Twitter Thread by Paul Enright



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a thread 1/It is not inconsistent to say “I love shorting stocks” but “hate managing a short book”. Let me explain.

2/Shorting means going to a PB like GS and borrowing stock in a co. you don’t own for the purpose of selling that stock. GS makes a lot of $ lending stock. Big liquid companies “cost to borrow” are a few bps but illiquid hard to borrow shorts can cost 50-90pct per year to borrow

3/All "hard to borrow" shorts IMO need to have a liquidity event in the thesis to make it worth the risk. Sometimes borrow can be recalled causing a squeeze and sometimes the cost of borrow can rise dramatically. And sometimes you can get a massive short squeeze.

4/For ex, in the middle of the GFC, Porsche engineered a short squeeze on Volkswagen stock using options. IN THE MIDDLE OF THE GFC WITH STOCKS DOWN 8-10 daily, VOLKSWAGEN WAS UP 30-50 a day, which is a good place pivot back to the risk of short ideas v short books.

5/Individual shorts involve individual idiosyncratic risk. Short books involve collective systemic risk.
A single stock can ruin a day, week, month, quarter or year. A short book can put you out of business.

6/A single short is usually 50 to 800 bps in size.
A short book can be 30 to 200pct of total capital.

7/A single short is a bottom up, fundamental exercise.
A short book is a top down decision based on a target gross and net exposure. If you want to run 250 gross with 50 net you will have to have a 100% of capital short book to pair against your 150% of capital long book.

8/Most decisions like this are made from the long side, ie, “I want to lever my longs I love so much and whatever the short is who cares as long as they don’t kill me”. That logic should be inverted. “Do I have a enough high quality, liquid shorts to fund a 150pct long book?”

9/ The answer is almost always no. So you back solve to get to that target short book by making illiquid shorts bigger than they should be, forcing shorts in liquid names just because they are liquid and won’t go up 100pct, and by creating baskets or outright shorting indices.

10/That is a top down decision by highly trained and skilled bottom up stock pickers. The model dominates. When the short book becomes more important than the short ideas, the risk manager alarm bells should go off.

11/The problem is risk is measured in a funny way. As vol goes down risk gets ignored but that’s when the tail risk becomes greatest.

12/The l/s model is designed to manage risk, but in the end, many use it to create more risk.