The Real Effects of Short Selling Activities

Mahdi Nezafat, Tao Shen, Qinghai Wang*

June 29, 2015

Abstract

Does short selling help or hinder disciplining managerial behavior? We examine managerial investment decision in a model with informed short-selling and short-term managerial incentives and show that short selling can cause firms to overinvest. The overinvestment problem is more severe for managers with stronger short-term incentives and for firms that lack quality investment opportunities. Empirically, we find that short interest is strongly and positively associated with subsequent corporate investment, and the effects of short selling activities on investment is greater when a firm's investment prospect is poor and/or when the sensitivity of the CEO compensation to stock price performance is high. Additionally, both short interest and corporate investment are negatively associated with subsequent stock returns.

JEL Codes: G30, G31
Keywords: Short Selling, Corporate Investment, Stock Returns

*Mahdi Nezafat, Broad College of Business, Michigan State University, East Lansing, MI 48824. E-mail: nezafat@broad.msu.edu. Tao Shen, School of Economics and Management, Tsinghua University, China, Beijing 100084. Email: shentao@sem.tsinghua.edu.cn. Qinghai Wang, Lubar School of Business, University of Wisconsin-Milwaukee, Milwaukee, WI 53201. E-mail: wangi@uwm.edu. We thank Charles Hadlock and Xu Jiang for helpful comments. We thank Lalitha Naveen and Alex Edmans for making their data publicly available. We alone are responsible for any errors.