Don't Sweat the Clear Stuff: Mutual Fund Shorts and Research Intensity

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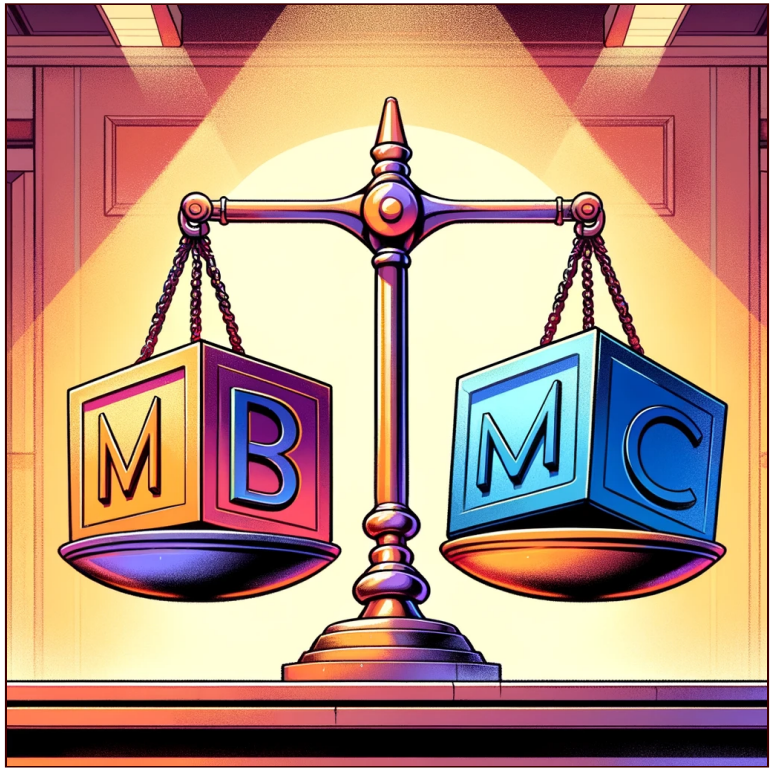

Information acquisition is determined by the MC and MB of becoming informed.

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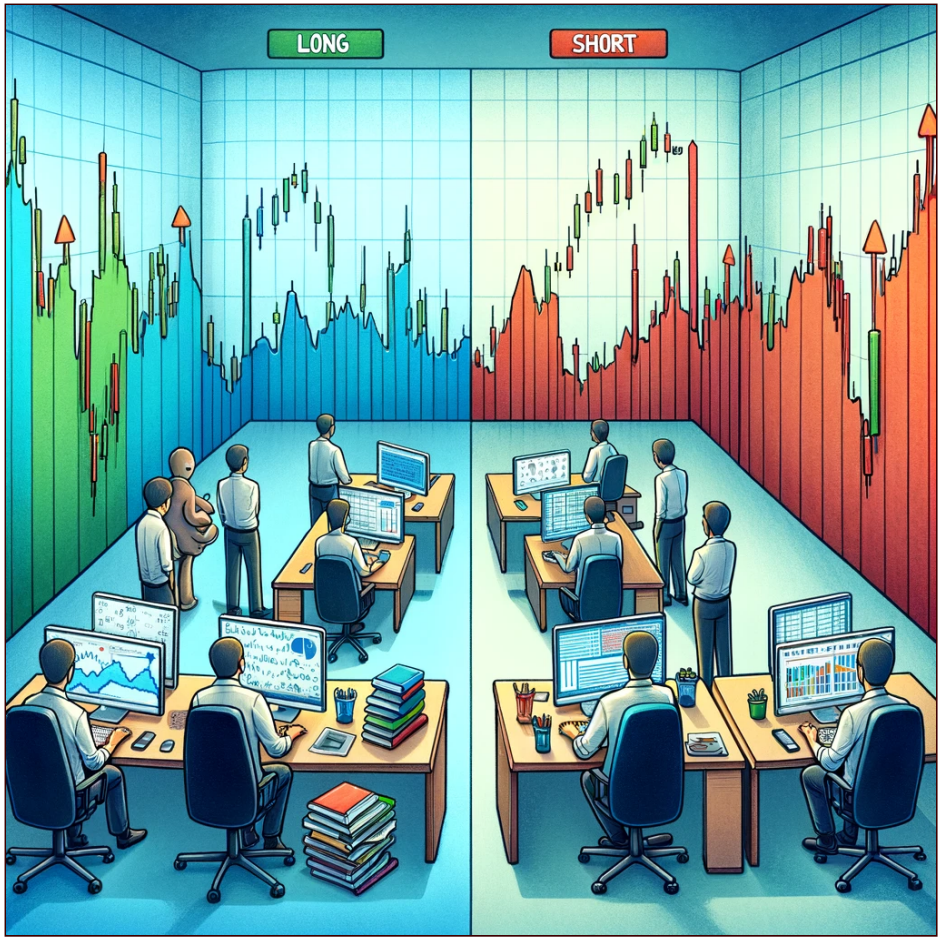
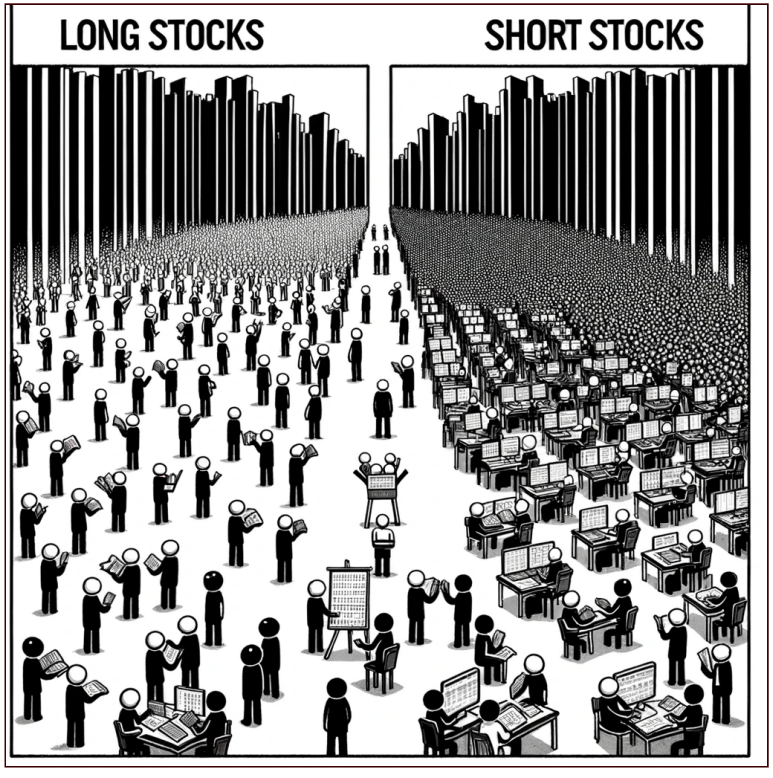
Shorts are informed, but we usually lump shorts together and call them short sellers.

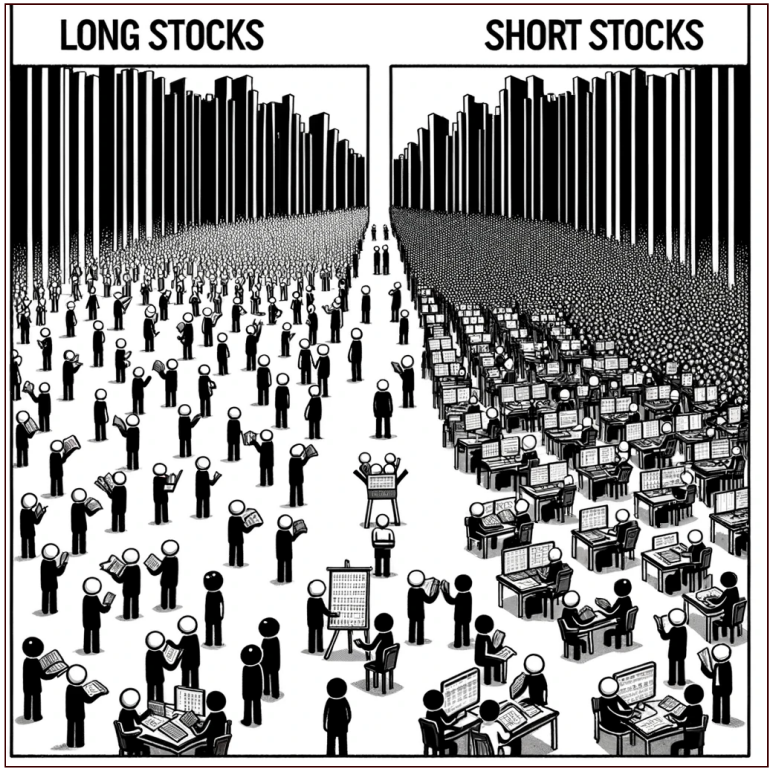
Common misconception that mutual funds don't short. Some of them do.

We combine all of these ideas to study the information acquisition activity, and the returns, for mutual funds' shorts and longs.





MFs learn more about their shorts than their longs.
5% more for shorts.



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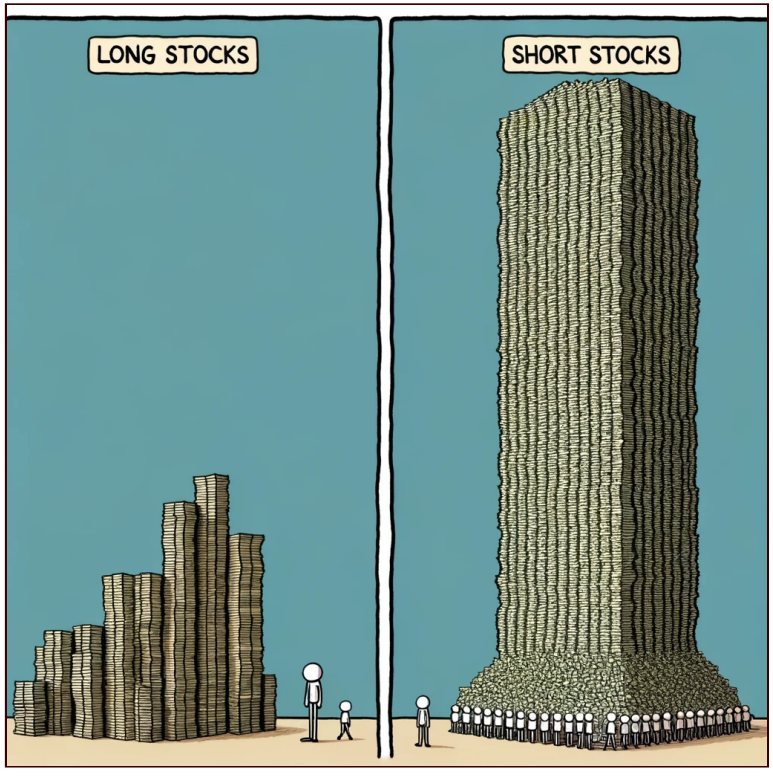
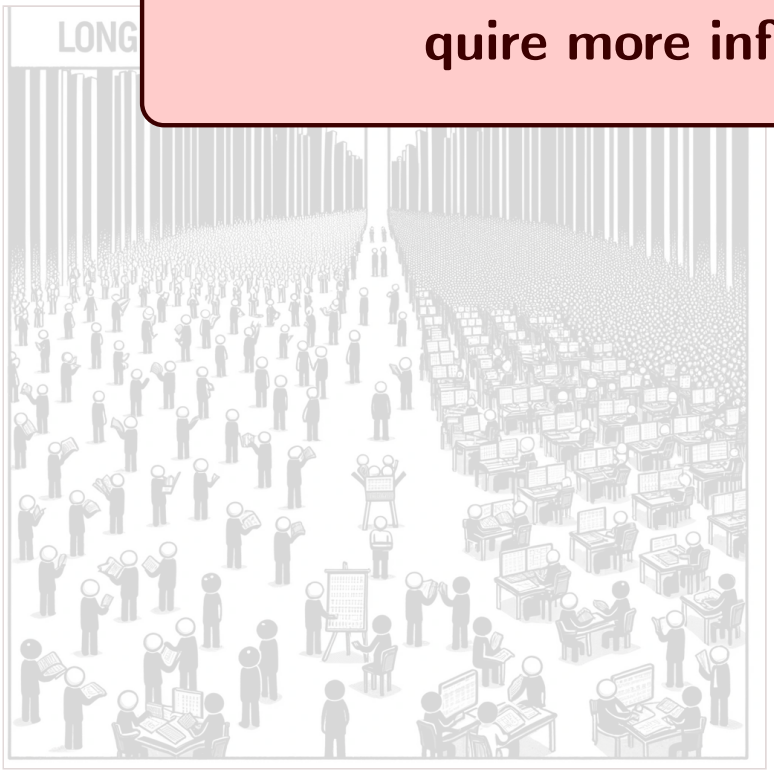
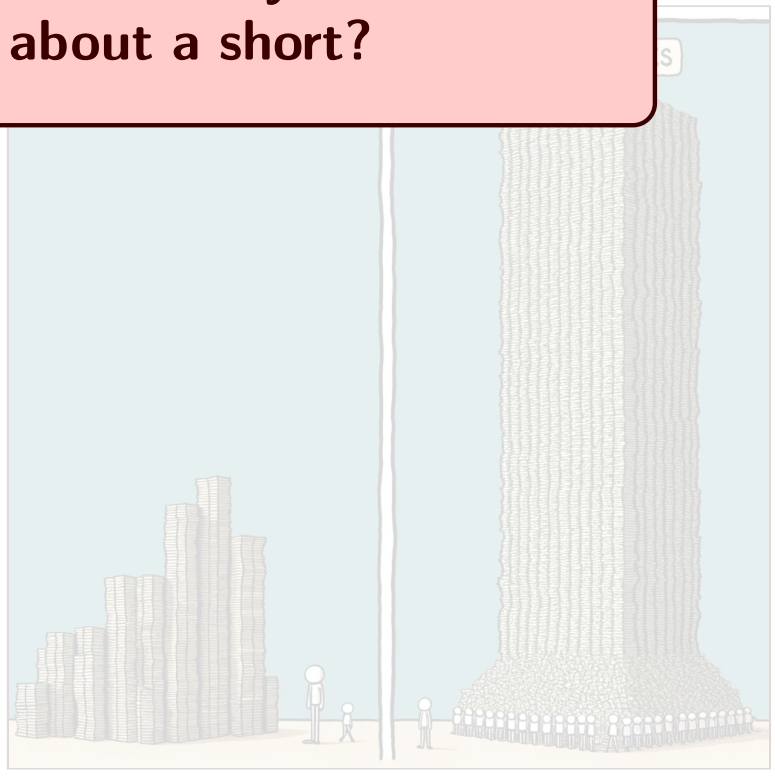


MFs do better on their shorts than their longs.
100bps more per quarter.

But... do MFs do better when they acquire more information about a short?





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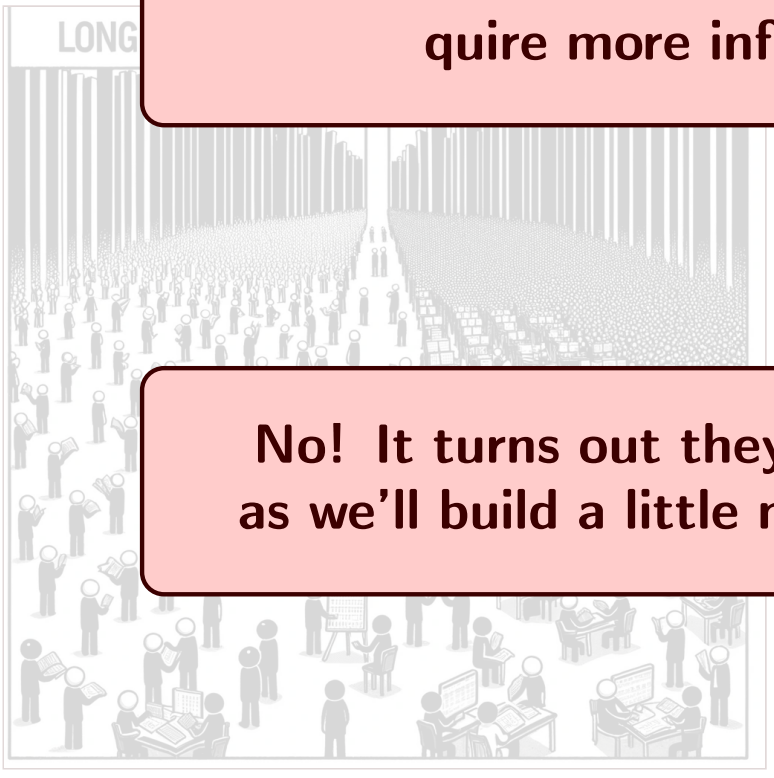

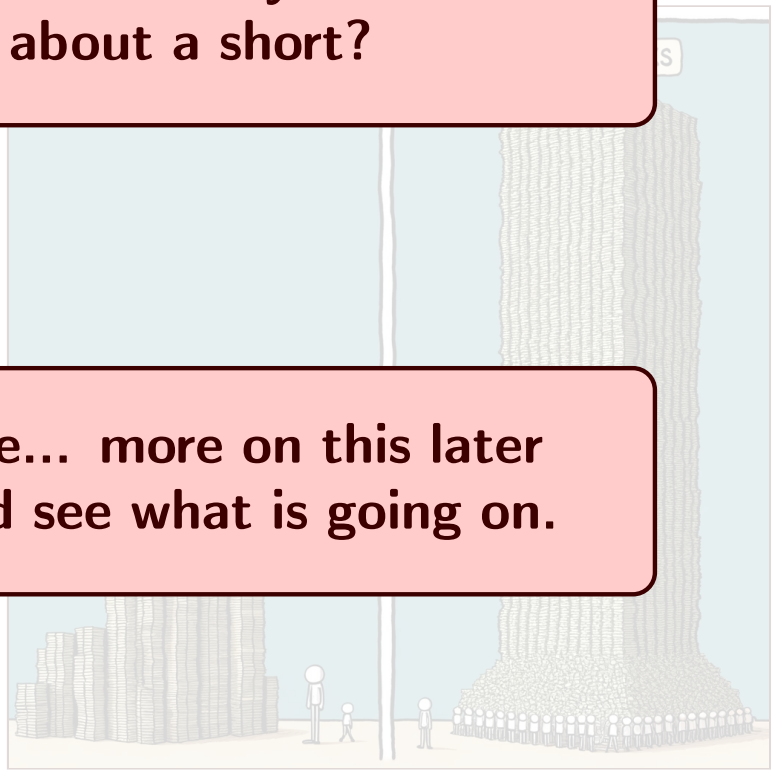

No! It turns out they do worse... more on this later as we'll build a little model and see what is going on.

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Outline

Two Main Sources:

1. EDGAR Log Files - hand-matched sample of IP addresses.
2. CRSP Mutual Funds - holdings data to ID long and short positions.

Other Sources: IBES, Thomson Reuters, Ravenpack, Morningstar, and the Stambaugh, Yu, & Yuan Mispricing Measures.

Sample:

- 4.9 million Mutual Fund Family–Stock–Quarter observations (2010–2017).
  - Survive the matching process.
  - At least one quarter where the Mutual Fund–Stock pair had a non-zero position.
  - Only mutual fund families that ever had a short position (55 of them).
  - 30 quarters.
- MFIA = LN of total requests from MF i for filings of Stock j in quarter t.
- Long and Short are indicators.

Important Variables:

- $MFIA_{ijt} \in \{Requests_{ijt}, Requests_{ijt,t-1}\}$
- $Long_{ijt}$ and $NewLong_{ijt}$; $Short_{ijt}$ and $NewShort_{ijt}$
  - A typicaly family makes between $1,000$ and $10,000$ requests per quarter.
  - 37% of observations are longs. 2% are shorts. The rest are no current position.

Two Empirical Facts

Question 1

Do fund managers acquire more information about their shorts than longs?

$$MFIA_{ijt} = \beta_1 Long_{ijt} + \beta_2 Short_{ijt} + \gamma_i + u_j + \omega_t + \epsilon_{ijt}$$

We are interested in β_1, β_2, and testing whether $\beta_2 - \beta_1 = 0$.

- $MFIA_{ijt} \in \{Requests_{ijt}, Requests_{ijt,t-1}\}$
- Including family, quarter, and stock fixed effects.
- Omitted category: Non-holdings during quarter t.
- We will use lagged measures of *MFIA*.

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We are interested in β_1, β_2, and testing whether $\beta_2 - \beta_1 = 0$.

	MFIA = Requests$_{ijt}$		
	MFIA	L1.MFIA	L2.MFIA
Long	0.11***	0.09***	0.08***
	(0.00)	(0.00)	(0.01)
Short	0.16***	0.15***	0.13***
	(0.02)	(0.02)	(0.02)
H_0:$\beta_2 - \beta_1 = 0$	0.05***	0.05***	0.05***
	(0.02)	(0.02)	(0.02)
N	4,880,267	4,715,840	4,552,324
R^2	0.37	0.37	0.38

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Mutual funds learn more about both their shorts and their longs.

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Mutual funds learn more about their shorts **THAN** their longs.

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- We also look at *NewShort* and *NewLong*.

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	MFIA = Requests$_{ijt}$		
	MFIA	L1.MFIA	L2.MFIA
NewLong	0.06***	0.01	-0.01
	(0.00)	(0.01)	(0.00)
NewShort	0.08***	0.06**	0.05**
	(0.02)	(0.02)	(0.02)
H_0:$\beta_2 - \beta_1 = 0$	0.02	0.05**	0.05**
	(0.02)	(0.02)	(0.02)
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Mutual funds especially acquire information about **NEW** positions.

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H_0:$\beta_2 - \beta_1 = 0$	0.02	0.05**	0.05**
	(0.02)	(0.02)	(0.02)
N	4,880,267	4,715,840	4,552,324
R^2	0.37	0.37	0.38

Fact 1

Yes! Fund managers acquire more information about their shorts than longs?

Question 2

Do mutual funds' shorts earn larger returns than their longs.

$$Return_{ijt} = \alpha + \beta Short_{ijt} + \lambda Z_{jt} + \gamma_i + \epsilon_{ijt}$$

We are interested in α and $Short + \alpha$.

- $Return_{ijt}$ is either excess returns from the four-factor model ($ExRet$) or characteristic-adjust returns ($DGTW$).
- Including a family fixed effect.
- We estimate the model on only long positions (α is the abnormal return).
- We estimate the model on only short positions (α is the abnormal return).
- And we estimate the model on both long and short positions.
  - α is the abnormal return for longs.
  - $Short + \alpha$ is the abnormal return for shorts.

Question 2

Do mutual funds' shorts earn larger returns than their longs.

$$Return_{ijt} = \alpha + \beta Short_{ijt} + \lambda Z_{jt} + \gamma_i + \epsilon_{ijt}$$

	Long Only		Short Only		All Positions	
	ExRet	DGTW	ExRet	DGTW	ExRet	DGTW
MktReturn	1.01***	0.03**	1.02***	0.05**	1.01***	0.03**
	(0.02)	(0.01)	(0.05)	(0.02)	(0.02)	(0.01)
α	0.29*	0.08	-1.29***	-1.18***	0.29**	0.08
	(0.14)	(0.10)	(0.25)	(0.14)	(0.14)	(0.10)
Short					-1.61***	-1.33***
					(0.26)	(0.23)
$Short + \alpha$					-1.32***	-1.25***
					(0.31)	(0.17)
Obs.	1,721,856	1,317,857	47,118	35,367	1,768,976	1,353,224
R^2	0.19	0.00	0.16	0.00	0.19	0.00

Question 2

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	Long Only		Short Only		All Positions	
	ExRet	DGTW	ExRet	DGTW	ExRet	DGTW
MktReturn	1.01***	0.03**	1.02***	0.05**	1.01***	0.03**
	(0.02)	(0.01)	(0.05)	(0.02)	(0.02)	(0.01)
α	0.29*	0.08	-1.29***	-1.18***	0.29**	0.08
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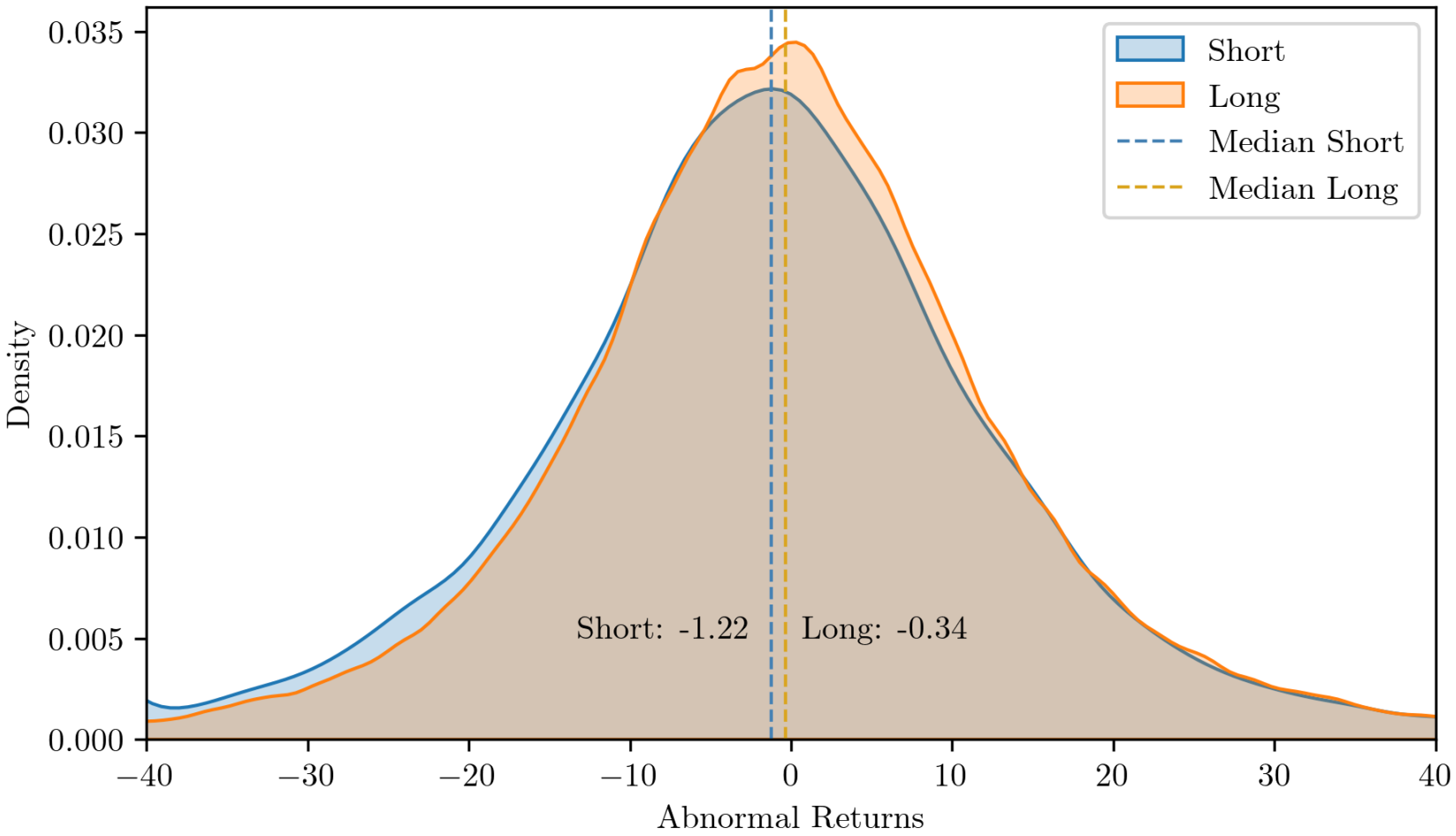
Obs	1,721,856	1,317,857	47,118	35,367	1,768,976	1,353,224
		0.00	0.16			0.00

Shorts earn larger returns than longs, on average.

Shorts earn over 100bps per quarter, on average.


Short
Long
Median Short
Median Long
Short: -1.22
Long: -0.34
Density
Abnormal Returns
0.035
0.030
0.025
0.020
0.015
0.010
0.005
0.000
−40
−30
−20
−10
0
10
20
30
40

Question 2

Do mutual funds' shorts earn larger returns than their longs.

$$Return_{ijt} = \alpha + \beta NewShort_{ijt} + \lambda Z_{jt} + \gamma_i + \epsilon_{ijt}$$

	All Positions					
	New at t		New at $t-1$		New at $t-2$	
	ExRet	DGTW	ExRet	DGTW	ExRet	DGTW
MktReturn	1.03***	0.08***	1.05***	0.05***	1.06***	0.06**
	(0.02)	(0.02)	(0.04)	(0.02)	(0.04)	(0.02)
α	2.26***	2.08***	-0.52**	-0.44***	-0.81***	-0.60***
	(0.17)	(0.20)	(0.22)	(0.12)	(0.25)	(0.17)
NewShort	-3.64***	-3.37***	-0.93***	-0.69***	-0.20	-0.37*
	(0.35)	(0.36)	(0.30)	(0.25)	(0.22)	(0.21)
$NewShort + \alpha$	-1.38***	-1.29***	-1.45***	-1.13***	-1.01**	-0.96***
	(0.42)	(0.28)	(0.35)	(0.26)	(0.27)	(0.23)
	6	139,044	198,931			28,111
		0.01	0.15			0.00

New long positions don't earn returns for very long.

New short positions earn returns for a couple of quarters.

Question 2

Do mutual funds' shorts earn larger returns than their longs.

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	All Positions					
	New at t		New at $t-1$		New at $t-2$	
	ExRet	DGTW	ExRet	DGTW	ExRet	DGTW
MktReturn	1.03***	0.08***	1.05***	0.05***	1.06***	0.06**
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	(0.42)	(0.28)	(0.35)	(0.26)	(0.27)	(0.23)

Fact 2

Yes! Mutual funds earn larger returns for shorts than longs.

Quick Recap

1. Mutual fund managers acquire more information about shorts than longs.
   - It's also the case that they acquire more information about longs that are riskier, smaller, and with more disagreement.
2. Mutual funds' shorts earn larger returns than their longs.
   - This is true for new longs and new shorts as well.

What makes it optimal to devote the most research effort to the trades that end up delivering the highest returns?

- To answer this we amend the Grossman-Stiglitz model of costly information acquisition and focus on one primary friction: **extra costs to go short.**

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Model

Environment.

- Risky asset with binary fundamentals $V \in \{\nu_H, \nu_L\}$, value gap $\Delta \equiv \nu_H - \nu_L > 0$; noise traders set $P_0 = (\nu_H + \nu_L)/2$.
- Before trading, a risk-neutral investor chooses research precision $\pi \in [0, 1]$ at cost $c(\pi) = \kappa\pi^2$ and observes a noisy binary signal $x \in \{\nu_H, \nu_L\}$ with $P(x = V) = \frac{1}{2} + \frac{\pi}{2}$.
- Positions are lumpy: minimum block $q_{\min} > 0$ and a fixed desk/monitoring cost F for any position.
- Costs differ by side: $C_L = F$ for longs; shorts pay $C_S = F + \phi + \eta q_{\min}$ (locate fee ϕ and borrow surcharge $\eta q_{\min}$).

Trade rule and thresholds.

- After seeing x, pick side $s \in \{L, S, 0\}$. One-block payoff: $\Pi = q_{\min}(V - P_0) - C_s - c(\pi)$.
- A side s is feasible only if research passes a *precision hurdle*

$$\pi \geq \pi_s^{\text{thr}} \equiv \frac{2C_s}{q_{\min}\Delta}.$$

Proposition 1 (Hurdles). Shorts need higher precision:

$$\pi_S^{\text{thr}} = \frac{2C_S}{q_{\min}\Delta} > \pi_L^{\text{thr}} = \frac{2C_L}{q_{\min}\Delta}$$

- *Why:* short-side costs $C_S = C_L + \phi + \eta q_{\min} > C_L$.

Proposition 2 (Observed research). Conditional on trading,

$$\mathbb{E}[\pi^* \mid s = S] > \mathbb{E}[\pi^* \mid s = L].$$

- *Why:* shorts only occur in the high-precision region; some longs occur in a long-only region with lower optimal π^*.

Proposition 3 (Observed returns). Conditional on trading,

$$\mathbb{E}[\,|\alpha| \mid s = S\,] > \mathbb{E}[\,|\alpha| \mid s = L\,],$$

- *Why:* shorts clear a stricter *value-gap* hurdle $\tau_S = C_S/q_{\min} > \tau_L$, so entry mispricings (and hence realized $|\alpha|$) are larger on average.

Proposition 1 (Hurdles). Shorts need higher precision: $\Rightarrow$ **Fact 1**

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- *Why:* shorts only occur in the high-precision region; some longs occur in a long-only region with lower optimal π^*.

Proposition 3 (Observed returns). Conditional on trading, $\Rightarrow$ **Fact 2**

$$\mathbb{E}[\,|\alpha| \mid s = S\,] > \mathbb{E}[\,|\alpha| \mid s = L\,],$$

- *Why:* shorts clear a stricter *value-gap* hurdle $\tau_S = C_S/q_{\min} > \tau_L$, so entry mispricings (and hence realized $|\alpha|$) are larger on average.

Extension with sequential learning.

Learning. Sequential Gaussian signals $x_j = V + \varepsilon_j$, $\varepsilon_j \sim \mathcal{N}(0, \sigma^2)$; per draw cost $c = \kappa\pi_0^2$ with $\pi_0 \equiv 1/\sigma^2$. After N draws,

$$m_N = \frac{1}{N}\sum_{j=1}^{N} x_j, \qquad \pi_N = N\pi_0.$$

Boundaries. Define dollar hurdles $\tau_s \equiv C_s/q_{\min}$. The optimal rule:

- keep sampling while $|m_N| < \tau_L$ and the option value of another draw $>$ cost;
- quit with no trade when $|m_N| < \tau_L$ and the option value has fallen to 0;
- take a **long** as soon as $\tau_L \leq |m_N| < \tau_S$;
- take a **short** as soon as $|m_N| \geq \tau_S$.

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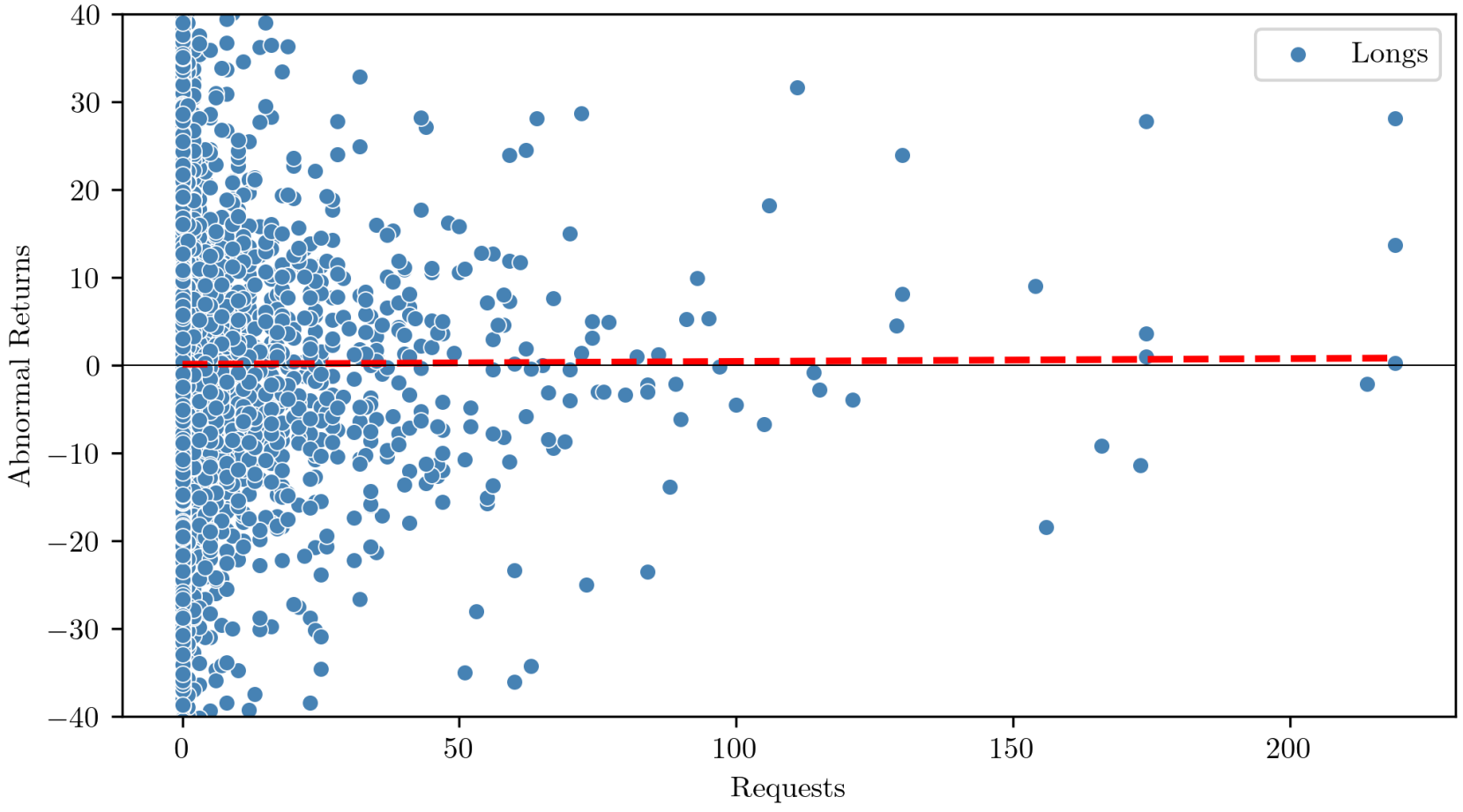
$$m_N = \frac{1}{N}\sum_{j=1}^{N} x_j, \qquad \pi_N = N\pi_0.$$

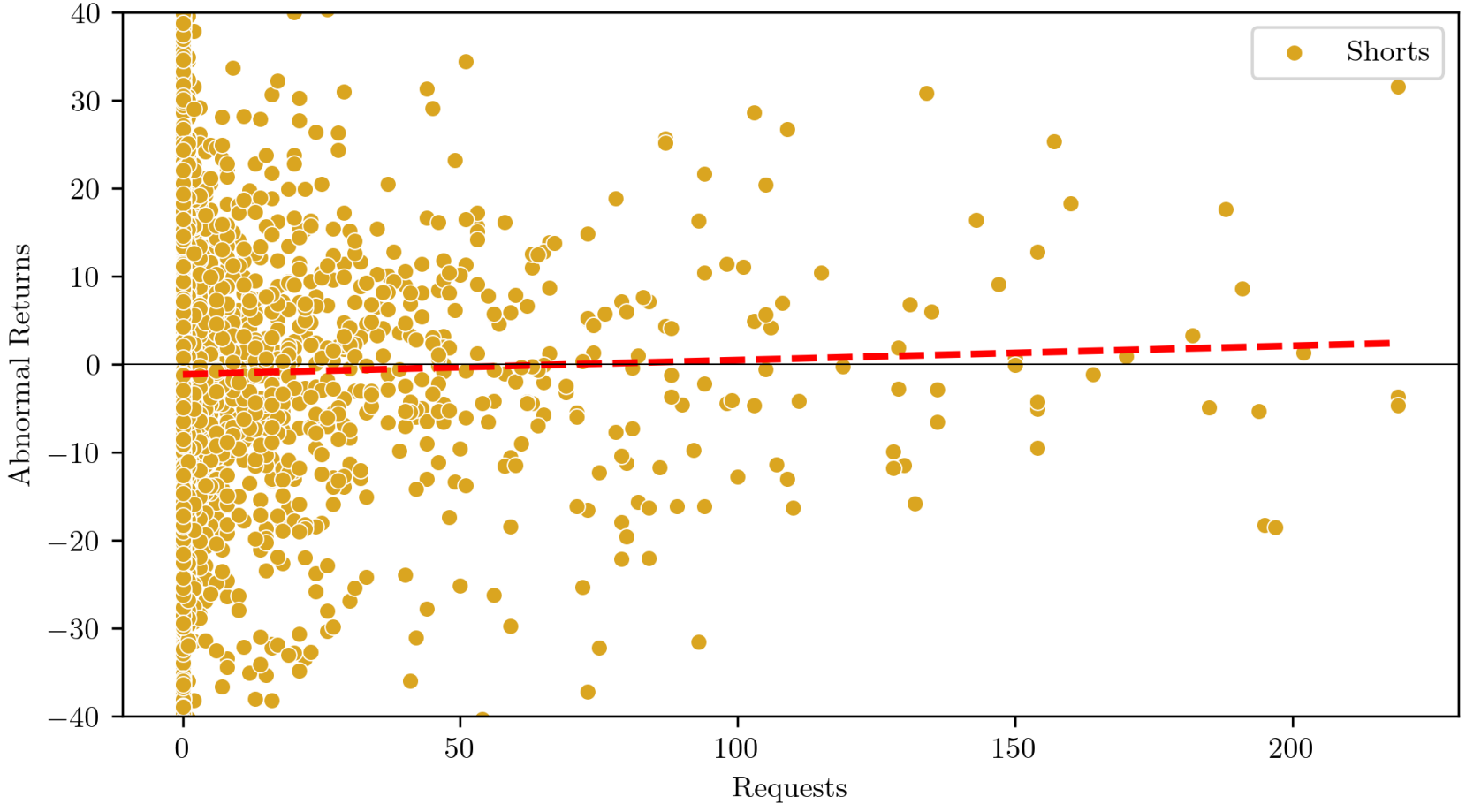
Proposition 4: more research $\Rightarrow$ *smaller* $|\alpha|$ for observed shorts.

Intuition. "Clear-winner" shorts hit τ_S quickly (small N) and deliver larger $|\alpha|$; borderline shorts need more draws (large N) and deliver smaller $|\alpha|$. Long side is nearly flat because its lower baseline hurdle τ_L makes the $1/\sqrt{N}$ shrinkage negligible in proportional terms.

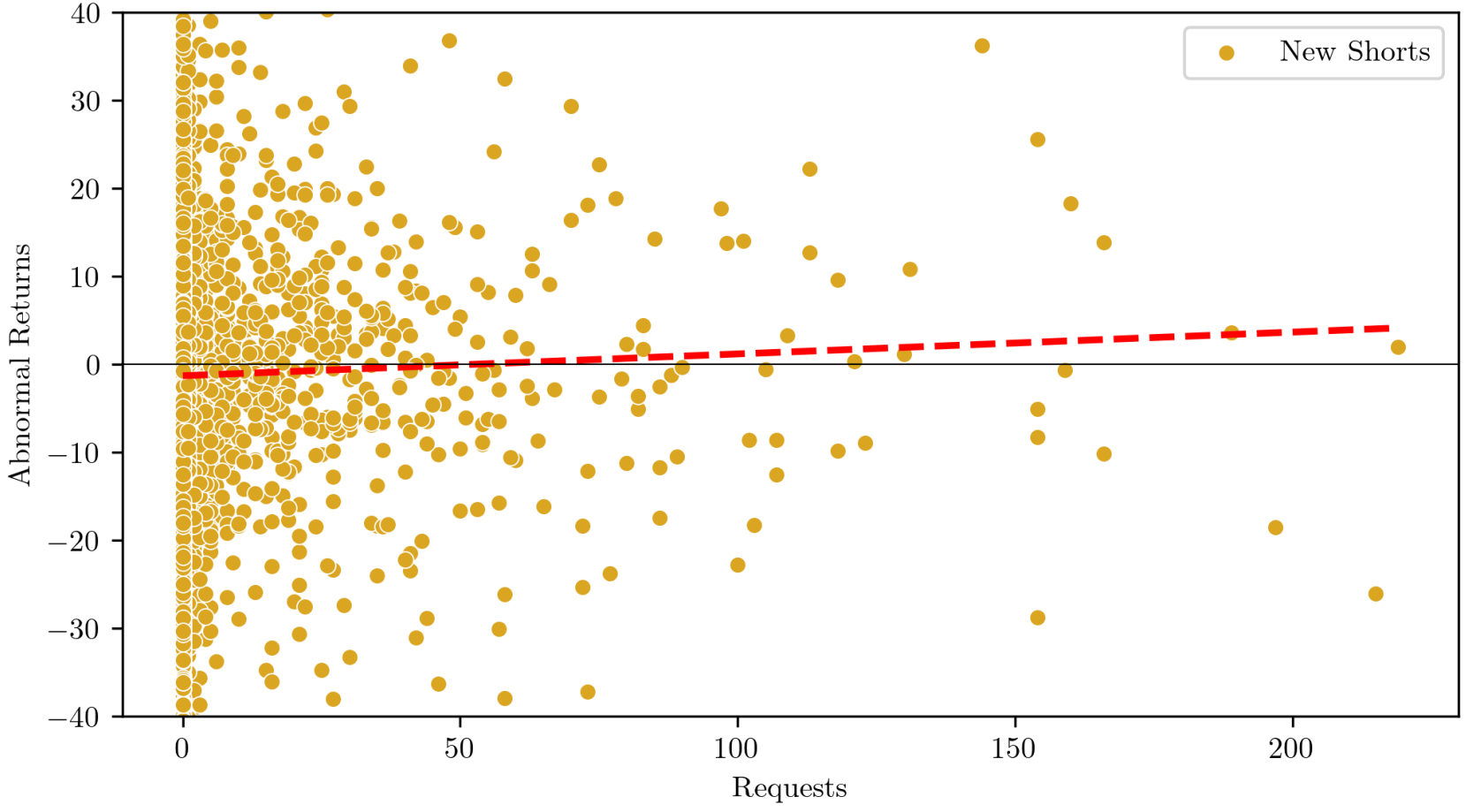
Testing Proposition 4



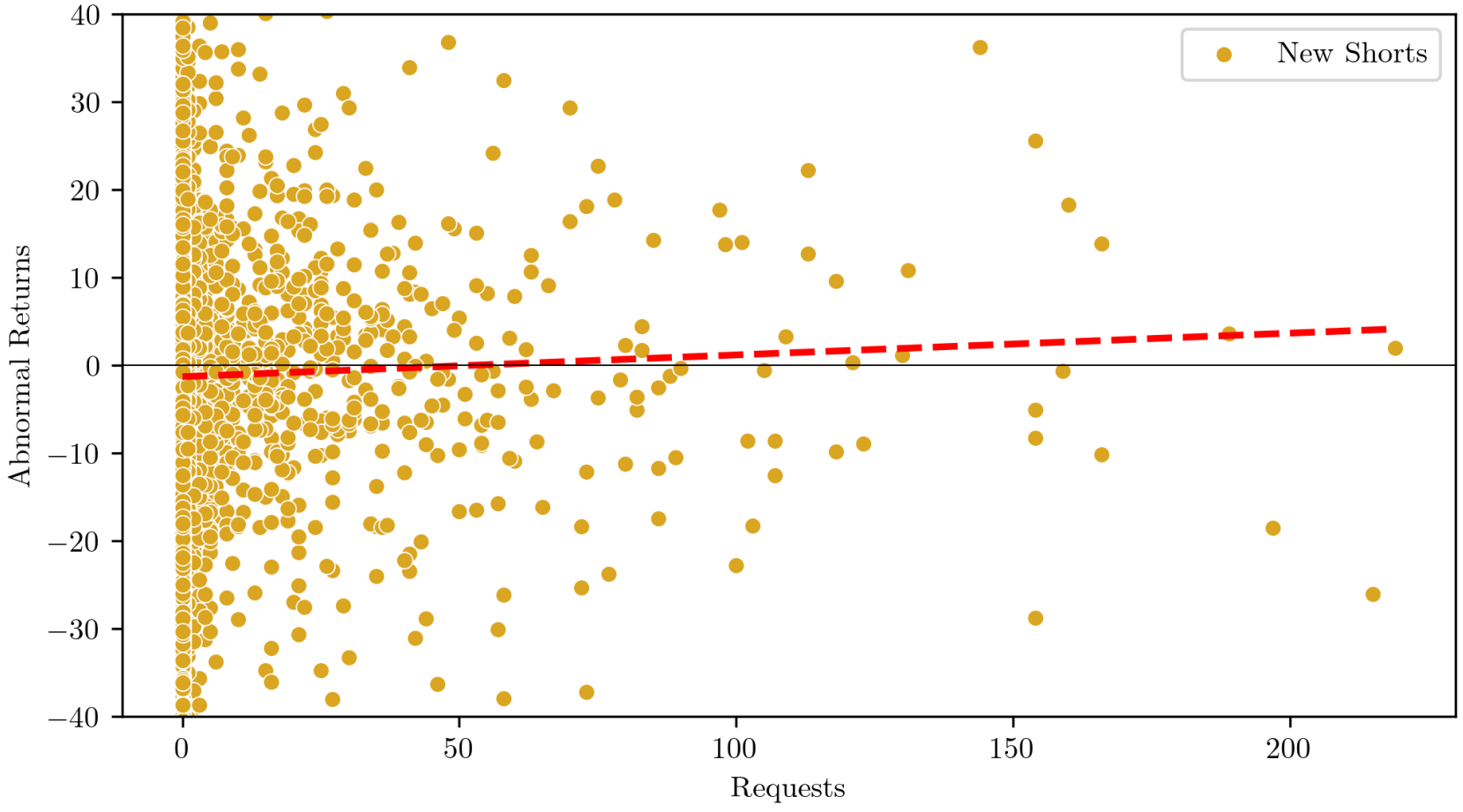
No relation between MFIA and returns for longs.



Positive relation between MFIA and returns for shorts...



... and for new shorts.



Returns and MFIA are *inversely related* for shorts!

$\Rightarrow$ Proposition 4!

$$Return_{ijt} = \alpha + \beta_1 MFIA_{ijt} + \delta Short_{ijt} + \beta_2 ShortXMFIA_{ijt} + \lambda Z_{jt} + \gamma_i + u_j + \epsilon_{ijt}$$

We are interested in *MFIA* and *ShortXMFIA* + *MFIA*.

	All Positions			
	MFIA = Requests$_{ijt}$		MFIA = Requests$_{ijt,t-1}$	
	ExRet	DGTW	ExRet	DGTW
MFIA	0.06*	0.08***	-0.04*	-0.01
	(0.03)	(0.03)	(0.02)	(0.02)
ShortXMFIA	0.20**	0.22**	0.18***	0.21***
	(0.08)	(0.08)	(0.06)	(0.07)
ShortXMFIA + *MFIA*	0.26***	0.30***	0.14**	0.19***
	(0.09)	(0.08)	(0.07)	(0.07)
Obs.	1,768,734	1,353,132	1,710,949	1,306,197
R^2	0.24	0.06	0.24	0.06
Family FE	Yes	Yes	Yes	Yes
Stock FE	Yes	Yes	Yes	Yes

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For shorts, returns are more positive with more MFIA. NOT GOOD FOR SHORTS! Proposition 4.

Altenative Explanation

Could it be that MFIA is counterproductive? Do families that do more information acquisition do worse?

$$Return_{it} = \alpha + \beta MFIA_{it} + \lambda X_{it} + \omega_t + \epsilon_{it}$$

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	L0.MFIA	L1.MFIA	L2.MFIA	L3.MFIA	L4.MFIA
	Return	Return	Return	Return	Return
MFIA	0.016*	0.014*	0.013*	0.011*	0.008
	(0.008)	(0.008)	(0.007)	(0.006)	(0.005)
TNAM	0.003	0.004	0.004	0.004	0.005
	(0.006)	(0.006)	(0.006)	(0.006)	(0.006)
NetFlow12	-0.259	-0.227	-0.188	-0.138	-0.071
	(1.150)	(1.121)	(1.124)	(1.121)	(1.144)
ExpenseRatio	-0.090***	-0.089***	-0.089***	-0.088***	-0.087***
	(0.025)	(0.024)	(0.025)	(0.025)	(0.026)
Obs.	1,169	1,169	1,169	1,169	1,169
R^2	0.09	0.09	0.09	0.09	0.09

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No... MFIA is associated with better future performance.

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	Return	Return	Return	Return	Return
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Additional Evidence for Proposition 4

Do managers learn less about the clear winners?

$$MFIA_{ijt} = \beta D_{jt} + \gamma_i + u_j + \omega_t + \epsilon_{ijt}$$

D_{jt} indicates whether a given stock-quarter is a *clear winner*.

LowUnderpriced = 1 when a stock is in the lowest quintile for analyst disagreement **(low uncertainty)** and the extreme lowest quintile for mispricing (**likely underpriced**).

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	New Long Only			New Short Only		
	MFIA	MFIA	MFIA	MFIA	MFIA	MFIA
LowUnderpriced	-0.04***	0.00	-0.01			
	(0.01)	(0.01)	(0.01)			
LowOverpriced				-0.08**	-0.12**	-0.11*
				(0.04)	(0.05)	(0.06)
R^2	0.45	0.48	0.48	0.63	0.66	0.66
Stock FE	No	Yes	Yes	No	Yes	Yes

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Weak evidence that clear winners among the new longs get less attention.

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				(0.04)	(0.05)	(0.06)
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Stock FE	No	Yes	Yes	No	Yes	Yes

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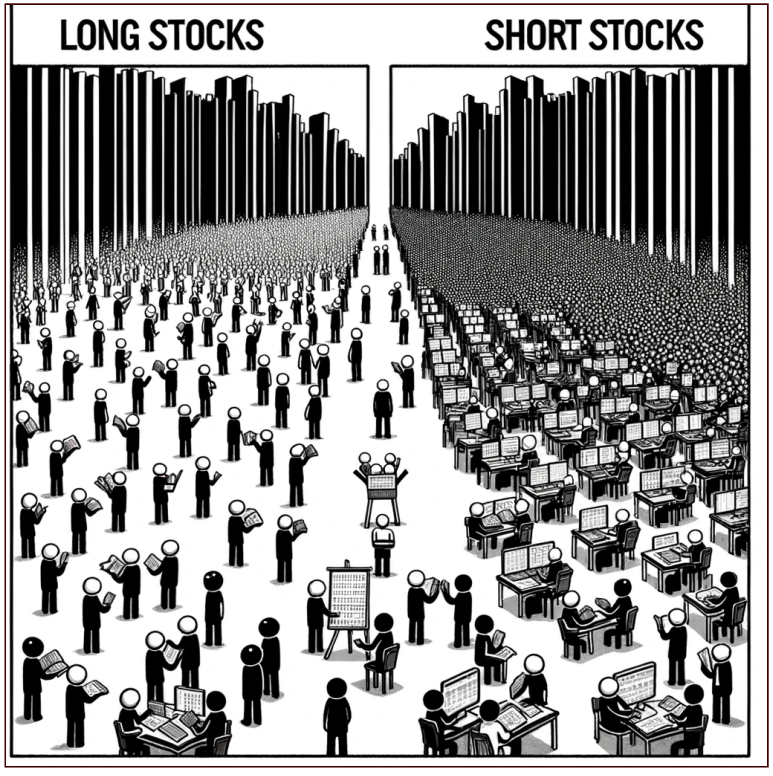
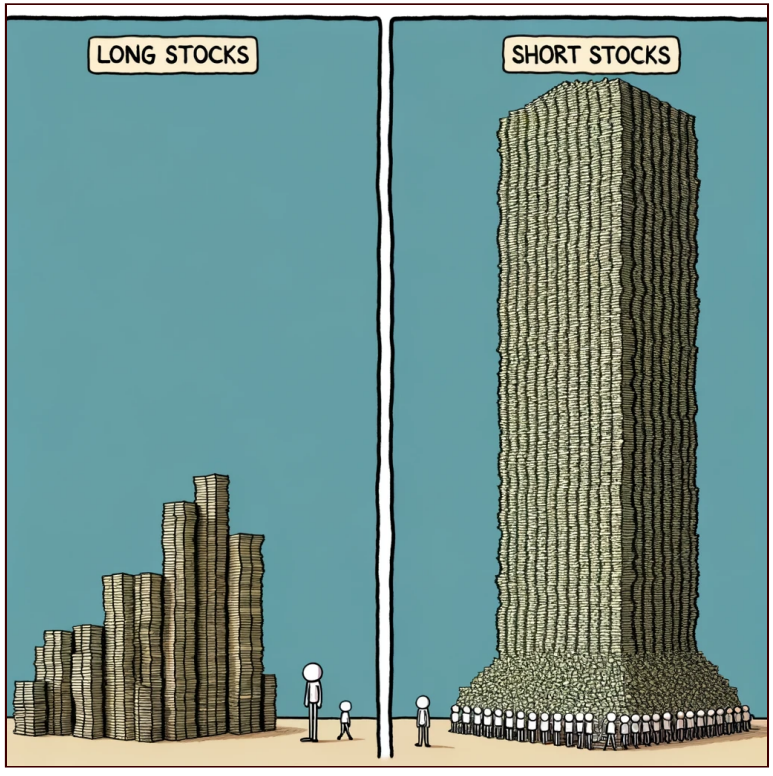
				(0.04)	(0.05)	(0.06)
R^2	0.45	0.48	0			
Stock FE	No	Yes	Y			

Stronger evidence that clear winners among the new shorts get less attention.

Conclusion

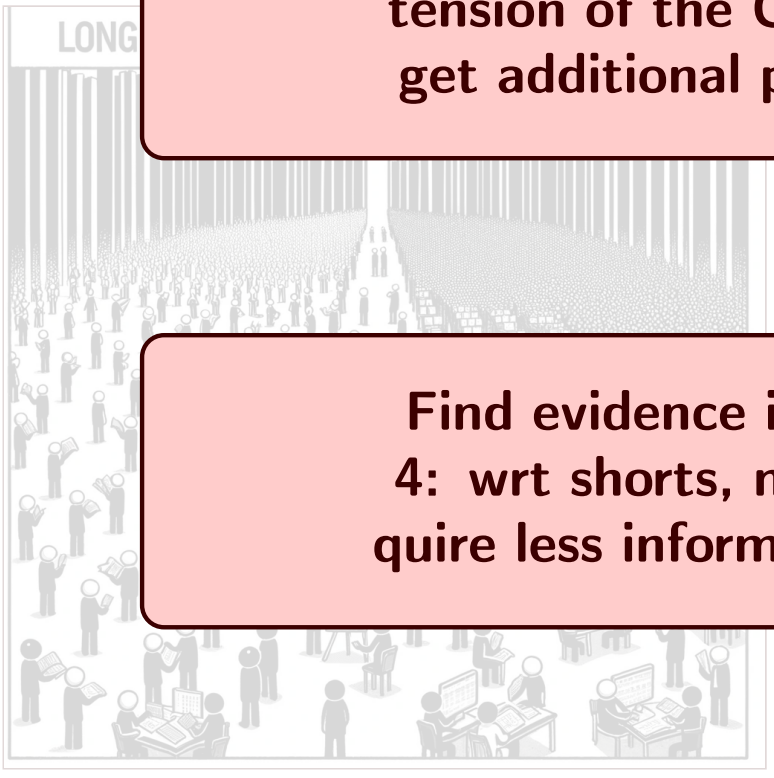


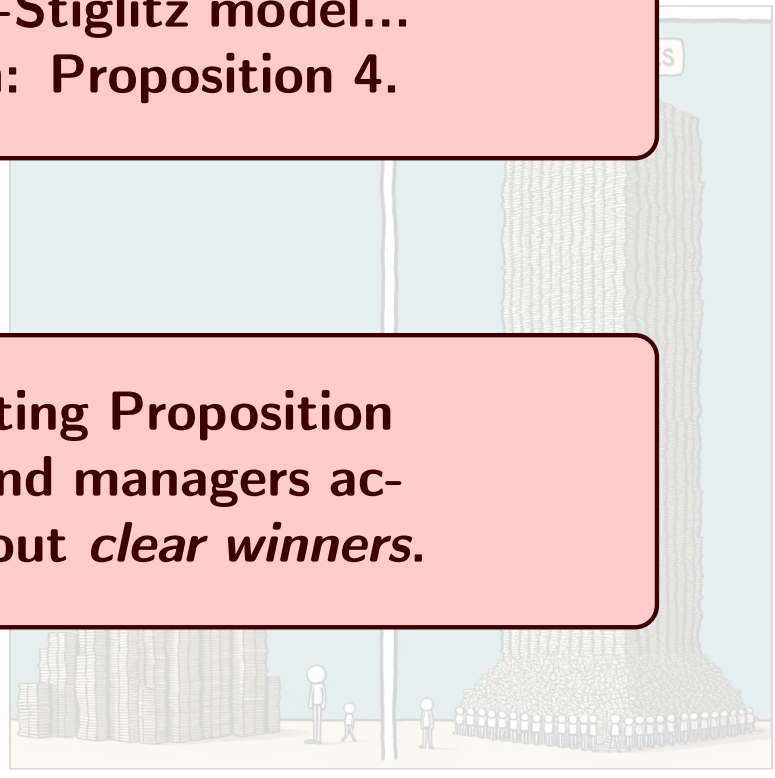
MFs learn more about their shorts than their longs.
5% more for shorts.



MFs do better on their shorts than their longs.
100bps more per quarter.

We rationalize these findings with an extension of the Grossman-Stiglitz model... get additional prediction: Proposition 4.





Find evidence in supporting Proposition 4: wrt shorts, mutual fund managers acquire less information about *clear winners*.

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