
Short Sellers Hiding in the Noise



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How a soft news story enables short sellers to hide their sales amongst the noise traders.

A short seller is often thought of as a slick Wall Street trader who doesn't mind making money as companies lose value and never considers the misery that may be at the other end of a **trade**. A hard, number-bound person, focused on quantitative information. With that in mind, you'd think that company news filled with data would be the type of story that encourages a short seller to trade.

In **"Why Do Short Sellers Like Qualitative News?"**, a paper in the *Journal of Financial and Quantitative Analysis*, we find that contrary to the expectation of short sellers trading more on news stories about companies' financial information, it's the softer, more qualitative news stories that gets them trading.

Short sellers – traders who borrow and sell stocks they believe will soon drop in price – are an interesting group for academics, not only because of how they are perceived, but because they are informed traders. They make up

one of the few groups of traders whose trades consistently predict future return, meaning that they generally get it **right**.

In our study, we find that short sellers trade more on days where the news is soft – more qualitative, less number-heavy. Using media coverage data from Factiva for the top 1,000 U.S.-based companies between January 1999 and December 2008, we created a measure of short sellers' trading activity, compared to the overall trading volume of a stock, to study the effects of media coverage on short selling.

Soft news contains few numbers; it is information about products, promotions, upcoming projects or strategy. In contrast, hard news stories are stories with many numbers: M&As, earnings statements, etc.

Soft vs. hard news

Why do short sellers trade more on soft news days? We considered two possibilities: They are better than most at interpreting soft news or they use the interest in a particular stock, generated by soft news, to mask their trades.

One possible reason for the proclivity of short sellers to react to soft news is that perhaps they are just smarter at interpreting the news. If there is a number attached to news, then its implications are more obvious; it stands out and the news is easy to figure out. In contrast, it may take more skill to interpret qualitative news. For example, an earnings report may be easier to decipher than an interview with the CEO describing business strategy. However, we find no evidence that short sellers are better at interpreting soft news.

The other possible reason is that short sellers don't gain information from either quantitative or qualitative news stories, but glean knowledge from other sources. To maximise the profit of trading on this information, short sellers would like to minimise their price impact, meaning that they would like to trade without altering the stock price. Their price impact is reduced if they can hide their trades amongst noise traders – those who trade without considering fundamental data about a security or firm. Such noise traders (for example less informed private investors) may be attracted to stocks with their interpretation of soft company news. If soft news stories attract noise traders and improve liquidity, this can give short sellers a reason to trade more on those days with soft news. We find evidence that suggests this is

the reason that short sellers increase trading in response to soft news.

In our paper, we examine how the liquidity of a company's stock changes based on the quantifiability of the news. We find that liquidity is higher on days with soft news. This finding makes sense: A stock is usually more liquid if there is more trading volume and there is more trading volume if people interpret the news *differently*. Opinion is a bigger factor in soft or qualitative news than in news about a company's bottom line. There is dispersal in the way soft news is interpreted, and therefore more trading. On the other hand, if there's a positive news story about a 2 percent earnings increase, the difference in interpretation is likely to be smaller since everyone agrees that the news is good. Thus, soft news increases liquidity more than hard news.

Informed traders, such as short sellers, can piggyback on this noise trading generated by soft news as a way to hide their informed trades. They trade more on days when there's more turnover in the market and thus reduce the price impact of their trades. By reducing their price impact, short sellers can make more money on these trades.

The Olympics effect on noise

To determine how short sellers behaved in a time without distraction, we focused on trades during the Summer Olympic Games, an event which would distract the noise traders from responding to company news. We chose the Summer Olympics because they attract attention without having much impact on the market, unlike global affairs, a terrorist attack or even an election, all of which could have important financial consequences. Stock prices don't react much to who wins the Olympics, but because it's a global sport event, traders are distracted for several weeks. In particular, it may affect individual investors, who we think of as making up a large portion of the noise traders.

We find that the effect of soft news on liquidity is completely eliminated during the Olympic Games. Therefore, during the Olympics, qualitative news does not matter to short sellers. We find that they react less to soft news stories than they do normally, because there is no cover.

Normally, without the distraction, soft company news causes noise traders to start trading. Short sellers either see this extra liquidity, or they see the news and know that there's going to be extra noise trading, and so they hide their trades amongst the noise, like hiding in a swarm of fish. When the Olympics

is on, the noise traders aren't buying or selling, so the short sellers stay away from the market too, as they have lost their cover.

Our results show how traders find liquidity and noise trading important and how news can be used as a liquidity enhancement. All traders should be aware of the short sellers in their midst, especially when they are attracted to information that is up for interpretation.

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