Please, Sell Single Stock Futures Short

Traders make this whole game unnecessarily difficult. After all, you can only buy or sell or you can only borrow or lend, and with only two choices, how hard can all of this be?

The answer, of course, is pretty hard indeed, and that is why many of the better traders in both futures and options concentrate their efforts not on the macro questions of whether the market itself is going to rise or fall – and hasn't that been a rewarding venture this year? – but on subtle relationships between various aspects of markets. Single stock futures (SSFs) are replete with these tradable features, which is why they are going to revolutionize, among other things, the entire securities lending business.

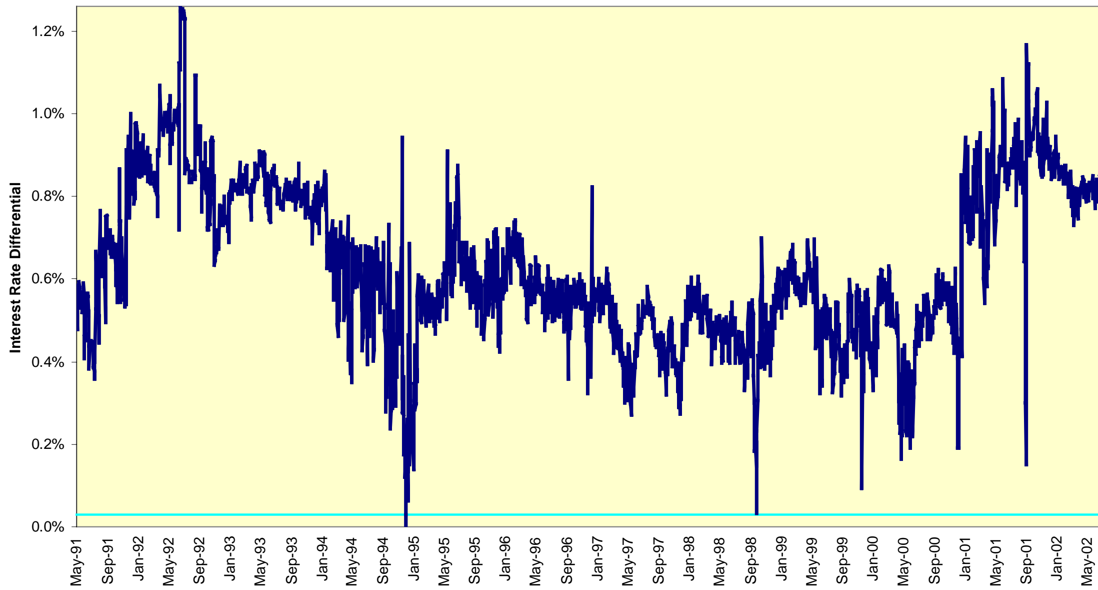
Stock Lending And Going Short
At this point in the bear market, most of us don't want to hear about new and improved ways of going short, and any paeans to market efficiency are unlikely to be greeted warmly, but the present system of going short in stocks is comic compared to how it is done in futures. In stocks, you first have to borrow the shares, and this means someone has to lend them to you. The supplies of stock are concentrated in trust banks such as Northern Trust, State Street or Bank of New York, and they are not particularly eager to lend them directly to entities such as hedge funds.

Instead, prime brokerages take on the role of locating shares, lending them out and assuming the borrower's credit risk. SSFs will replace this individual borrower credit risk with the AAA credit risk of the Option Clearing Corporation. This embedded credit swap and the financial safeguards created by futures' daily margining will lower the cost of going short and attract new entrants into the business.

The mechanics of going short in futures trading also will expand the market. In futures, as those of you who trade index futures know, all you need to do to go short is enter a sell order. You do not need to wait for an uptick, nor do you have to have the stock in question available for delivery; it is understood by all parties involved that while a short futures position indeed is an obligation to make delivery at the selling price, the seller in all likelihood simply will offset this obligation by buying the short position back.

Interest Rates
Before short-term interest rates head down toward Japanese levels – they actually got to 2 basis points, or 0.02%, in the Land of the Rising Sun and Sinking Stocks – let's take a look at how borrowing and lending is accomplished in futures. We should expect SSFs, in the front month at least, to trade at the stock's price plus the short-term interest (repo) rate minus the expected dividend yield. This is because you do not tie up funds in the future as you do in the stock, but the stock's owner, not you, receives the dividend. The difference between the SSF and the stock is called the "basis" of the future; if the basis is identical to the interest minus the dividend, it is said to be at fair value or full carry.

We can compare the net interest rate picture for buying a stock on 50% margin and buying the single stock future. The stock buyer can borrow 50% of the purchase at broker loan and post T-bills with a 10% haircut for the balance. The SSF buyer is borrowing at the repo rate and will forfeit 10% of the T-bill's return in a margin account. The dividend effect is equal in both cases.



The short seller of a stock receives the funds, which can earn T-bill interest with a 10% haircut. The seller of a SSF will earn the repo rate of interest built into the basis. Once again, the dividend effect is equal in both cases. At present, the low level of repo rates eliminates the normal interest rate advantage for going short in SSFs.

Rebates

Prime brokerages normally rebate part of the interest of short sales to the seller. Despite our era's penchant for creative accounting, you can't borrow and sell short the same shares twice. So, when a stock is in great demand by short sellers, they frequently forego part of that rebate, or even pay for the privilege – a negative rebate - of going short on an issue. Owning a stock with a negative rebate is like being in a swimming pool full of sharks but without the sense of decorum.

These low and negative rebates will not occur in a vacuum. For reasons not explained here [ ], we should expect the forward curve of that stock's SSF to trade at less than fair value, and we should expect the volatility of that stock's options to rise.

For those who have wondered how and why the SSF market will grow, consider this: Not only will the futures be linked to the stock, but the shape of their forward curve will be linked to the rebates between prime brokers and short sellers, and both of these will be linked to the option market.

These multiple levels of arbitrage and intermarket relationships will create a very active trade based not on the simple decision to buy or sell the stock – hey, that's easy, right? – but on more subtle factors. This is far more than an academic interest for the individual trader; just as has been the case in a wide variety of markets ranging from convertible bonds to foreign exchange, it is the liquidity supplied by these professional relationship traders that makes a market possible for individuals.