DOW THEORY FORECASTS

# Taking it in the shorts

Investors typically look for qualities that enhance a stock's performance. But keen investors also consider characteristics that detract from returns. Plenty of academic studies -- as well as our own research -- suggest that heavily shorted stocks tend to underperform.

In a short sale, an investor borrows shares and sells them, hoping to repurchase the stock at a lower price and collect the difference.

For example, shares of XYZ Corp. trade for $50, which an investor considers too high. A broker locates 100 shares in another account and loans them to the investor, who then sells for $5,000. A month later, XYZ slumps to $40, prompting the purchase of 100 shares at a cost of $4,000. These shares are sent to the broker, and the investor pockets $1,000.

To be sure, many heavily shorted stocks rally, triggering a short squeeze. To limit losses during a squeeze, short sellers cover their positions by buying back the borrowed shares.

A chain reaction may follow, as new buying fuels even more buying and shares climb higher. Contrarian investors purchase heavily shorted stocks, hoping a short squeeze will drive their shares up. Even absent a squeeze, shares sold short must eventually be repurchased, which may push the price higher.

But research suggests that short sellers tend to be well informed. Thus, the most heavily shorted stocks typically underachieve over time.

We divided S&P 1500 stocks into 33 equal-numbered baskets for a back test since 2010, when our short-interest data started. Much of the underperformance of short-sale targets was concentrated in stocks where short interest was high relative to a company's float, or the number of shares available for trading. The three baskets with the highest short interest as a percentage of float averaged 12-month returns of 9.2%, well below the 14% gain of the average stock.

The basket with the most heavily shorted stocks returned a dismal 7.1%. Stocks with the highest short ratios, or the number of shares sold short relative to average trading volume, also underperformed, though by a smaller amount.

## Our advice

Investors should think twice before buying the most heavily shorted stocks. Our research suggests that while stocks with short interest as a percentage of float above 6% tend to underperform, those with more than 12% return far less. You can find the ratio for most stocks on financial-media websites, including Yahoo Finance. Importantly, investors should be especially wary of short-sale targets with weak Quadrix® Overall scores.