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The Short Squeeze: The 'Invisible' Cost of Short Sales

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Abstract

We study a risk-neutral trader's decision to short an overpriced stock. A short squeeze occurs when a sudden increase in the price of a stock escalates due to the short sellers' heightened demand for the stock to cover their existing short positions. We model how the potential squeeze limits the short position before the short-sale constraint becomes binding. Using the CRSP data, we empirically confirm the model prediction that the probability (cost) of a short squeeze is higher (lower) for stocks with greater liquidity. Short squeezes thus serve as an "invisible" cost of short sales, limiting the scope of arbitrage.

Keywords: Short selling; Short-sale constraint; Short squeeze; Limit to arbitrage

JEL Classification: G10, G12

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