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The Angels of Market Efficiency

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Mr. Ben Axler, Chief Investment Officer and founder of Spruce Point Capital responds (***Financial Post***, December 17th, 2019) to my article on short sellers of his kind (***Financial Post***, December 13th, 2019). He trots out the worn-out argument that short sellers only reveal the sordid truths hidden in the bosom of corporations.

In short, "professional" short sellers are sort of the guardian angels of market efficiency acting as a countervailing force to the fawning, relentlessly positive and often corrupted recommendations of sell-side analysts! Indeed, sell-side analysts tend to see glasses as half-full; for short sellers, glasses are always empty and… dirty.

The consequences of short-sellers' actions may be dramatic. The near collapse of the financial system in 2008 owed a good deal to the savage, incendiary role of short selling (particularly of the "naked" sort). The book "On the Brink", written by Hank Paulson, U.S. Treasury Secretary at the time of the financial crisis, makes clear the noxious role played by short sellers during that frightening period. That's what angels of market efficiency do!

Mr. Asler invites me to share with him what I find wrong in their report on Canadian Tire. Much, too much for a short article but an overarching theme would be the relative ignorance of the Canadian retail market that pervades their report. Spruce Point Capital assumes the competitive and buying behavior of Canadians are identical to Americans. That assumption has proven costly in a number of instances (Think Target, Kmart, Sam's Club, Best Buy, Sears). Similarly, Canadian retailers which crossed over to the US market were often taught a painful lesson about the differences between the two markets.

So, Spruce Point Capital's report on Canadian Tire (CT) is insensitive to the particular nature of the Canadian retail and financial markets. It keeps comparing CT unfavourably to Amazon and Walmart as the be-all, end-all of retailing. That myopic American perspective may explain the case of Dollarama.

Barely a year ago in October 2018, Spruce Point Capital launched a virulent campaign against Dollarama producing a long negative report to buttress its claim that the stock price of Dollarama should or would drop from $46 to $28; the stock price actually leveled off briefly at $31 in December 2018 from which level it soared back to above $45.

I made two basic points in my earlier piece, which bear repeating.

1. Canada is a benign place to practice financial/casino capitalism as our regulators never adopted either of the two following measures put in place in the USA. As a consequence of the financial crisis, the SEC has clamped down on "naked" short selling, the practice of selling shares but delaying the delivery of the shares for as long as possible in the hope of buying back the shares at a much lower price without incurring the cost of borrowing shares from other holders. Also, in 2010, the SEC introduced a measure whereby if the price of a security falls by more than 10 per cent, transactions in the stock are stopped for the remainder of the day and all of the following day.
2. Large institutional investors with a significant position in a company have, or should have, the analytical wherewithal to assess public claims made by short sellers against this company. If they find those claims to be ill-founded or even false, they should state so publicly instead of, as is the case now, letting the company fend off the attack by itself. And these large institutional funds should not lend their shares to short sellers of the Spruce Point Capital ilk.

Should Canada let American short sellers roam free and wreak havoc in our financial markets? To ask the question is to answer it.

The author is solely responsible for the opinions expressed in this article.