Keep an eye on stock short sellers to avoid losing in bond investments too, study says

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(PhysOrg.com) -- Savvy investors who follow short sellers to predict bearish news about a company's stock -- and sell their stocks in that company to avoid losses -- should keep an eye on the company's bonds as well, a new UC Davis study suggests.

"Bond investors could avert significant losses by following the simple rule of selling bonds based on elevated or rising short interest, " said Paul Griffin, professor at the UC Davis Graduate School of Management, who co-authored the study with Hyun Hong, assistant professor of accounting at the University of Memphis.

The findings are new in the academic literature, according to Griffin.

"Traditionally, traders and academics alike have focused on analyzing the positions of short sellers as an indication for investors to sell the stock, and therefore to avoid the loss from a further decline in the stock's value," Griffin writes in a working paper on the research, "Price Discovery in the Corporate Bond Market: The Informational Role of Short Interest."

In their study, Griffin and Hong analyzed more than 9,000 bond observations, or sales and purchases of a bond in a given month, from 660 companies from 2005 to 2007. They discovered that bonds showed a similar pattern to short sales.

According to their research, the excess (risk-adjusted) returns on bonds decrease in the months immediately following a high or increasing "short" position. At any point, one can determine the total number of shares borrowed and sold short because brokers have to report this to the exchanges. This number reflects the short interest position, Griffin said.

Selling short describes a strategy in which an investor borrows a stock, sells it in the market, waits for the market price to decline, and buys it back at a lower price than the one at which he sold it, returning the stock to the original owner while making a profit.

The researchers also found that regardless of whether earnings are up or down relative to analysts' projections, bond prices fall around earnings announcements for abnormally high short-position stocks.

Griffin and Hong used readily available bond data that institutions use to track their own bond portfolios.

More information: The paper is available at: papers.ssrn.com/sol3/papers.cf … ?abstract_id=1955345

Provided by UC Davis