Markets What is a *short squeeze?*

Why is this in the headlines?

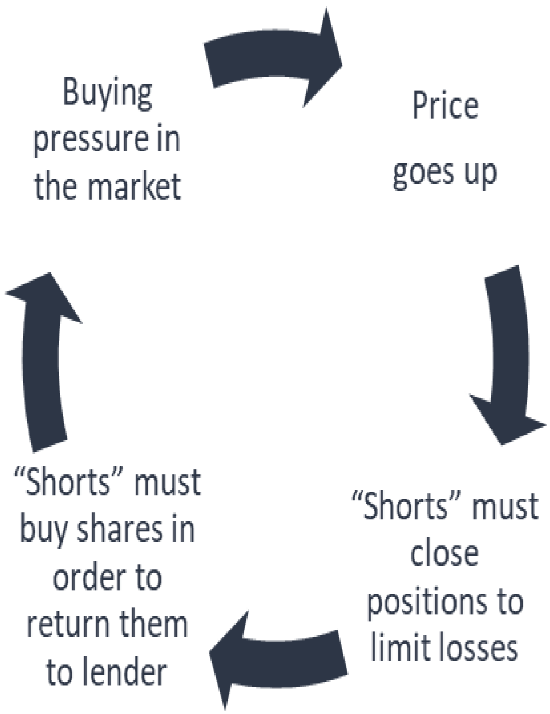
What is meant by a *short squeeze*? The phrase has grabbed attention recently as retail investors created a short squeeze on GameStop stock forcing prices higher and creating losses of $billions for some hedge funds. Do pension funds and asset owners need to worry?

A vicious (or virtuous) cycle

A Short-Seller ("*Short*") creates a short position by selling a borrowed stock. This means that at some point in future, the *Short* must buy the stock that's just been sold and return it to the lender of the stock. *Shorts* do this because they believe a stock will fall in price: They profit on the difference between the price at which they sell and the lower price they hope to pay when they subsequently buy it back and return it to the lender.

How does the trouble start?

Things can go wrong for the Short-Seller when the price goes up too much. When the price rises, *Shorts* make a loss. If the losses get too big, a *Short* may not be able to risk even bigger losses. That means that they are forced to close their positions to avoid losing any more. This is where the trouble gets bigger. Being forced to close a position means that the *Short* becomes a forced buyer of the stock (to return it to the lender and close the position). This activity puts buying pressure on the stock which pushes the price up further, increasing *Shorts*' losses; and so the *vicious cycle* continues as even bigger losses force more positions to close forcing prices up further.



It gets worse (or better)

Sensing a short squeeze, other investors also buy the stock, knowing that the *Shorts* will buy at almost any price. From their perspective, they have a *virtuous cycle* of almost limitless price rises. Eventually the price of the stock becomes dissociated from all sense of reality.

Should we be worried?

Some say that the ability to short stocks is a crucial element of allowing markets to function efficiently, allowing capital to be priced and allocated where it is most effective. Others say that it is a problem because it is opaque, can be highly leveraged and ultimately is a trade which profits from distress. Indeed it can sometimes exacerbate distress. Asset owners might worry whether the activities that are undertaken on their behalf are consistent with their mission and beliefs.

Do you need to do anything?

Many asset owners lend stock, in return for a small fee.

Asset owners that lend stock:

- Are facilitatators of short-selling
- May give up their voting rights on their investments

Being aware of this and developing policies around this is increasingly important. For example, pension funds are now required by law to show how they exercise their voting and engagement policy and whether stock-lending constrains them.

Short selling checklist

Is short selling in line with your mission and investment beliefs?

Does your investment strategy employ short-selling?

Do you facilitate short selling by lending your stocks?

Who makes money out of lending stock – you or your managers?

How do you vote and engage on lent stock?

How do you monitor stock lending and shorting?

Want to know more?

If you would like to learn more please get in touch. We can provide more detail around the mechanisms described here. We can also help you to address the questions above, ensuring that, mission, strategy and implementation are fully aligned.

"action follows intent"

(tPR DC Governance Guide)

Investment Governance Services helps pension funds and other asset owners to achieve better outcomes. We do this by becoming part of your team providing additional flexible governance resources at Board or Executive level.