

The Cutting Edge

The Search for Meaning in ETF Short Interest Figures



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Several recent articles, McDonald (2004) and Button (2004), have discussed growth in the short interest reported for ETF shares. To put the ETF short interest figures in perspective, the short interest in the average stock listed on the New York Stock Exchange accounts for about 2% of the company's equity capitalization. The mid-May short interest reported for the iShares Lehman 20-Plus Treasury Bond Fund was 180% of the fund's shares outstanding, down from a high of 697% in mid-March. The short interest in the Sector SPDRs Financial fund in mid-May was 132% of the fund's shares outstanding. These specific short interest figures probably reflect the use of short ETF positions to hedge interest rate risk or to profit from the recent rise in interest rates, but large short interests are common in a number of ETFs.

While the short interest in the S&P 500 SPDR is significantly off its December 2003 peak of 33.9%, at 23.6% in May, and the QQQs are well off their March 2004 peak of 65.9% at 47.8% for May, the iShares Russell 2000 short interest reached a peak of 85.5% in May. This new high short interest for the Russell small-cap fund seems to reflect the use of short positions in these iShares to hedge or profit from a variety of activities related to the annual Russell index rebalancing. The unusual magnitude of some of these ETF short-interest figures is probably best illustrated by noting that the dollar values of the short interests in the SPDRs and the QQQs are several times greater than the dollar values of the short interest in *any* other U.S. share for which short interest is reported.

**Short Interest Percentages For The Ten
Largest ETFs As Of May 14, 2004**

Fund	Short Interest Percentage
S&P 500 SPDR	23.6%
Nasdaq-100 Index Tracking Stock	47.8%
iShares S&P 500	5.5%
iShares MSCI-EAFE	3.7%
DJIA DIAMONDS	22.4%
S&P 400 MidCap SPDR	12.5%
iShares MSCI-Japan	1.8%
iShares Russell 2000	85.5%
Vanguard Total Market VIPERs	0.9%
iShares Russell 1000 Value	5.4%

The table shows short interest as a percentage of fund shares outstanding for the ten largest exchange-traded funds as of mid-May. Additional short interest data on these and other ETFs is available monthly at http://www.etfconsultants.com/Short_Interest_200404.xls

What Is The Significance Of These High Short Interest Figures?

The fundamental answer to that question is very simple: selling exchange-traded funds short can be an effective risk management practice. The large and irregularly growing short interests in the 500 SPDRs, QQQs, DIAMONDS, MidCap SPDRs, Russell 2000 and S&P 600 ETF shares reflect their use in risk management applications, largely by broker-dealers and hedge funds. A number of analysts, e.g., McNally and Emanuel (2002) have highlighted the use of ETFs as a substitute for futures. As the McNally and Emanuel report illustrates, a long or short position in an ETF may be particularly attractive to a hedger relative to a futures contract when the position is going to be held over a period longer than the life of a single futures position. Unlike the futures position, the ETF short does not have to be rolled over to extend the life of the hedge. These risk management applications, particularly on the

short side, have some important implications for ETF investors and issuers.

Short Selling Increases Trading Volume

Short sellers do not stay short for years at a time. The existence of a substantial short interest is generally associated with increased trading activity and, sometimes, with tighter bid-asked spreads. In the markets for actively traded ETFs, ETF investors, traders and issuers all consider a high rate of trading activity to be desirable. Fund issuers see high trading volume as the best and cheapest advertising an ETF can get. Investors, sometimes too optimistically, associate high volume with tighter spreads. There is no question that SPY and QQQ shares trade on much tighter spreads because of their extraordinarily high volumes. It is doubtful that differences in volume tighten spreads very much on the average ETF.

The Short Interest Replaces Shares That Would Otherwise Be Issued By The Fund

Although they like its effect on trading volume, a large short interest is not always greeted warmly by ETF issuers. If the short interest in an ETF is calculated at 80% of the fund's shares outstanding, shares that appear long in ETF shareholders' brokerage accounts are equal to 180% of the shares issued by the fund. In other words, the short sellers are supplying shares to long investors. If the short sellers were not in the market, the longs who buy shares from them might otherwise be served by the fund issuer. Let's put the effect of this substitution for a purchase of shares from the fund in an economic perspective. Even at the reduced level of the QQQs short interest in May 2004, if all the shares furnished to longs by short sellers in mid-May had been issued by the fund, the revenue collected by the QQQs Trust would have increased by more than \$20 million at an annual rate.

Actually, we need to put that \$20 million annual figure into further perspective. The QQQs would be a much smaller fund if the shares did not trade as actively and did not provide a substantial trading cost advantage to any investor who wants broad exposure to the Nasdaq market. Without extremely high trading activity, stimulated in part by the short sellers, even fewer shares might be issued by the fund.

Short Selling May Reflect Fund Performance Weaknesses

ETF performance was not very good in the aggregate in 2003, the period of greatest growth in ETF short interests. One reason to choose a specific ETF as a hedging instrument on the short side is that the fund manager is not delivering outstanding performance. Substandard fund performance reduces the risk of an ETF short sale.

Individual Investors Should Make Sure That Their Broker Is Not Lending Their Equity ETF Shares

Under U.S. Treasury regulations, any entity reporting qualified dividends for 2004 must certify that it owned the shares during a specific period and that the distribution is not a payment in lieu of dividends. If the broker lends out your ETF shares, you may receive a payment in lieu, not a qualified dividend.

Large ETF Short Interests Help Make Most Estimates Of Institutional Ownership Of ETFs Into Gross Exaggerations

The only reliable sources of data on institutional holdings of any equity security are the 13(f) and similar reports filed with the Securities and Exchange Commission. These reports routinely show lower institutional ownership of ETFs than most published estimates of institutional ETF ownership. When large short interests in many of the larger ETFs are added to shares issued by the funds to get the share count held by all long shareholders as a group, the institutional share of the total long positions is significantly lower than any published figures for institutional ownership.

ETF holders are now and have long been predominantly retail investors. The most active ETF traders are now and have long been

predominantly broker-dealers and hedge funds, not traditional institutional investors. That structure makes sense and it works for me. I just wish everyone else would accept it. Ironically, some recent developments might stimulate institutional use of ETFs, but that is a topic for another column.

B I B L I O G R A P H Y :

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