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Betting on the Likelihood of a Short Squeeze

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Ilias Filippou (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=1778008)
Washington University in St. Louis - John M. Olin Business School

Pedro Angel Garcia-Ares (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=1926425)
Instituto Tecnológico Autónomo de México (ITAM)

Fernando Zapatero (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=37875)
Boston University - Questrom School of Business

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Abstract


A growing body of literature argues that skewness-seeking is an optimal investment strategy under plausible conditions. Yet, the difficulty of estimating skewness leads many investors in this category to look for proxies, some of which have also been documented in previous work. In this paper we show that indicators of possible short squeezes provide another such proxy and motivate skewness-seeking investors to buy call options --preferred to the stock for this purpose, as also shown in the literature. The baseline analysis uses a novel measure of feasible --yet low probability-- short squeezes in the near term, and the main result is corroborated using standard information related to short interest. As in similar instances, investors are willing to pay a premium for the upside potential. This type of investment strategy has attracted much attention recently, but we document that it has been used for decades.

Keywords: Short Squeeze, Anomalies, Limits to Arbitrage, Options

JEL Classification: G11, G12, G14, G32

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