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A short history of our most maligned trading technique

STIRLING LARKIN THE AUSTRALIAN 12:00AM August 27, 2016

Abraham Lincoln once began a letter by saying “everybody likes a compliment” and if we were to award one to the global economy following the Great Recession, which began late last decade, we could congratulate it for “restoking” multi-asset international market valuations to record high levels.

But that is where the gratuities end, because for global investors there is little else to celebrate nor congratulate and for Australia ultra high net worth investors, the tradecraft of short selling, or “shorting” has returned as both a viable and preferable trading tool during these particular times.

Short selling is the sale of any security or asset that is not owned by the seller, or that the seller has had to borrow. It exists as a legitimate investment activity, which plays an important role in supporting efficient markets.

Even more importantly for Australian investors, enjoying the liberty and ability to express a market view by participating on either the long (buy) or short (selling or shorting) side serves us all well by ultimately delivering us what is referred to as “price discovery”, or put simply, where the true market value should lay for any given asset or valued exchangeable.

But despite this legitimacy, “shorting” remains a cultural and at times, professional evil; the film, *The Big Short*, played on this stigma, even though the “evil” within that story wasn’t the people shorting, it was, in fact, the investors going long (buying) credit default products.

Like any progresses, change comes wedded with resistance and disdain and one only has to recall the similar experience with futures contracts during the 1980-1990s to recant *deja vu* — futures are now accepted across the mainstream as both *bona fide* and beneficial to market microstructures and operations.

So ignoring the stigmas, why consider short selling at a time such as this? As discussed in this column often, markets in basic summary are supposed to silhouette real economies sitting behind them and the classic model suggests that stereotypical business cycles loop every seven to nine years: It has been exactly eight years since the midpoint of the Great Recession.

Given this, markets, being forward-looking and predictive, are structured to

predicate, pre-empt and forward allocate for future expected outcomes. Of course, we all appreciate and accept that in this era of unconventional monetary stimuli, classic silhouetting doesn't actually materialise in practice, nevertheless, all real economies that present development markets appear to continue expressing business cycle attributes which allow us to predicate investment decisions — all but Australia, which hasn't had a technical recession since September 1991, doesn't appear to have one anytime soon and has become somewhat detached from the tenets of the underlying real economy. Australian ultra high net worth investors accept that global markets — oddly across almost all asset classes simultaneously — present as “toppy”, stretched, expensive and unjustifiably stable.

Accepting this, returns must continue to be yielded and shorting elevates in importance for consideration. Also, since the turn of the millennium, since the Great Recession and even over the past 24 months, newer and cleverer ways to express short views have become accessible and practical for both retail and institutional market participants, globally and here in Australia. Regardless of how a short is achieved, the tradecraft of shorting is different than long participation, if only at prima facie on a heuristic and behavioural basis.

Shorting “naked” — the practice of short-selling a tradable asset of any kind without first borrowing the security or ensuring that the security can be borrowed, as is conventionally done in a short sale — in particular unnerves many, including those experienced enough to know that naked shorting is no riskier than going long with one's own capital (going naked with other's capital, is a different premise). It must ultimately be remembered that markets turn, they flip and the savvy among us need to switch-step from bearishness to bullishness at the drop of a pin.

Becoming perennially bearish can become addictive and it does become a honeypot-trap for many (including yours truly on occasion).

Markets are not shadows of real economies, they are silhouettes. Going long, going short, being bearish and then, possibly, bullish, are all interchangeable characteristics of a successful, enduring and balanced global investor. Short selling may not be for everybody but during a time when options continue to narrow and risks amount, affording oneself a useful, dependable and lucrative market investment tool seems nothing short of clever.

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