Two golden shorting rules

September 2018 – James Miller, Portfolio Manager

Short selling shares aims to profit from share price declines. Short selling is a very different proposition to going long. Not only is your upside capped, and downside unlimited – but you also have a to pay a fee to borrow the stock. The easy answer can be to exclude shorting from your portfolio completely. However, at Firetrail Investments we believe there are significant benefits to be gained from shorting, and that investors should consider allocating a part of their portfolio to shorting.

In the article below we outline ways to obtain short exposure through managed funds in Australia, and also two of the golden rules that we follow at Firetrail when uncovering opportunities for stocks to short.

How do I get access to shorts in Australia?

When looking at managed funds, there are broadly two categories of funds that offer shorting. In our view, the most important decision that investors in these funds must make is the overall level of equity market exposure desired. The two categories are:

1. **Market exposed funds**, or otherwise known as long short funds. These funds have a positive exposure to the equity market. The direction of the equity market is the best indicator of returns – if the equity market falls in absolute terms, then it is likely that these funds will have also fall. Common long short funds in Australia have 130% long equities, and 30% short equities – giving 100% equity market exposure.
2. **Market neutral funds** are funds where exposure to the equity market has been minimised or eliminated. These funds, such as Firetrail Absolute Return, have short positions equal to their long positions meaning the equity market exposure has been minimised. Returns are not dependent on whether the market is up 20%, or down 20%, but instead by whether the manager has chosen the right stocks to buy long, and right stocks to sell short.

Whilst I have narrowed down the funds to these broad two categories – within the categories there are managers with different styles (value, growth, pairs trading etc).

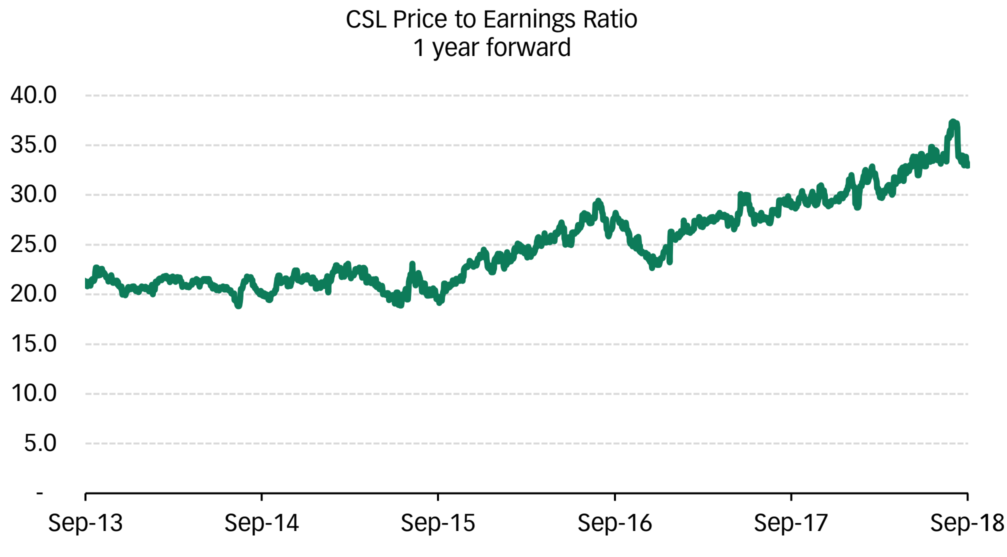
Two golden rules we have on shorting

Shorting is the opposite to going long. It requires a different psychology when investing. Our experience in shorting has provided two key lessons that are applied when finding shorting opportunities.

1. Ignore Valuation

Valuation can be a strong indicator signal to buy a stock as a long position. But it's not so good on the short side! Stocks can remain expensive on valuation for long periods of time….and even get more expensive. Holding a short position in a stock that has a high valuation can be a dangerous investment proposition.

Take a look at the case of CSL over the past five years. It's been a great performer – driven by not only earnings improvement, but also a significant increase in its valuation. This can be seen in the increase in the Price to Earnings Ratio from 20x to ~35x in the chart below:



Source: Factset

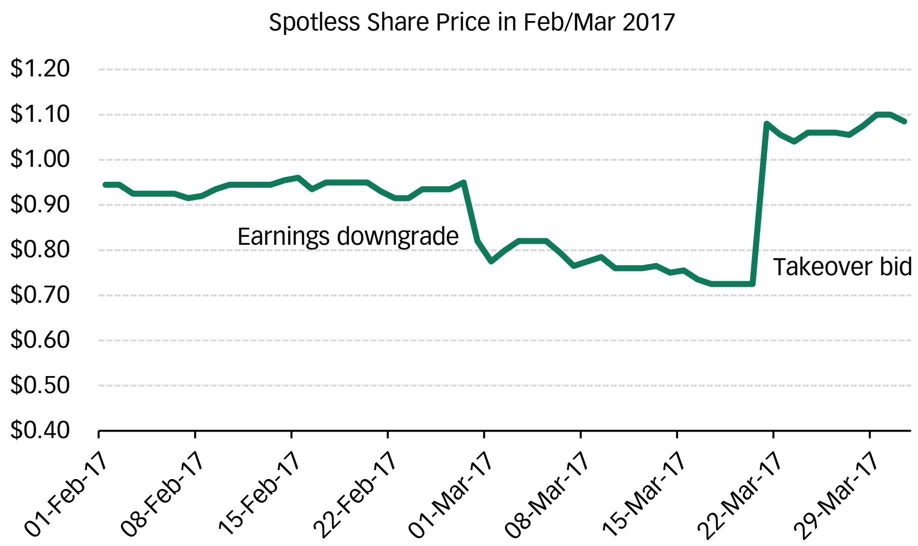
Under these circumstances it could be argued that CSL is expensive, and we do not necessarily disagree with this. But in our view, it will likely remain at its current level until we see a catalyst occur. In the short-term share prices tend to follow earnings, and a catalyst to short the stock would be if our research suggested that they would not meet market expectations. Currently this isn't the case for us – and CSL isn't a short position.

2. <u>Don't hold on to shorts forever</u>

"Time in the market, rather than timing the market" …….is not true for shorting!

Controlling your timeframe for shorting is critical – the longer you hold on to a short the higher the risk is that the share price will rise (and hurt your returns). We advocate holding shorts for a shorter period of time than you would hold most of your long positions. Be opportunistic in looking for the catalysts.

A great example of the importance of managing a timeframe is the example of Spotless, which was the subject of a takeover offer from Downer in March 2017. Just 3 weeks earlier, Spotless had reported its first half 2017 financial results, which had resulted in brokers downgrading earnings forecasts by 20%. The share price fell 18% over two days, and over the next 3 weeks the short interest increased to 6% of the company. It was then that the takeover bid from Downer arrived – at a 60% premium to the price at the time. A painful day for the shorts!



Source: Bloomberg

Holding on to a short position after a catalyst has occurred, like the Spotless earnings downgrade, is the riskiest time to be short. Not only are company boards and management under immense pressure to improve earnings and the share price, but it is also a time where possible suitors could make a play for the company. Managing the timeframe for holding a short position is one way of minimising this risk.

Shorting is a valuable tool

There is a different mindset required to short successfully. Not only can shorting be used to reduce levels of equity market exposure, but shorting can be a great contributor to returns in a portfolio when rules are followed.