Ideas @ Edelweiss Multi Strategy Funds – Short Selling – Part I

This is Part 1 of 2 where we discuss short selling. In this month's Ideas @ Edelweiss Multi Strategy Funds, we discuss the many known challenges of short selling and in next month's piece we will present a counter thesis as to why short selling in an Indian context is easy.

Short selling is conceptually difficult for a number of reasons. Due to the equity risk premium, stocks have a tendency to rise not fall which means that short sellers are always swimming against the tide. Further more, there is no limit to how much a stock can rise, but it can only fall to 0. Hence, the theoretical risk of a short-seller is unlimited whereas his gains are bounded. This issue is compounded further by the fact that good companies can grow their way out of temporary valuation bubbles and asset prices can get manipulated upwards. This manipulation can be official through genuine insider purchases, open offers, buybacks etc. or unofficially through unscrupulous market participants. Distressed and broken companies can also frustrate a short seller by temporarily staying afloat through asset sales, QIPs, preferential allotments, rights issues, spin-offs of loss making divisions and various other financial engineering activities. The Street - analysts, brokers, investors and most so management are all structurally bullish, making short selling a psychologically difficult and lonely activity.

Practically speaking, short selling in Indian equities also faces challenges. The primary avenue for short selling is the single stock futures and options (F&O) market which have no liquidity beyond 1 month. This means that even medium to long term ideas need to be evaluated every month. Liquidity can be sporadic or non-existant and present in a non-random fashion. The F&O universe has only 163 names at present out of the 5,749 listed firms on the bourses. Truly awful companies may not even be in the F&O universe to short and a gruesome stock may be in the ban-list or may exit the F&O universe before the short thesis plays out. Initial margins for highly speculative and volatile stocks can be very high. For example, the initial margin for Financial Technologies after the NSEL fiasco was around 90% - almost completely eliminating any form of leverage. And roll-overs may be at sub-risk free rates or even at a discount (backwardation), which means that the carrying cost of a position may eat a material part of your upside if you are right. Lastly, shorts have negative compounding - if you are wrong, your position gets larger, if you are right your position gets smaller.

Why would anyone engage in such a challenging activity? Stay tuned for next month's edition of Ideas @ Edelweiss Multi Strategy Funds and we will tell you why.