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Days to Cover and Stock Returns

Harrison Hong, Weikai Li, Sophie X. Ni, Jose A. Scheinkman & Philip Yan

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The short ratio - shares shorted to shares outstanding - is an oft-used measure of arbitrageurs' opinion about a stock's over-valuation. We show that days-to-cover (DTC), which divides a stock's short ratio by its average daily share turnover, is a more theoretically well-motivated measure because trading costs vary across stocks. Since turnover falls with trading costs, DTC is approximately the marginal cost of the shorts. At the arbitrageurs' optimum it equals the marginal benefit, which is their opinion about over-valuation. DTC is a better predictor of poor stock returns than short ratio. A long-short strategy using DTC generates a 1.2% monthly return.

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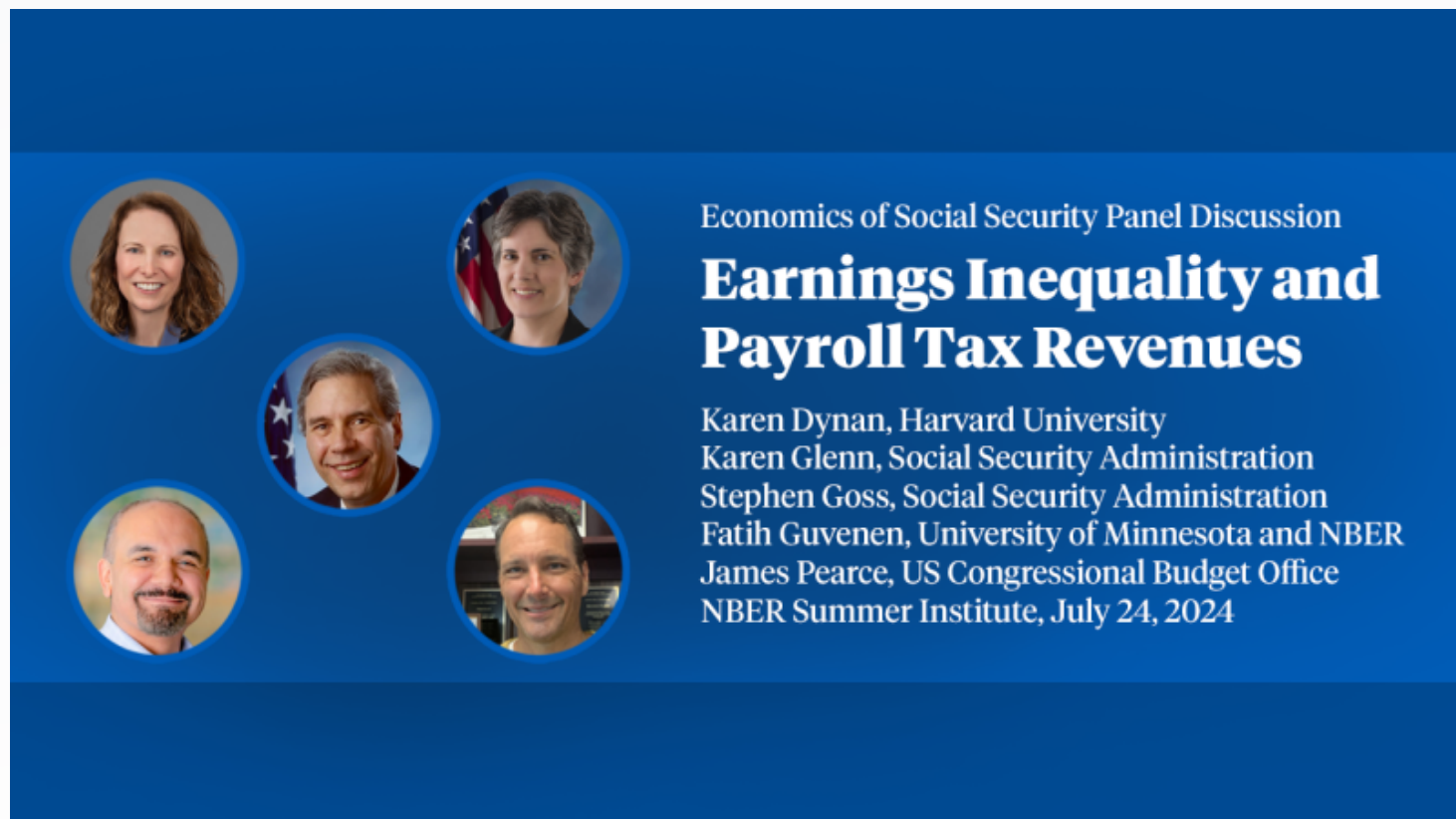
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Contact Us

1050 Massachusetts Avenue

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