Hull Investments, LLC
External Research Summary

Variable: Aggregate Short Interest
Authors: Rapach, Ringgenberg and Zhou
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Reviewer: Rick Anderson

“We show that short interest is arguably the strongest known predictor of aggregate stock returns. It outperforms a host of popular return predictors both in sample and out of sample, with annual R² statistics of 13% and 11%, respectively. In addition, short interest can generate utility gains of over 300 basis points per annum for a mean-variance investor. A vector autoregression decomposition shows that the economic source of short interest’s predictive power stems predominantly from a cash flow channel. Overall, our evidence indicates that short sellers are informed traders who anticipate future aggregated cash flows and associated market returns.”

The authors used Compustat short interest data from January 1973 through December 2013 for common stocks, ADRs, ETFs and REITs. They removed issues with prices less than five dollars per share and issues below the fifth percentile in market capitalization. They calculated an equally weighted short interest (EWSI) variable as the average of [short interest divided by shares outstanding] for each stock in their monthly sample. There are at least two other common definitions of the short interest ratio: (1) short interest divided by average daily volume and (2) short interest divided by float. The short interest to average daily volume ratio is used to gauge the “squeezeability” of an individual stock.

According to the authors, the average of EWSI from 1973 through 1982 was 0.31%. For the period from 2003 through 2013, however, the average was 5.01%. In order to remove the steady upward trend in aggregate short interest, they regressed EWSI against time and created a detrended series – the difference between actual observations and the regression estimates.

The authors found R-squared levels of 0.0194, 0.0633, 0.1095 and 0.1094 for subsequent one-, three-, six- and 12-month returns. Both the forecasts and detrending regression line were estimated out of sample. The authors provide evidence that aggregate short interest is superior to 14 monthly predictor variables reviewed in a paper written by Goyal and Welch (2008).

The authors provided their monthly data from 1973 through 2013. This data was detrended over the entire period, so there is some benefit of “knowing the trend ahead of time.” The untrended time series is not available because of agreements with Compustat.

This is an interesting variable with some information. Moreover, the authors argue that short sellers are informed traders who anticipate future corporate cash flows. As a result, the variable may retain its predictive power going forward.