Publish date

Short-sellers caught out by higher costs

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Published: July 16 2008 22:38 | Last updated: July 16 2008 22:38

The cost of borrowing shares for short sales on Wall Street has been rising steeply in recent weeks, hampering the ability of hedge funds and other sophisticated traders to profit from market declines.

The Securities and Exchange Commission on Tuesday revealed emergency action to clamp down on abusive short-selling, making it more difficult for traders to engage in so-called "naked" short sales of leading financial firms.

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Short sellers aim to profit from share declines by selling shares and then buying them back in the market at a lower price. In a naked short, they sell shares without having made arrangements to borrow them first.

However, the SEC clampdown, which takes effect on Monday, comes against the backdrop of sharply higher borrowing costs for shares – a development that has made it very difficult to short well-known names such as General Motors, traders say.

"It has become much tougher as the number of funds that want access to stock has gone up," says the head of prime brokerage at one Wall Street firm. "And stocks these days get hot much more quickly, which makes it even tougher."

The rise in shorting has been largely caused by the growth of hedge funds, which account for most of the activity. Hedge funds that both buy shares and sell them short account for about 40 per cent of the $3,000bn in hedge funds globally, according to Hedge Fund Research.

The rise of so-called 130/30 funds, a modified from of long/short fund, has contributed $100bn in the past three years, or about another $30bn or more deployed in short strategies.

Shares sold short rose four-fold to $5,000bn in the three years to 2006, according to research from the London Business School, and the price of shorting rose about 300 per cent.

Generally, hedge funds borrow shares from money managers such as Fidelity or Barclays Global Investors to make short sales. But even as the demand for shares to borrow has grown, money managers are cutting the number of shares they lend for fear of depressing the market and of not having enough shares on hand to meet their own needs.

Hedge fund managers say they are worried about getting calls from brokers or money managers asking for their shares back, which could lead to a so-called "short squeeze" in which bearish investors have to buy stock to cover their short positions.

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