When Short-Sales Were Outlawed

You ever watch one of those nature programs about some oceanic feeding-frenzy when the sardines or herring or some other poor schlep of a fish panic and form a tight ball in defense? Kind of makes you want to shout at the television, “Don’t form the ball!” because you know they are about to repeat an error their ancestors have been making since time immemorial, whenever that was.

I felt the same way in September 2008, when the SEC decided to protect markets by inhibiting their ability to engage in what financial theorists (Motto: Smarter than sardines, but not by much) call complete markets. In practice, they wanted to ban short-selling because, I don’t know, maybe people thought that firms requiring a sum total of $700 billion in taxpayer money to stay afloat were overpriced at some number greater than $0.

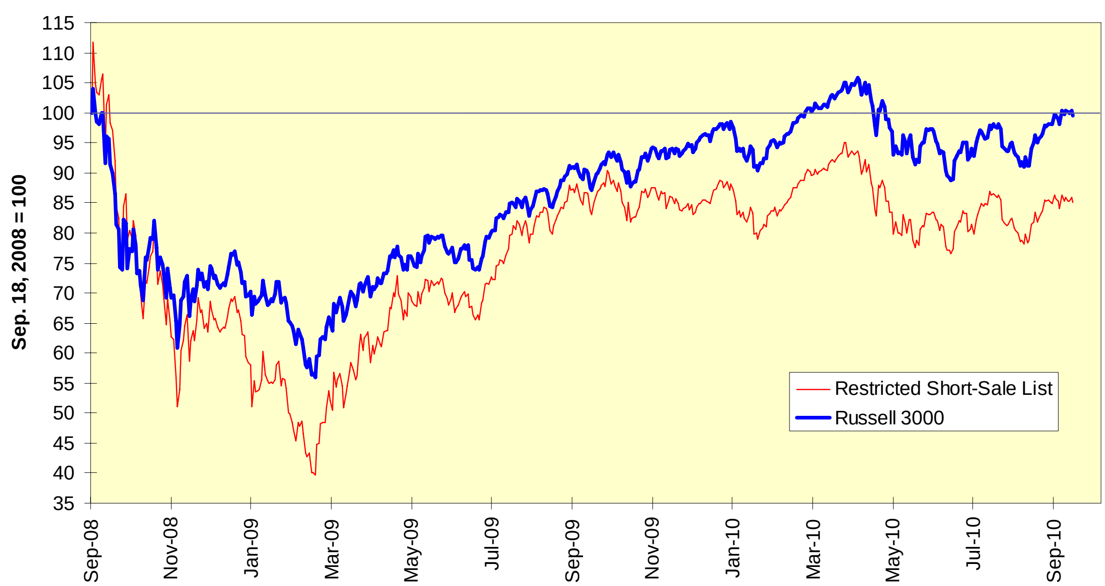
They put together a restricted short-sale list, which quickly expanded to more than 900 names. Predictably, option market makers, futures traders, convertible bond arbitrageurs, long-short funds, inverse ETFs could not function properly. While the restrictions were in place only between September 19 and October 8, 2008, inclusive, they managed to wreak havoc. This three-week period was the depth of the crisis.

Comparative Performance

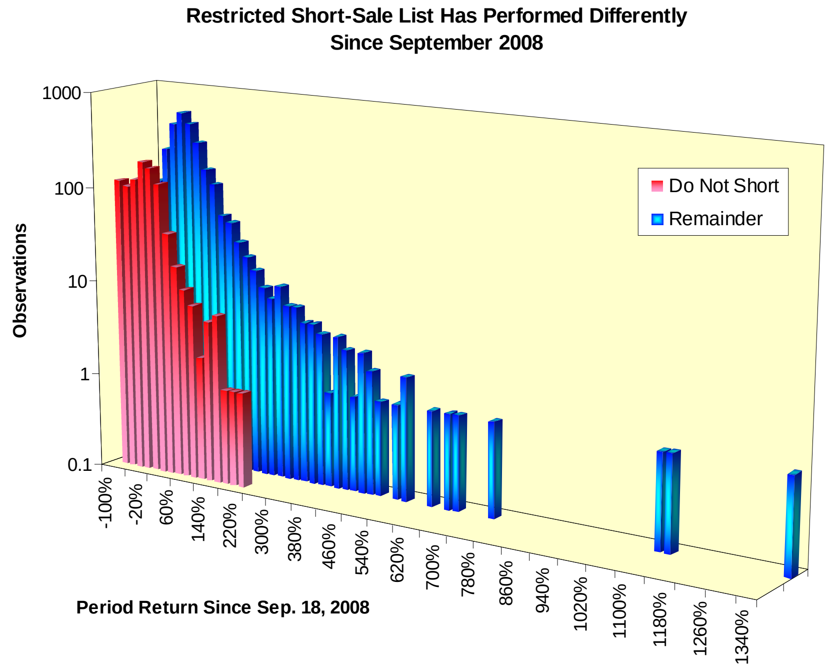
Our good friends at *Bloomberg* maintained this list of stocks, which provides me with an excuse for comparing how the restricted short-sale list has fared vis-à-vis the Russell 3000 index since then. Unsurprisingly, the restricted list has continued to underperform the broad market. This is what happens when the forces of creative destruction are forced into slow-motion operation.

Comparative Total Returns:

Restricted Short-Sale List Vs. Russell 3000



Now let’s look at a second comparison, the distribution of period returns for both the restricted short-sale list and the Russell 3000 ex that list. Please note how the upside for the restricted list hits a brick wall at 220% period returns; in contrast, the unrestricted remainder has a significant number of much greater returns.



As one of the principal differences between a stock and a bond is stocks have an embedded call option provided open-ended gains to the upside whereas bond returns are limited to coupon income plus par value if held to maturity, we must conclude the restricted list has traded as if someone removed its embedded call option. Without anesthetic. That was the Faustian bargain of that unhappy era: Uncle Sam used your money to provide an apparently free put option to these firms but that put option was financed by selling an out-of-the-money call option. We can see that implied strike price after two years has been a period gain of 220%.

There are no free lunches, either via banning short-sales or using a printing press to create money out of thin air. Somewhere the devil gets his due. Will the SEC and other regulators remember this the next time around? No more than will the sardines.