

New analysis reveals how Porsche-VW 'short squeeze' distorted the stock market

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Credit: Pixabay

A "short squeeze" happens in the market when investors bet against a stock that aggressively increases in price, causing these sellers to cut losses and exit their positions.

The biggest short squeeze in history occurred in 2008 when Porsche embarked on an unexpected series of maneuvers that left it controlling a huge percentage of Volkswagen's (VW) stock. This briefly made VW

the most valuable listed company in the world.

"In a short squeeze situation, when the price starts increasing rapidly—which goes against short seller strategy—short sellers usually get scared, and they try to cover by buying the stock in the open market at a loss, which pushes up the price even further," said Angel Tengulov, assistant professor of finance at the University of Kansas School of Business.

"What we're documenting is how this short squeeze event led to distortion in market quality and price discovery of the underlying stock."

His paper titled "Market Efficiency and Limits to Arbitrage: Evidence from the Volkswagen Short Squeeze" analyzes this domination plan involving the two German auto giants. He and co-authors Franklin Allen, Marlene Haas and Eric Nowak argue this was a manipulation designed to save Porsche from insolvency, and the laws designed to prevent this kind of abuse were not effectively enforced, resulting in significantly impeded market efficiency. It's published in the October issue of the *Journal of Financial Economics*.

"If we take a step back, we can differentiate between information-based stock manipulation and action-based stock manipulation. Both types were ruled out in the United States by the introduction of the Securities Exchange Act of 1934," he said.

The Porsche-VW paper primarily focuses on the European securities market. Tengulov contends that if the EU (and Germany in particular) wants to develop and maintain well-functioning capital markets, strict disclosure requirements must be put in place.

"More importantly, they need strict enforcement of securities laws. As a recent example, we have the Wirecard AG scandal, which has the

potential to turn out to be the biggest accounting fraud and corporate governance scandal in Europe," he said.

Tengulov and his co-authors spent months collecting data from court proceedings, translating it from German into English, then analyzing the results.

"One interesting aspect of this research for me is how companies can use financial derivatives in mergers and acquisitions," said Tengulov, who earned a doctorate in finance from the Vienna University of Economics and Business and speaks German fluently.

"What really happened was that Porsche, a company 10 times smaller than the size of VW by sales, was trying to acquire majority voting interest in VW partially through cash-settled financial derivatives, which were completely in stealth mode."

At the time, the regulations in Europe were structured so companies did not have to disclose ownership in other companies through such financial derivatives if that did not exceed a certain threshold. Porsche managed to accumulate approximately a 43% stake in VW with options to buy an additional 31%.

"When they disclosed that to the market, everybody was absolutely surprised," he said.

A native of Bulgaria, Tengulov joined KU this summer. He said he does not own a Porsche but does drive a VW. ("The German translation of Volkswagen means 'people's car,'" he said.)

"One important lesson of this research is that short squeezes are not a phenomenon of the past," he said. "Another even more recent example is the January 2021 events surrounding GameStop, AMC and other

companies that happened in the U.S."

Tengulov emphasizes most people are not truly aware of the fact that [social media platforms](#) can act as a coordination device for retail investors (among others), which in turn can have huge market impact.

"This is a gray area, and U.S. regulators are in the process of establishing the extent to which the coordination was in accordance with [stock market regulations](#)," he said.

"Regulators really must think about what would be an effective framework and an effective way to enforce this framework in order to prevent [market](#)-distorting events such as short squeezes from happening."

More information: Franklin Allen et al, Market efficiency and limits to arbitrage: Evidence from the Volkswagen short squeeze, *Journal of Financial Economics* (2021). [DOI: 10.1016/j.jfineco.2021.05.015](https://doi.org/10.1016/j.jfineco.2021.05.015)

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