XPS Investment

Does the GameStop experience highlight a need for pension schemes to avoid 'short selling' investments?

We have recently seen a small number of sharp and very large stock market price moves in individual names. These moves have punished the short positions taken by some institutional investors resulting in significant losses over the last couple of weeks.

This current episode re-raises the question of whether shorting is simply too risky to be used within pension scheme investment strategies. In this short note Simeon Willis takes a look at the issue of short selling for pension schemes.

The background to GameStop

One of the most prominent of the recent short selling news stories has surrounded GameStop – a struggling but loyally followed bricks and mortar US video game retailer. GameStop's stock had become well known for being 'shorted' by hedge funds. An uprising of individual investors, united by messages on the social media portal 'Reddit', sought to fight back, buy the stock and push its price up to force losses on the short positions. This has been highly effective, at one point leading to a price rise in the stock of over 1700% since the start of 2021. This has imposed heavy losses on those hedge funds who were short the stock, as their stop-loss controls forced them to close out their positions.

This is reminiscent of 2008 when a similar issue arose with VW stock, which caused significant losses on hedge funds, albeit prompted by the purchase of shares by Porsche. This contributed to the subsequent deleveraging of the whole hedge fund market witnessed following the global financial crisis.

What is shorting?

'Shorting' is where investors bet that the price of an investment will fall, as opposed to a 'long' investment where an investor is rewarded from a rise in the price.

Shorting is a commonplace approach and many pension scheme investment managers employ the practice for different purposes. Given the scope for such wild market moves the recent market experience raises the question: ***"Is shorting an activity pension schemes should be participating in?"***

Simeon Willis – Chief Investment Officer

Different types of equity shorting

Within the equity market, you can:

- **short sell a stock that you don't own** to bet against that stock, which is a 'net short' strategy;
- **sell-short one stock you don't like and buy-long another stock that you do like**, which is known as a relative value trade;
- **use derivatives to sell a basket of stocks** such as the FTSE 100 to short the market as a whole; or
- **use derivatives to sell a basket of stocks** such as the FTSE 100 to **remove exposure that you already own** elsewhere in your portfolio – this would be a risk reducing trade or a 'hedge'.

Should pension schemes enter into short equity positions?

One angle is that pension schemes are investors, and as such they should be looking to place capital in the real economy to drive productivity growth and deliver value which is shared with both the wider economy and the pension fund itself – a win:win situation. The pension scheme benefits from its good investment decisions and the underlying company benefits from being funded to do something that is valued by society.

The issue with shorting is that as an activity it does not directly serve a purpose in efficiently allocating capital. Unlike the win:win for traditional long investment, for every correct shorting bet, there is one winner and three losers: the winner is the shorting investor but the losers are the party that have lent the stock to the short seller, the party that bought the stock off the short seller, and the underlying company itself. It also creates an environment where investors want companies to fail which is difficult to consider to be constructive, particularly in the context the now widely accepted role of investors in driving positive change in companies.

One of the arguments in defence of short selling is that is allows better pricing of stocks as it factors in all market participants' views and that it can also be a powerful tool in efficiently managing portfolios.

Taking a position in a stock in the hope it fails seems very much at odds with the now widely accepted role of investors in driving positive change.

The pros and cons of different shorting strategies

There is a wide range of shorting approaches used in the market with a wide range of opinions. We focus on two commonplace examples below:

Long/short investment

This is a fundamental approach within the hedge fund and absolute return fund market.

A long/short investment typically has little or no directional market exposure, meaning they don't benefit from market risk premiums such as the equity risk premium. Therefore the investor needs to be taking active decisions which are better than the average investor. Being above average is a relative measure and is much more difficult than simply being knowledgeable or intelligent investors. By definition only 50% of the market will be above average, even if 95% of the market participants are intelligent.

This makes consistently winning with relative value bets difficult and in our view needs to be approached cautiously in light of this. As such, governance involved in monitoring managers that employ long/short strategies will need to be greater with a higher probability of manager turnover as your views on a manager's prospects for delivering performance change over time. There is also a higher probability of managers failing to deliver the desired performance than some other strategies. Where this approach is adopted we would encourage its use to represent only a modest part of a portfolio.

Hedging and risk management

Using short positions to neutralise or reduce risk **helps pension scheme investors manage assets more effectively** and we are strong advocates for using short approaches to achieve certain specific objectives. Examples include temporary hedging of equity exposure whilst key decisions are taken in relation to a scheme's long term strategy, or a fund manager using short equity futures to reduce exposure whilst selling the underlying investments more gradually to avoid excessive trading costs.

In conclusion

Shorting is a powerful tool, and one that can be used in ways that are both desirable and undesirable from an investor's perspective. It's an important tool for a number of routine pension scheme investment activities. Of greatest importance is having a full understanding of the application it is being used for and what this may mean for your scheme's risk profile and ongoing governance.

About us

XPS Pensions Group is the largest pure pensions consultancy in the UK, specialising in actuarial, covenant, investment consulting and administration. The XPS Pensions Group business combines expertise, insight and technology to address the needs of more than 1,500 pension schemes and their sponsoring employers on an ongoing and project basis.

We undertake pensions administration for over 920,000 members and provide advisory services to schemes of all sizes including 29 with over £1bn of assets.

For further information, please get in touch with Simeon Willis.

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