Short-sale ban disrupts trades for hedge funds

Short sellers, convertible arbitrage, relative value managers hit hardest

By Alistair Barr, MarketWatch

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SAN FRANCISCO (MarketWatch) -- The short selling ban has boosted shares of many financial companies, but it's roiling the $2 trillion hedge fund industry.

That's because managers have been left with limited access to one of their most important investment tools. Short sellers, who specialize in betting against shares, along with convertible arbitrage funds and so-called relative value managers have been among the hardest hit, investors said this week.

"If this goes on longer, it will become much more problematic," Bill Ferrell, head of hedge fund investment firm Ferrell Capital Management, said in an interview. "Whenever government intervenes in a free market, you're playing with fire."

Short selling involves borrowing stock and selling it in the hope of buying it back later at a lower price. It's an integral part of most hedge fund strategies because it helps managers generate returns even if markets are falling. See special report on leading short sellers.

The Securities and Exchange Commission, fearing that short sellers were attacking some banks and brokers, banned bets against roughly 800 financial-services stocks on Monday. More shares have been added to the list since then, with unlikely companies including jewelry retailer Zale Corp. (ZLC) and drug store operator CVS Caremark (CVS) joining in recent days.

This year was already set to become one of the worst in the history of the hedge fund business, but the ban has piled on the pressure.

The only solace for most managers and investors interviewed by MarketWatch was that the ban is scheduled to end on Oct. 2. unless the SEC extends it -- a worrying possibility for the industry. On Friday, an SEC spokesman said regulators have not yet decided whether to extend the ban.

"It's very unfortunate," said Manuel Asensio, managing member of hedge fund firm Mill Rock Advisors. "It really complicates a difficult investment-management task."

Shares of Zions Bancorp (ZION) , which have been heavily shorted in recent months, surged almost 17% last Friday when the SEC announced plans to ban short selling of financial stocks.

"This type of volatility is not constructive at all -- it's disruptive," Asensio said.

Selling longs, not shorting

Known as a prominent short seller, Asensio now runs a long/short equity hedge fund, which takes both positive and bearish bets.

Asensio can't increase short positions on financial-services shares, so he said he may have to sell some long positions to hedge against broader declines in the stock market.

Other traders may have used a similar strategy, judging by the performance of the stock market since the SEC ban. The Standard & Poor's 500 index slumped more than 3% this week. Technology stocks dropped even more, with the Nasdaq Composite index losing 4%.

Meanwhile, many financial-services stocks rebounded, with the Amex Securities Broker/Dealer Index (XBD) surging more than 6% this week and the KBW Bank index (BKX) climbing almost 1%.

J.P. Morgan Chase (JPM) , Citigroup (C) and Bank of America (BAC) , the nation's largest banks, surged more than 20% this week, while Morgan Stanley (MS) rebounded almost 10% and Goldman Sachs (GS) jumped almost 30%.

Hedge fund losses

Such volatility has left several hedge funds nursing losses this month. Managers don't publicly report performance, but indexes that track industry returns already show that September may be a painful month.

Managers tracked by an investible index run by Hedge Fund Research have lost almost 5% on average so far this month.

Convertible arbitrage managers tracked by the index have lost almost 9% so far in September.

These types of funds buy convertible debt and short the underlying stock to try to make money from pricing anomalies between the related securities.

Without the ability to short financial shares, convertible arbitrage hedge funds have fewer opportunities to make money and have become much less likely to by convertible bonds.

Indeed, the convertible bond market has frozen, with no convertibles sold in the U.S. since the first week of September, according to Dealogic.

Relative value woes

So-called relative value hedge funds have also been hit hard by the short selling ban. HFR's investible index tracking this strategy has slumped more than 6% so far this month.

Relative value managers look for differences in the price of securities that have historically traded in relation to each other. When such relationships break down, they take offsetting long and short positions, betting that things will return to normal.

This type of "spread trade" is a common tactic used by several different hedge funds. And it's being hurt by the short selling ban, according to Ferrell.

A manager may be shorting shares of one bank while investing in the stock of a rival that they think is financially stronger. Profits are generated if the rest of the market realizes the diverging fortunes of the two companies and shares of the weaker bank fall and those of the stronger one climb, Ferrell explained.

The ban doesn't force managers to close existing short positions. That means managers with spread trades can keep them on. But if they're forced to hold the trade for a long period, during which time no other shorts are allowed on financial shares, there's more chance the market will move artificially against the position, Ferrell said.

"This creates a fictitious market for the two bank stocks," he added.

Many hedge fund managers have just stopped investing or shorting financial stocks until the ban expires, Ferrell noted.

Alternatives

There are other ways to bet against financial stocks, but they are usually more complicated, less effective and more expensive than shorting stocks, managers and analysts said.

One tactic involves shorting an exchange-traded fund that tracks a broad stock market index such as the S&P 500. Then a manager can invest in all the stocks in the index that aren't in the financial sector. That's cumbersome, but creates the desired bearish bet.

Single stock futures and put options are also ways to bet against companies, but those markets are often less liquid than the stock market, making such trades more expensive, said Josh Galper, managing principal at Finadium, a consulting firm formerly known as Vodia Group.

Equity swaps are another alternative. These are derivative contracts that can be negotiated with brokerage firms to generate profits for investors if specific stocks rise or fall.

However, at least one major prime brokerage firm is being very conservative about offering equity swaps that generate profits when financial stocks fall, according to a top broker at the firm.

To hedge themselves, brokers usually short the underlying shares when offering such equity swaps. The SEC ruled earlier this week that short selling as part of bona fide market making activities is allowed. But brokers are unsure about what counts and don't want to unwittingly breach the new limits, the person explained, on condition of anonymity.

Some exchange-traded funds have been disrupted because of SEC's ban.

The Rydex Inverse 2x S&P Select Sector Financial ETF (RFN) lets investors bet aggressively against all the financial stocks in the S&P 500 index.

Trading in this ETF had to be temporarily halted when the SEC announced the short selling ban last week.

That's because Rydex uses equity swaps, options and futures to make sure the ETF moves inversely to the financial sector. Since the short selling ban, swaps brokers have been less willing to hedge themselves by shorting financial shares, despite the market maker exemption.

That's made it difficult for Rydex to create new shares of this bearish financial ETF to meet demand.

The ETF has been trading this week, but it's failed to move exactly in the opposite direction of financial stocks. That makes it a less attractive hedging tool.

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