Seed Weekly

14 August 2019

The Long and the Short of It

This almost feels like an obligatory opening statement, but it needs to be said : South African investors have been through a tough time.

Exposure to companies listed on the JSE, for the most part, have not been rewarding. Elsewhere it hasn't been much different. Had SA investors bought the FTSE 100, Eurostoxx 50 or ASX 200 indices, they would have seen a fairly similar outcome. It might not be fair to compare the SA equity market with developed markets, but SA investors do have some flexibility in where to place their money. For the most part, money not invested in SA would mostly be channelled to developed markets.

Over the past five years, the MSCI World Index was up by 7.66% p.a. The same index (excluding the US influence, the MSCI World ex USA Index) – was up only 2.68% p.a. over the last five years. Both exclude emerging markets and tells a one-sided story.

This has not always been the case. Over time, some countries have been more attractive than others, but only in the past five years has the gap between the US and the rest been opened up. It has been far easier to generate good returns by investing in US companies than anywhere else. Naturally, there have been solid results from individual companies outside the US, but it has not been nearly as broad. This is merely one perspective. For investors outside the US, and in SA specifically, there was opportunity for short sellers to make money.

Simply put, short selling is a way to make money through a falling share price. The basic mechanics is best explained by way of an example :

Investor A approaches **Institution B** and asks for a loan. The loan is not cash, but rather 10 shares (script) in **Company X**. The price of **X** is R 100 today. **Investor A** borrows the shares and sells them in the market at R 100, making R 1,000.

After some time, the price of **X** is down to R 50, and **A** decides to buy back the shares to return them to **B**. To buy back 10 shares at R 50 costs R 500, so **A** makes a profit of R 500 on this transaction. Conversely, if the share trades at R 150, and time has come to pay back the loan, **A** will have to buy back the shares at this price, costing R 1,500 and resulting in a loss of R 500.

It seems simple, but there are certain costs involved. **B** has no incentive to enter into this transaction, so they need to be paid interest on the loan. This will have to come out of **A**'s profit, or it might be added to the loss. Any dividends paid during the loan is also **B**'s due. This transaction will have third parties involved, mainly the broker. They will charge for their services but will also monitor the position.

At times, short sellers can be placed in a difficult position. The price of a share is determined by supply and demand. If there are more buyers than sellers, the price tends to go up (in the short term), and if there are more sellers than buyers, the price should go down. Short sellers can be forced out of their positions. In this scenario the share price would continue to go up, and if it goes up enough, some short sellers will be forced to buy back their shares at the current market price. If the broker does not force you to cover your position, they will at the very least require you to post additional margin (cash), which you are not allowed to invest (i.e. throwing good money after bad).

Recently, a company called Beyond Meat went public. They produce plant-based meat substitutes. The IPO was priced at $ 25 per share in May 2019, and the current price is around $ 163 (going as high as $ 239 during July). This surge post-IPO is clearly an anomaly, but it indicates a considerable interest in owning a piece of this business – much more so than the company could have known before going public. In fact, a secondary offering is being considered at $ 160. As you can imagine, the company and book-runners thought very long and hard about the company's valuation prior to the IPO and came up with a fair value of $ 25 per share. The market is pricing the

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shares at far more than that. Currently, the company is not profitable. The market cap is $ 10bn, while revenue is $ 88mn. It might very well be that the share is over-priced, and the market is being irrational.

All these factors make it seem like this is the perfect share to short. However, to date this has been a painful exercise for those who are short. Currently, this is the share with the highest short interest in the US, with 45% of the float having been sold short (click to read Beyond Meat Is Costliest US Short Bet After 700% Surge published by Bloomberg).

Apart from the fact that short sellers faced enormous losses from the price increase, it also became the most expensive share to short in the market. Lenders are asking a rate of up to 138% to lend script, according to this (click to read Beyond Meat still tops the list of most expensive short plays published by Market Watch).

Time for some DIY math: Let's say we sell some shares at $ 75 (which is already a massive price increase post-IPO). We then buy them back at $ 160 and pay three to four months' interest at 138%. That is a substantial loss and makes it clear that shorting a stock based on fundamentals is not necessarily a sure-fire way to make money.

Short selling has been in use for decades, but remains a risky business reserved for specialists. As part of a normal, functioning market it has its place, provided everyone remains aware of the risks. It is important to ensure that proper disclosures are made, ensuring that clients are able to make informed decisions on whether to allocate their own money to such a strategy.

Few are aware that ETFs frequently take on the role of lender in these transactions. It is clear why, as they are buy-and-hold investors according to the rules of the fund. There is no trading except for rebalancing back to their benchmark index. ETFs should have a large pool of shares that remain untouched for long periods, and sometimes they lend these out. In exchange they earn some interest to offset the tracking error against the benchmark index. In a well-functioning market with a responsible approach to investing this makes sense, as the holders of the ETF benefit from the transaction. The problem comes during times of market stress, when borrowers go broke. This happens during difficult times and could negatively impact the holders of ETFs.

These factors are worth considering, as excessive lending can be detrimental to the market during corrections. It is important to understand how the ETF, or any other security, operates before buying. As such, we are cautious about short strategies. At times it can be profitable, but picking out the losers ahead of time is challenging. In a bull market prices may dislocate from fair values for long periods of time. As the old saying goes, *"The market can stay irrational longer than you can stay solvent".*

We prefer to stay long, as there is plenty of profits to be made long-term if you manage to stay the course and remain invested. It is not perfect, but being invested in the right shares throughout market cycles will produce positive outcomes.

Kind regards,

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ADDITIONAL INFORMATION (where applicable)

Performance has been calculated using net NAV to NAV numbers with income reinvested. Full performance calculations are available from the manager on request.

DEFINITIONS (where applicable)

Annualised Return	Annualised return shows longer term performance rescaled to a 1-year period. Annualised return is the average return per year over the period. Actual annual figures are available to the investor on request.
Highest and Lowest Annual Return	The highest and lowest returns, since launch, for any rolling 1-year period have been shown.