market is entering bubble territory, their role seems more important than ever.

Mark Hulbert is a regular contributor to MarketWatch. His Hulbert Ratings tracks investment newsletters that pay a flat fee to be audited. He can be reached at mark@hulbertratings.com.



Barron's: Tech Valuations Are Getting Scary. Here's How We Know.

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