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The puzzling behavior of short sellers around earnings announcements

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We examine the performance of 'predictive' and 'reactive' short sellers who take relatively large short positions immediately before and after quarterly earnings announcements, respectively. While both types short into advancing markets, it is surprising for reactive shorts since their trades are in stocks that just announced unexpected good news and thus, according to the post-earnings announcement drift anomaly, will subsequently have abnormally high cumulative returns. Nevertheless, we find that for both types of short sellers: (1) subsequent cumulative returns are significantly negatively related to the amount of abnormal short selling, suggesting they are informed, and (2) relative to non-earnings dates, the subsequent returns around earnings announcements are significantly more negative, indicating they appear to be adept at exploiting earnings announcements. Surprisingly, we find that the subsequent returns of reactive short sellers are significantly greater than those of predictive short sellers except for S&P 500 stocks, perhaps due to their greater analyst following. Importantly, we are left with two puzzles. First, reactive shorts would have significantly improved their performance had they based their trades on the size of standardized unexpected earnings ('*SUE*'). Second, predictive shorts of Micro stocks would have significantly improved their performance had they simply waited until earnings were announced and then based their trades on *SUE*.

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1. Introduction

Theory and evidence on short selling generally conclude that short sellers are informed traders. For example, Diamond and Verrecchia (1987) state that short selling is not done for liquidity purposes because short sellers cannot use the sale proceeds for consumption. Consequently, the average short seller is more informed than other sellers. Empirically, Diether et al. (2009b) find that stocks perform poorly over relatively brief time periods that follow increased short selling activity. Over longer periods, Boehmer et al. (2008) similarly find that heavily shorted stocks underperform lightly shorted stocks.[1]

We examine short selling around earnings announcements because they are the most important recurring news announcement that a firm makes and often have a notable effect on its stock price. Additionally, the well-documented post-earnings announcement drift ('*PEAD*') anomaly where, on average, an announcement of significant unexpected earnings is followed by significant abnormal returns of the same sign on the announcement day and over the next several weeks, would appear to present short sellers with a notable opportunity.[2] In this study we analyze two types of short sellers. The first type is the *predictive* short seller who shorts immediately before earnings announcements (day '*−1*'), and the second type is the *reactive* short seller who shorts immediately after earnings announcements (day '*0*').

There are four objectives of this study. Our first objective involves examining returns ('*Ret*') on the day that short sales take place as well as subsequent 5, 10, and 20-day cumulative returns ('*CRet*') associated with each type of short seller in order to see if their trades are consistent with an attempt to exploit the *PEAD* anomaly.[3] Specifically, we separately compare predictive and reactive short selling activity to the return on the announcement day ('Ret_0') since it is a *market-based* measure of earnings surprise. In addition, we examine the relationship between short selling activity and an *accounting-based* measure of earnings surprise known as standardized unexpected earnings ('*SUE*') since this measure largely determines Ret_0. Importantly, both Ret_0 and *SUE* are known to be directly related to *PEAD* (Ball and Brown (1968), Beaver (1968), Bernard and Thomas (1989, 1990), and Foster et al. (1984)). We find a strong positive correlation between short selling intensity and contemporaneous returns for both types of short sellers. This observation is consistent with short sellers being contrarians who tend to trade into advancing markets. For predictive short sellers this is only mildly surprising since this observation takes place on the day *before* the earnings announcement. Nevertheless, the magnitude of their short selling is inversely related to announcement day returns, particularly for S&P 500 Stocks, consistent with exploiting the *PEAD* anomaly. Most surprising is the case of reactive short sellers because it shows that larger short positions are being taken in stocks that have larger returns *on* the announcement day. By doing so, they are acting in a manner that is at odds with the *PEAD* anomaly. Nevertheless, the 5, 10, and 20-day cumulative returns associated with both types of short sellers are significantly negatively related to the amount of abnormal short selling, indicating both are informed.

Our second objective is to determine whether there is something unusual about short selling around earnings announcements in comparison to 'non-earnings dates' that are midway between two consecutive earnings announcements. Given the findings of Diether et al. (2009b) and Boehmer et al. (2008), this analysis is performed in order to see if either type of short seller is able to exploit earnings announcements, the most important recurring news event of a firm. We find that relative to cumulative returns around non-earnings dates, those around earnings announcements are significantly more negative for both types of short sellers, indicating that they appear to be adept at exploiting earnings announcements.

Our third objective is to compare *CRet* of predictive short sellers with those of reactive short sellers. In essence, we compare the ability of predictive short sellers to *forecast* the value-relevant information

[1] There is also evidence that short interest and stock returns are negatively correlated. See, e.g., Asquith et al. (2005), Desai et al. (2002), and Boehmer et al. (2010).

[2] There is a long stream of literature dating back to Beaver (1968) and Ball and Brown (1968) about the immediate and subsequent effect that earnings announcements have on stock prices. For a thorough review and analysis of the literature on the relationship between earnings and stock returns, along with suggestions for future research, see Richardson et al. (2010).

[3] Both abnormal and raw returns are used; unless they are in conflict, 'returns' hereafter refers to both measures. We confirm the presence of the *PEAD* anomaly during our sample period.

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