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Short Selling and Common Stock Prices

J. Randall Woolridge and Amy Dickinson

An analysis of overall market data and of individual companies traded on the NYSE, Amex and OTC markets indicates a positive but statistically insignificant relation between changes in short position and stock prices (even after accounting for market movements and risk). Short sellers, on average, do not earn abnormal returns. Furthermore, the relation between short selling and stock price does not seem to be materially affected by whether the stock is traded on the NYSE or Amex or over the counter.

The results provide strong evidence refuting the popular notion that short sellers earn abnormal profits at the expense of less informed traders. Short sellers do not appear to drive prices down through their short sales. In fact, if anything, short sellers provide market liquidity by shorting into up markets and reducing short positions in down markets.

While short selling has been an accepted form of trading in markets for centuries, it has come under increased scrutiny by regulators and the media in recent years as some market observers have blamed it for increased market volatility and declines in both the overall market and individual security prices. This article evaluates the short sales-stock price relationship, focusing on three issues related to short selling:

- Do short sales, in and of themselves, affect security prices?
- Is a high level of short interest a bullish or bearish indicator for stock prices?
- Do short sellers, on average, earn abnormal returns?

These propositions are tested in two phases. Initially, to assess the overall short selling and security return relationship, we evaluate monthly short sale and stock return data for the NYSE, Amex and NASDAQ markets. Then we analyze monthly short sale data and stock returns for individual companies using a random sample of 100 NYSE, Amex and NASDAQ companies. The study covers the 1986-91 period.

Overall, the results provide strong refutation of the popular notion that short sellers earn abnormal profits at the expense of less informed investors by artificially driving down stock prices. We find, on an aggregate market level as well as the individual company level, a positive relation between monthly short-selling activity and stock returns. The positive relation between short selling and returns for individual companies holds when

both short ratios and short interest are regressed against raw as well as market and risk-adjusted returns. While these findings do not imply a causal relation between short-position changes and stock returns, they do indicate that, on average and on a month-to-month basis, short sellers are selling as stock prices are going up and reducing short positions when stock prices are declining. Other tests show that a high level of short interest is not necessarily a bullish or bearish indicator for stock prices and that short sellers do not, on average, earn abnormal stock returns.

SHORT SELLING IN THE EQUITY MARKETS

Figure A shows monthly total short interest (in millions of shares) on the NYSE, Amex and NASDAQ for the 1986-91 period. While short interest increased in all three markets over the period, the NYSE experienced the most volume and growth of short interest. Also evident on the NYSE is a pre-Gulf War increase in short interest and a subsequent decline; no similar change is evident on the NASDAQ or Amex.

It also appears that the volatility of short interest was greater on the NYSE than on the NASDAQ or Amex markets. Figure B shows percentage changes in monthly short interest for the NYSE, Amex and NASDAQ. Monthly percentage changes declined slightly.

Figure C provides monthly short interest ratios (SIRs) for the NYSE and NASDAQ for the 1986-91 period. SIRs in both markets increased, with the SIR for the NYSE averaging nearly twice the SIR for NASDAQ over the entire period and being somewhat more volatile. Overall, the 1986-91 data indicate that short interest and SIRs are greater and more volatile for the NYSE than for NASDAQ.

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