Use Futures To Go Short

The entire *sturm und drang* about naked short selling last week might have been interesting had it not been so unnecessary. Single stock futures (SSFs) can and have been used to do the exact same trade since November 2002. Advocates on both sides of the debate are arguing about the best way to escape a room whose door is and has been open.

First, let's take a little detour. Certain topics, such as gasoline prices and short-selling of stocks get people's blood boiling. I laid out some of my feelings on short-selling and the uptick rule in a March Columnist Conversation posting. Let's stipulate there are a number of short-sellers who engage in rumor-mongering and other tactics both reprehensible and illegal. Off with their heads! But let's stipulate as well there is an entire industry, including investment banking, brokerage and ratings agencies, devoted to the opposite on the long side and they have the full and unbridled support of the government and your tax dollars.

If you do not agree, consider the Federal Reserve's three pre-opening rate cuts in August 2007 and both January and March 2008, their assumption of Bear Stearns' garbage mortgage collateral in March and last weekend's willingness to extend the full faith and credit of the U.S. Treasury to Fannie Mae and Freddie Mac.

What effect does this have, you ask? To expand on another Columnist Conversation, on April 29, 2008, the cost of a credit default swap on ten-year Treasury notes was €9.7 basis points. It has more than doubled since that time to €20 basis points. Next, the yields on these Treasuries have risen steadily from the March lows while corporate credit spreads have increased as well; I noted in May the highly negative effects of higher realized borrowing costs on stock prices.

If anyone wishes to compare the total costs to you as a citizen and as an investor in the form of inflation, credit risk and misallocation of resources of the government's repeated interventions in financial markets to those of a few naked short-sellers of mismanaged investment banks and mortgage lenders, please let me know.

Using Single Stock Futures

If any of the below looks at all familiar, I wrote a series of columns on SSFs in 2001-2003 when I was involved with SSF development for NQLX (originally Nasdaq Liffe Markets); I now advise OneChicago on SSF issues and applications.

Let's distinguish between short-selling and naked short-selling. The former involves locating a stock, borrowing the shares and selling them; the latter skips the location of the stock and borrowing same. As option market makers in particular have emphasized in recent days, their ability to engage in naked short-selling until such time as shares can be located and borrowed is vital to their ability to function in today's electronic markets. Both market makers and normal short-sellers have a vital role to play in markets.

These short-sellers are exposed to a number of risks, including the risk of recall by the stock's beneficial owner. Moreover, the costs involved are non-transparent: The rebate of interest earned on the sale's proceeds is set bilaterally by the lender and the borrower and can vary from a near-full rebate on easy-to-borrow issues to a negative number for those stocks hard-to-borrow. It becomes like airline pricing where no two passengers may be paying the same rate for the same service.

Now if you go short the SSF several of these problems are solved instantly. First, you can go long or short the SSF in a vacuum, just the way you can in any other futures contract. If you go short crude oil futures, you do not have to locate 1,000 barrels of crude oil and borrow it first. The long side of this trade is engaging in an opposite commitment, to take delivery of 100 shares at expiration. The net price impact of you selling and someone else buying should be zero.

Second, futures contracts have a de facto European exercise; while you can offset your short position by buying the short futures position back prior to expiration, no one can force you to make or take delivery of the underlying 100 shares of stock prior to expiration. As an aside, SSFs differ markedly from most other futures in the percentage going to delivery; nearly 95% of the contracts are settled by making or taking physical delivery of the shares.

Third, the costs involved in SSFs are known and once the trade is made are fixed. The fair value of a SSF is the stock plus the short-term interest rate cost of carry minus the future value of the expected dividend. That fair value

is held in place by arbitrage; should the price of the future get driven down by short-sellers, it would be too easy for an arbitrageur to sell stock, either short or out of inventory, and replace it with the depressed SSFs. The opposite exchange of futures for physicals or EFP trade would occur if the price of the SSF got bid too high.

The difference between the stock and SSF price, or basis of the future, is best expressed in interest rate terms. Interactive Brokers has an online quote screen (go to the 'EFP Int' tab) showing both the highest and lowest interest rate returns across a number of SSFs. If a stock is hard-to-borrow, meaning the short-sellers have piled on en masse, these EFP rates should decline toward zero or go negative. This was not the case with any of the financial issues such as Bank of America, Citigroup, Goldman Sachs, Lehman Brothers, Fannie Mae, J.P. Morgan, Merrill Lynch and Morgan Stanley. These issues, all now part of the SEC's version of the Witness Protection Program, have active SSFs.

Those stocks with the highest interest rates may be subject to cuts in the dividend; as we subtract the future value of the expected dividend, so in subtracting a smaller number we get a higher SSF price. The June dividend cut by Fifth Third Bank was telegraphed by an unusually high EFP rate.

Fourth, going short with SSFs quite often is significantly cheaper than the conventional short-sale process. The short position in a SSF captures the net basis and the funds put on deposit as your performance bond or initial margin can earn a T-bill rate of return. The performance bond set at 20% of the current market value is a much smaller capital commitment than short-sale commitment of as much as 150% of the original sale. A detailed interactive calculator to compare these costs is available on the OneChicago Website.

Finally, we have learned the hard way credit quality matters. The Options Clearing Corporation, a AAA-rated clearinghouse (and a real AAA as opposed to some other AAAs we have seen) is the counterparty to each and every SSF trade. About the last thing you want is to have a representative of the FDIC standing on the hood of a car and shouting, "Please stop shoving! It's only money!" into a bullhorn in front of your counterparty's office.

Should you welcome the liquidity and transparency of SSFs and take comfort in the fact they make short-selling easier and cheaper? Well, let's answer that question with a question: You have had the same process forever in commodity futures, and have plunging prices been a problem there of late?