Short selling activity and waiting games
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Discussion

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• Summary

• Comments

• Questions

• Conclusion
Summary

- Motivation: Theory inconclusive about impact of more informed traders on price efficiency:
  - If informed have same information “rat race” may lead to full revelation.
  - If informed have different information “waiting game” may lead to less informative prices.

- Show that an increase in short-selling on individual stocks leads to a decrease in the buy-sell initiated order imbalance of institutional investors trading in these stocks.
  - Effect is larger for stocks that are more costly to short (Reg SHO experiment).

- Further, document that following increase in short interest, institutional investors:
  - trade at lower speed.
  - assign orders to larger number of more unfamiliar brokers.
  - pay higher fees.

- Conclude that evidence is more consistent with ‘waiting game’ interpretation and that short-selling may not improve price efficiency.
Causality?

(M) Alternative Mechanism: short sellers and institutional investors both react to negative public news.

- The authors reject (M) because the negative correlation between short interest and order imbalance is stronger for stocks that are more costly to short (i.e., out of the REG SHO experiment).

- However, this is exactly what you expect if agents react to negative news: If stocks are more costly to short, then investors will only short if the news is more negative. But more negative news also may lead to a stronger drop in buy—sell initiated orders, no?

⇒ Why not break-down the buy-sell imbalance and study separately buy and sell initiated orders. Is the negative relation arising because buys decrease or because sells increase following more shorting?

- If it is the latter, then it seems (to me) also consistent with (M) above.
Theory?

▶ Theory predicts that if the correlation in private information signals is **negative** then a waiting game may arise (**Foster and Viswanathan (1996)**).

▶ Intuition: Informed views others' information to pull the stock in the **wrong** direction (absent their trading), thus it can be optimal for them to wait and let the stock move even further away from the ‘true’ value to build his optimal position at more favorable prices.

▶ However, it is not at all clear that this theory predicts that differentially informed investors who all have negative information want to wait!

⇒ Seems important to break down the order imbalance into buy minus sells:
  ▶ If buy initiated trades drop in response to increase in short-selling, then possibly consistent with ‘waiting game’.
  ▶ If sell initiated trades increase, then seems to me a harder sell.
Questions

▶ Trading speed is defined as first day orders divided by cumulative five-day trades. Thus ‘speed’ can decrease for two reasons:

(a) first day orders fall

(b) five-day cumulative trades increase

(or both)

▶ Which it is, matters a lot for interpretation:

▶ (b) seems more consistent with the behavior of going to multiple, unfamiliar brokers and paying higher fees. It is simply sourcing more liquidity to trade more in response to worse negative news.

▶ (a) makes the behavior to go to unfamiliar brokers hard to understand.

▶ Can you sort the institutional order flow and behavior in different groups (e.g., active versus passive managers, hedge vs. mutual funds, long only vs. long/short etc...)?

▶ It is very surprising that their buy-sell imbalance has strong predictive power for returns, given empirical evidence that most funds do not outperform the market.

▶ Would be nice to see cross-sectional evidence.
Conclusion

- Interesting empirical evidence.

- Would be nice to refine analysis to present impact of shorting separately on buy versus sell initiated trades.

- Can you offer more convincing evidence to reject alternative simple mechanism that both short sellers and institutional investors both react to negative news?

- Interpretation and link to ‘waiting game’ theory depends crucially on the negative correlation of the signals (I would think).

- Even if all the additional analysis confirms current results, is it sufficient to conclude that short selling constraints might make markets more efficient?

⇒ Link between short-selling and price efficiency (this paper) and the policy implications of imposing short-selling constraints deserves a discussion (and perhaps a theoretical analysis).