Short selling: Wall Street Bets, John Maynard Boomer, BaFin, Fink and climate change

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Given the last week's flurry of short selling stories, from Wall Street Bets and Gamestop to Wirecard and BaFin, spiced with flow machine Larry Fink and BlackRock, we discuss the societal value of short sellers. We further elaborate on how this applies in bond markets and its potential usefulness for climate change mitigation.

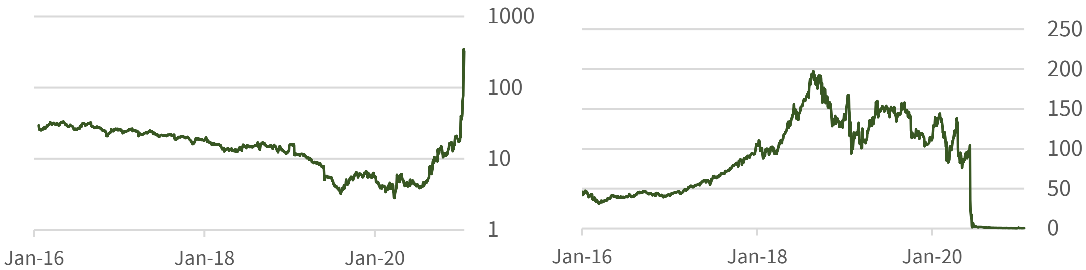
A classic short squeeze

In a masterly stroke of irony, the hedge-fund industry had its share of von Hayekian creative destruction this week, guided by the Keynesian paradigm "the market can stay irrational for longer than you can stay liquid."[1] The story around Wall Street Bets (WSB) and the GameStop ($GME) stock will be used to scare potential short-sellers for ages to come. Or perhaps more importantly, their risk managers. The idea for the trade of the WSB consortium was to attack oversized and imperfectly risk-managed positions of hedge-funds by driving up the price of GME stock to the point where losses for the short seller were so big that the funds had to liquidate their positions by buying back stock, and thus further drive up the price, for the gain of WSBers.

WSB AND KEYNES "MARKETS CAN STAY IRRATIONAL LONGER THAN YOU CAN STAY LIQUID."

This was a classic short squeeze. Was the hedge funds' original short position well motivated? Personally, I was surprised that Gamestop was still in business- I have not frequented their premises since the age of WiiU and have dependents well into their game consumption prime - and might have had sympathy with such positioning. However, it does not matter, as that original Boomer economist Keynes taught us: whatever the rationality of the original trade, you need to have risk capacity to hold onto the position.

Figure 1. Two sides of short-selling: Gamestop (left, log scale) versus Wirecard (right, €) share prices.



[1] For a brief and vivid depiction of the juxtaposition of Keynes and von Hayek, please see "[Fear the Boom and Bust- The Keynes vs von Hayek rap battle]". We are aware that the quote may not have come from the economist himself but ask for some artistic liberty.

The social value of short selling?

A broader debate has arisen, is this a social movement of a strange kind, bringing Representative Alexandria Ocasio-Corte and Senator Ted Cruz to express a mutual opinion?[2] Around goes a discussion about hedge funds' short positions being economically destructive. In many ways, it seems a Main Street vs Wall Street debate, where short positions and their hedge fund masters often are seen as being on the side of the latter. But is this true? **Reverse the question: do short sellers add any broader economic value? We would argue yes.** And we will rely on von Hayek rather than Keynes to make that argument.

The basic tenet of our view is that dying companies with broken business model will cling on to economic life draining the economic system of economic resources and infer bigger losses on investors (and society) than otherwise necessary. Von Hayek's "creative destruction" means that by more rapid destruction of dying economic entities, resources are freed up for other more useful purposes. In the context of portfolio management, one could look at it as the alternative cost of holding onto a position. The big loss for shareholders of Exxon stock may not be that their have fallen so much in value, but that had they been invested in something other - like an index ETF or Tesla stocks – they would have made large positive gains from that position instead. Had their stocks fallen quicker – driven by short-sellers - they might have moved their capital quicker to participate in other opportunities, and thus also been a more effective capital allocation mechanism.

SHORT-SELLERS SHORTEN AND REDUCE ECONOMICE RESOURCE ATTRITION IN UNMENDABLE BUSINESS MODELS

As an example of financial benefits of short selling, consider bond investors – which most of us are in terms of our pension allocations - holding bonds in a company in a prolonged and futile battle to survive. The longer the battle goes on, a process of asset attrition goes on, and the lower recovery values on the bond investment once the company finally defaults. A short seller that drives up cost-of-capital more quickly than the "natural" cost of capital (in times of quantitative easing, inverted commas are necessary) simply shortens the process. The effects of the Great Financial Crisis of 2007-2009 would likely have been worse if the system had not been challenged and allowed to keep on running without any short-sellers. Depending on your mood, you could express the bond short-seller as a "grim reaper", a doctor delivering euthanasia or amputating to cut away gangrene.

Almost as a thought, to prove the point on the economic usefulness of short sellers, last week threw a quite relevant example of short-selling and dire consequences into the limelight. On Friday, it was announced[3] that the head of the German financial regulator (BaFin) would step down, on the basis of severe mismanagement of the Wirecard disaster. Financial Times journalist have been investigating the now defunct Wirecard over fraudulent statements on their business. During some time of their

BAFIN'S FIGHT OF (IMAGINARY) SHORT-SELLERS IN WIRECARD LIKELY LED TO WORSE OUTCOMES FOR ALL STAKEHOLDERS EXCEPT FRAUDULENT MANAGERS

[2] See eg. https://www.cnbc.com/2021/01/28/gamestop-cruz-ocasio-cortez-blast-robinhood-over-trade-freeze.html.

[3] "BaFin bosses forced out over handling of Wirecard scandal", Financial Times, 29 Jan 2021.

investigative work, the journalists were charged by German prosecutors for being involved with short-selling hedge funds (with key position takers being of UK and Israeli descent[4]), in what can only be described as an attempt to help out Wirecard. The losses for the investors on Wirecard would likely have been smaller if short-sellers had been more aggressive, BaFin had not engaged in fighting them, thus pricing in the fraud at an earlier stage. The economic system would have been better off, had the locusts been allowed to operate, to use German politico-economic language.

As another example, short-sellers have a very central role in the history of Sweden's economy. The country ran an entirely unsustainable economic system in the 1980s and early 1990s. Debt-financing of an inert, inflexible, over-taxed economy. When the system broke, and radical transformation of it occurred in the early 1990s, it was not due to the willingness of the political system to do so, but of market forces – namely bond short sellers- forcing the system to transform. Change would not have been so deep and successful, had the country's politician not had the short selling pressure. The evidence is still out on whether European authorities banning of short-selling in the European sovereign crisis in the early 10s will be better for the long-term macroeconomic outcome for some of the nations involved.

SWEDEN'S MACROECONOMIC TRANS-FORMATION FROM 80'S ECON BASKET CASE TO AAA WAS CATALYSED BY SHORT-SELLING

Short selling is a dangerous gamble: in the same way traders land in 'gamble for survival', so do companies and their managements. Companies will fight short sellers especially in desperate situations: he optionality of fight or flight is reduced when there is nowhere to fly because the corporate jet has been impounded. But anyhow, short sellers can be, and often are, wrong, both in their fundamental assessment and then in their trading. Tesla short sellers will know. *But here we shall note a fundamental difference in short selling of bonds versus equities. Bond prices are (almost) mathematically bounded between 0 and 250. If you short sell a bond at $100, there is only so much that you can lose. Your position does not have the same downside as $GME or TSLA stock that can go 10000% in the wrong direction. So the distinction between fixed income and equities in terms of short-selling is important.*

SHORT-SELLING IN BONDS AND EQUITIES IS DIFFERENT DUE TO FUNDAMENTALLY DIFFERENT RETURN PROSPECTS

Short selling and the climate transition

Let us now turn to why short selling could have such an effect in the most important challenge our species might have faced: planetary climate change. The parameters are clear: we have a certain carbon budget, say 350 gigatonnes of CO2e emissions, to have a reasonable chance of staying within 1.5-2 degree targets. We are depleting that budget by around 35-40GT per annum. That pace is too high.

Many of the companies and other economic agents that are culprits of this excess rate of CO2 budget depletion are enjoying extremely low costs of capital right now. ExxonMobil

[4] "'Cultural background' of Wirecard short-sellers noted by German regulator", Financial Times, 7 Jan 2021.

raised 4.5bn of capital in near-zero yields from European investors in June last year,[5] in an instant and few questions asked. To put it gently, there does not seem that there is an abundance of short-sellers in such debt despite what is more and more starting to look like an obsolete busines model – if we listen to the scientists. But we believe such short strategies would be, if anything, the greenest strategies imaginable. And very likely profitable if structured smartly.

There is a slightly theoretical but useful limit argument in terms of fixed income shorting for this green impact. Let us start with a short-seller that is short some bonds in imaginary fossil producer Oxxen. Assume the short seller has an unlimited balance sheet and is looking to short-squeeze Oxxen.

Oxxen at this point is looking to raise debt capital. The going rate for debt for that is 4%. The company is running a negative cash flow,[6] so it needs the money and comes to the bond market to raise the capital. When she hears this, the short seller responds by offering all potential investors in Oxxen to be paid 5% on a contract tied to Oxxen creditworthiness. Ie. the potential Oxxen bond buyers get the same risk exposure as buying a bond directly but they get 1% more. Naturally the investors will then buy the 5% "bond" offered by the short seller.

PUMPING CO2 INTO THE ATMOSPHERE IS A LONG-TERM BROKEN BUSINESS MODEL. SHORT-SELLERS HAVE AN OPPORTUNITY IN HASTENING THAT MODEL'S EXIT.

In order to attract investors back – remember Oxxen needs the money to cover cash outflow – the company then needs to offer 6% in order to attract investors. But for our short-seller, armed with an unlimited balance sheet, offering investors 7% is straighforward. This goes on until the yields that Oxxen has to offer to get investors to lend it money are so high that Oxxen effectively becomes insolvent. Capital costs have become so high that the company is no longer a going concern. Oxxen cannot get the money it needs to serve its other debt, and at this point, Oxxen declares bankruptcy.

What has then been gained? The short-seller may or may not have made money on her original short position – this depends on the original size of their short vis-à-vis how much competitive capital and at what rate that capital was issues in order to make Oxxen come to this point. But the short seller's economic gain is of little relevance to the rest of us.

Instead, there is a societal gain. Oxxen is clinging on to a broken business model which is based on monetizing CO2 emission without paying for the negative externalities. The full cost to society is negative once you count those externalities, so Oxxen could in fact be considered parasitic economic factor. The short-seller in this case is simply cleansing the system of that factor, much faster than the system would have been able to do it itself. As noted earlier, this will not be without a fight. Oxxen is in a corner and will play all the tricks in the book to resist its demise (except fundamentally changing its business model).

[5] "Exxon Mobil creates Euro curve in one", Global Capital, 23 Jun 2020.

[6] It is straightforward to extend the argument to a situation where Oxxen is cash flow positive today, but where the company would become cash flow negative if it were to meet a higher cost of capital, e.g. through loan and bond rates.

End of January 2021 climate flow announcements

Finally, a short-seller's best help, which is also at the core of the Wall Street Bets movement, is flow. That is why the (future) flow announcements over the past two weeks on climate related risks could provide a fertile ground for climate based short-selling. Both the European Central Bank and the Federal Reserve have set up climate change committees. Whatever they might arrive at eventually, it will not be better than neutral for the funding costs and bond yields of carbon culprits. Larry Fink of BlackRock made (yet another) commitment to climate change. The contours of decarbonizing capital flows are appearing on the horizon and that can give impetus to a new kind of bond vigilante, helped by institutional flow from some of the biggest asset buyers in the market.

FLOW: THIS WEEK THE ECB, THE FED ANNOUNCED CLIMATE COMMITTES, AND BLACKROCK DEEPENED ITS CLIMATE COMMITMENTS.

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