Fresh alternative

Karen King of IHS Markit analyses the virtues of the firm's short-squeeze model

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Karen King is an executive director of sales at IHS Markit. She works across both the buy and sell side, specialising across the firm's equity franchise with specific focus on securities finance and trading services in the APAC region. Prior to that, she worked at Goldman Sachs, where she was actively involved in building and maintaining client portfolios for the private wealth desk. She also worked with Goldman's securities lending trading and sales desk, where she traded Southeast Asia.

When a *Nikkei Business Review* report on 19 December showed that GNI Group, a pharmaceutical company listed on the Mothers Board of the Tokyo Stock Exchange, was going into full scale production in Japan, the biotech firm saw its shares spike from 2,143JPY to reach 2,709JPY by 27 December, a tasty profit for holders of the stock, but a less satisfactory outcome for uninformed short sellers. The signs that the firm could be on the cusp of a price rise were already available before the Japanese-language newspaper printed its story.

IHS Markit's short squeeze model (see graph) showed an increase of GNI's stock on loan throughout November, and on 5 December, 100% of the shares on loan were out-of-the-money, indicating short sellers were facing capital constraints on losing positions. In conjunction with the positive news, this can lead to short covering moving the price higher.

Beginning this April, our Research Signals service has expanded the use of IHS Markit's industry-leading securities lending data to launch a short-squeeze model to cover the Asian and European markets, adding to the US model that has been live since 2015.

The model is designed to flag short squeezes before they happen. We define a short squeeze as a sudden spike in price – a three standard deviation move versus the prior 60 trading days over one to three days – followed by a drop in shares on loan over five consecutive days, for names with an insufficient supply of shares and high borrowing costs, or stocks that short-sellers are betting against.

The short-squeeze model is powered by the comprehensive global securities lending data collated by IHS Markit covering major Asian stock markets, including Australia, Hong Kong, South Korea, Taiwan, Singapore and Japan. Each day, we receive borrows and loans directly from market participants, which allows us to produce the model's key measure: short-seller profitability.

As short-sellers lose money, the risk of mass short covering increases. Therefore, the model provides a risk signal for investors who are short. If they have a large position and the signal ranks the stock as likely to squeeze, it could be an indication to come out of that trade.

This measure of capital constraints is combined with momentum data, earnings announcement events, abnormal trading and positive sentiment signals in a multifactor model to score stocks by their short-squeeze risk across a given universe.

However, the short-squeeze model is not just a risk indicator for investors holding short positions. It also acts as a signal to locate outperforming stocks versus the underlying benchmark.

The model is back-tested by taking a long position in decile one stocks (most likely to squeeze) and a short position in decile 10 stocks (least likely to squeeze) over our highly shorted Developed Pacific universe, going back to January 2011.

Results show the top-ranked stocks outperform the bottom-ranked stocks by 7bps on a daily basis, and 75bps per month using monthly rebalancing. Additionally, back-testing of the model demonstrated that while short squeezes occur on average at 0.76% of the time daily, this rises to 1.23% for stocks in decile one of the model – a 61% increase.

Using alternative data such as short-squeeze prediction not only keeps short-sellers better informed to avoid losses but also assists long-holders looking for outperformance and better-timed entry into the market. With the model in your toolbox, you can be one step closer to identifying the next GNI Group. HFM

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