

RUSSELL CLARK'S SHORT
SELLING STRATEGY



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Why short sell?

In general, short selling is a losing strategy.

Most investors are better served by being long the market over the longer term. However, a well constructed short portfolio can offer more portfolio protection than the more common options of buying a put option, or shorting index futures.

Having run a net short strategy for over half my investing career, I have found the following ideas and techniques help to maximise the chance of a short sale being profitable.



Russell Clark, Portfolio manager

Short selling technique

- > Great long ideas have a habit of moving higher and higher over time, and typically end with a parabolic move. A long position will increase in size naturally as it moves higher, meaning that investors will be most heavily invested in a long idea as it moves parabolically. Momentum investing works well with long investing.
- > Short ideas tend to fall more erratically, with the first move lower being the most profitable. Being profitable at short selling requires the ability to pre-position in a stock before it moves lower, so timing is key. Momentum investing rarely works with short selling.
- > When deciding to short sell an industry, I utilise a three part process – Macro, Micro and Market.
- > I only short when all three parts are pointing towards an optimal moment to short sell.

Macro factors



Look for a change in trends in the macro environment

- Currencies
- Commodities
- Interest rates and bonds



In particular I focus on currencies, as they have a strong mean reversion bias. If we forecast significant currency weakness I can short sell exporters to those countries.

Typical signals of potential currency weakness include the following:

- Large current account deficits
- Negative net international investment positions
- Large short foreign exchange positions within the financial system
- Declining industries (ie falling oil prices, tend to weaken the currencies of major oil exporting nations)



Micro factors



MACRO

What are individual companies are seeing and doing

- Excess capital expenditure
- Regulatory changes
- Increased competition

MICRO

Most industries are cyclical. Cyclical tops are often caused by new entrants and excessive competition entering the market. A cyclical downturn typically ensues.

MARKET

Market returns can also be reduced by regulatory change, when governments seek to promote competition within an area.

Market factors



MACRO

When the Macro and Micro are in agreement, I then look to Market based signals to help determine when to short.

MICRO

Indicators that I look for are following:

- Unsupported bull market (see next page)
- Dispersion – particularly small caps underperforming large caps
- Overweight holdings in the market, and large ETF participation

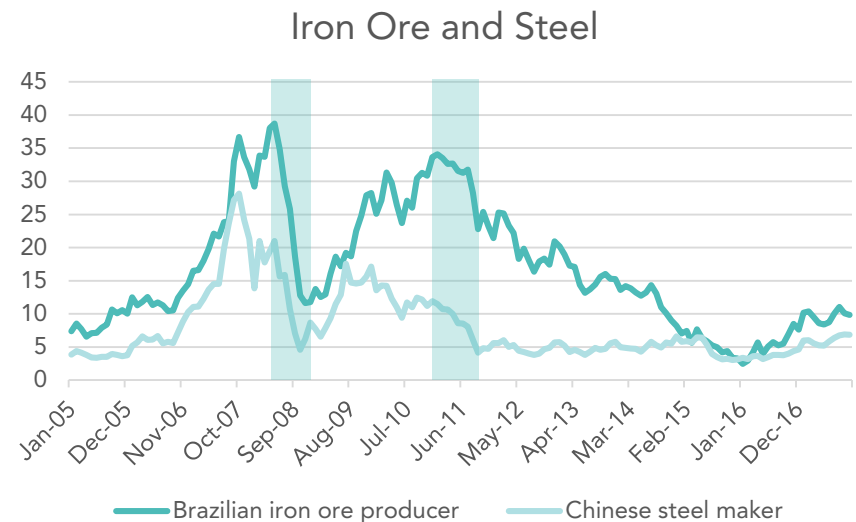
MARKET

Short Selling Theory Expanded – Supported and Unsupported Bull Markets

- > Short selling opportunities are often identified through the idea of supported and unsupported bull markets.
- > A supported bull markets rests on the idea that when an industry is doing well the players supporting the industry (eg customers) are also doing well.
- > An unsupported bull market is a market when all the profits aren't accruing evenly. These markets are inherently unstable and tend to offer good shorting opportunities.

Example:

- > Iron ore is a key component of steel, therefore iron ore and steel (proxied here with the share prices of a large Chinese steel maker and a large Brazilian iron ore producer) tend to have similar fortunes.
- > However, in 2008 and again in 2011 the iron miners' share price broke away from the steel producer. This constituted an unsupported bull market and offered good shorting opportunity.



Historical Worked Examples

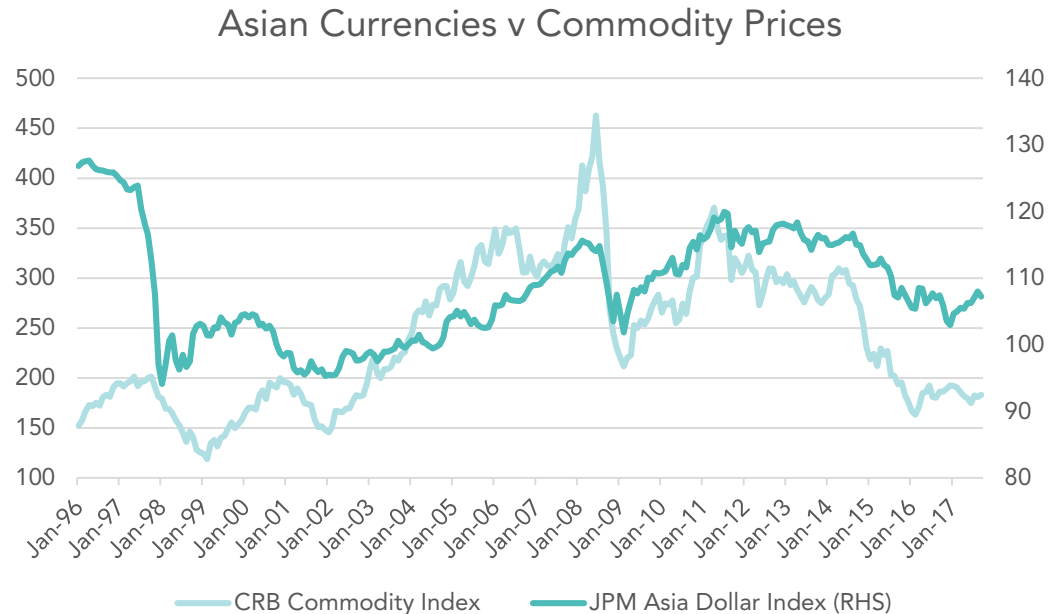
Short Mining

MACRO

MICRO

MARKET

- > Commodity prices historically tend to follow Asian currencies.
- > ADXY showed signs of topping in 2011 and 2012, while commodity prices were still very high.



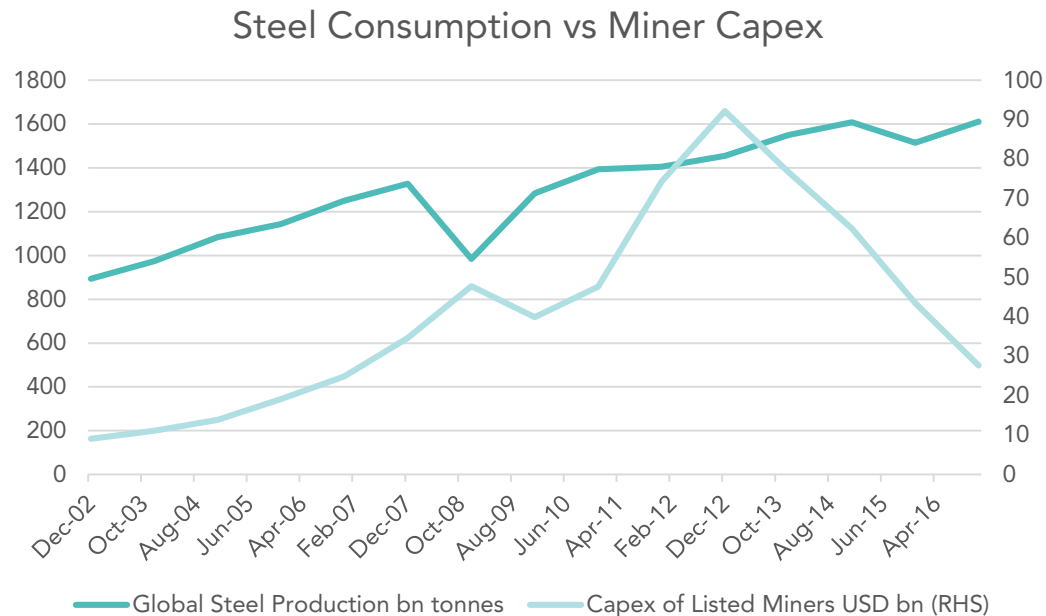
Short Mining

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MARKET

- > Mining companies were greatly increasing capex even as global production of steel began to slow in 2012. As steel manufacturers are the main purchasers of iron ore they were unlikely to see a return on this investment.



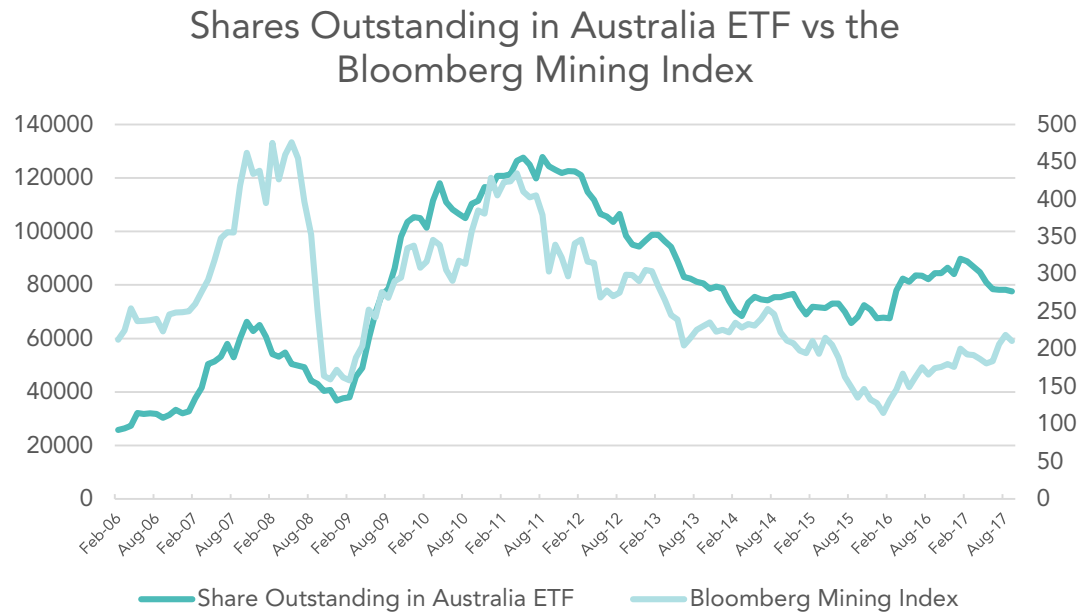
Short Mining

MACRO

MICRO

MARKET

- > Comparison between individual mining companies showed that smaller miners were beginning to underperform relative to the industry as a whole.
- > There was a big increase in the shares outstanding in Australia ETF (used as a proxy for the mining industry).



See more at <https://www.horsemancapital.com/marketviews/russell-clark/2013/03/update-the-end-of-the-mining-bubble>

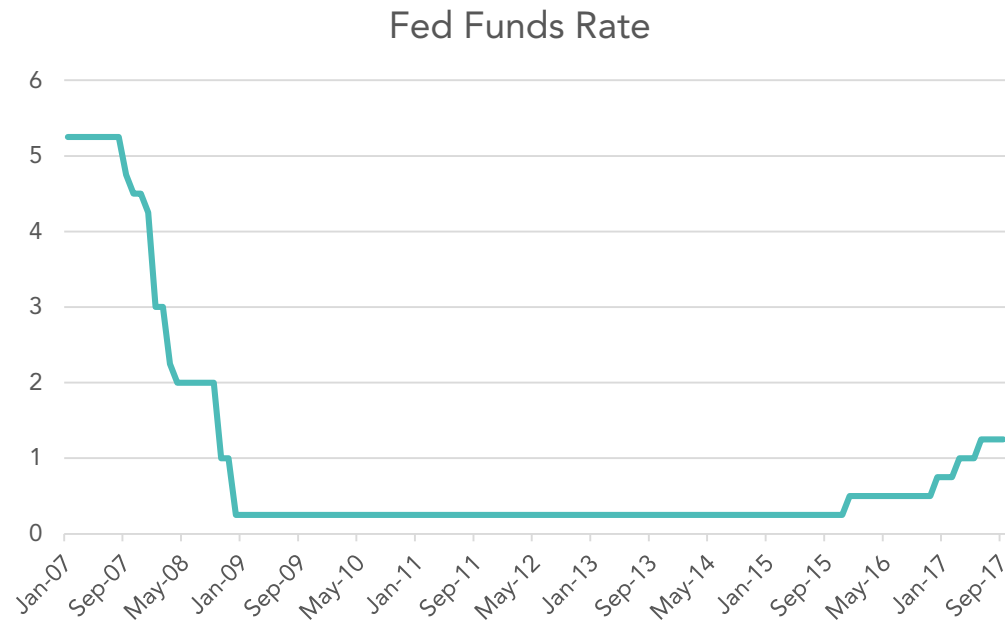
Short US Mall REITS

MACRO

MICRO

MARKET

- > In 2015, the Federal Reserve began to raise rates. This could potentially be negative for interest rate sensitive assets such as REITS.



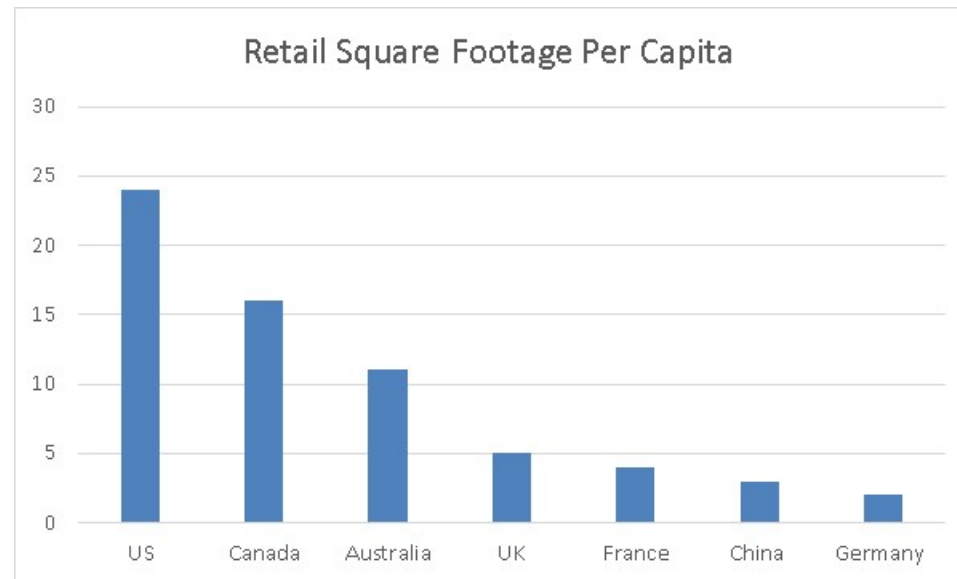
Short US Mall REITS

MACRO

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MARKET

- > Data taken from ICSC Fact Sheets showed that the US has more retail footage per capita than any other country, suggesting that there was oversupply.
- > Online shopping was reducing the demand for physical retail outlets, creating a further surplus of retail space.



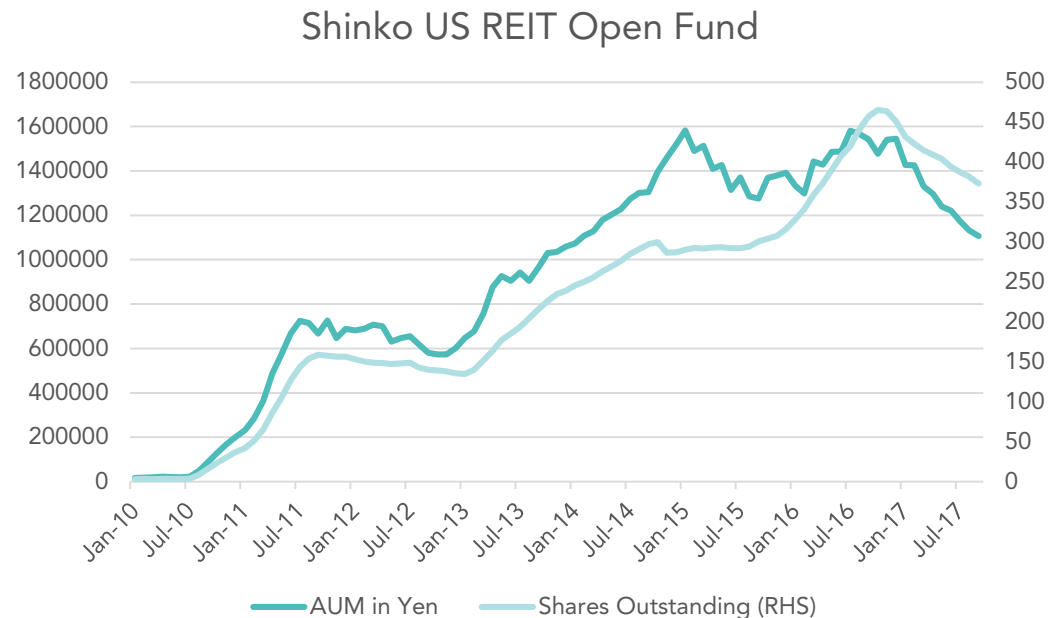
Short US Mall REITS

MACRO

MICRO

MARKET

- > Mall REITs exhibited classic unsupported bull market tendencies as the share prices of key tenants began to materially underperform the shopping mall REITs.
- > Japanese high-yield funds hold large positions in US mall REITs. As assets began to fall, they became forced sellers to meet dividend payments, creating an oversupply and subsequent fall in price.



See more at <https://www.horsemancapital.com/marketviews/russell-clark/2017/03/mall-rats>

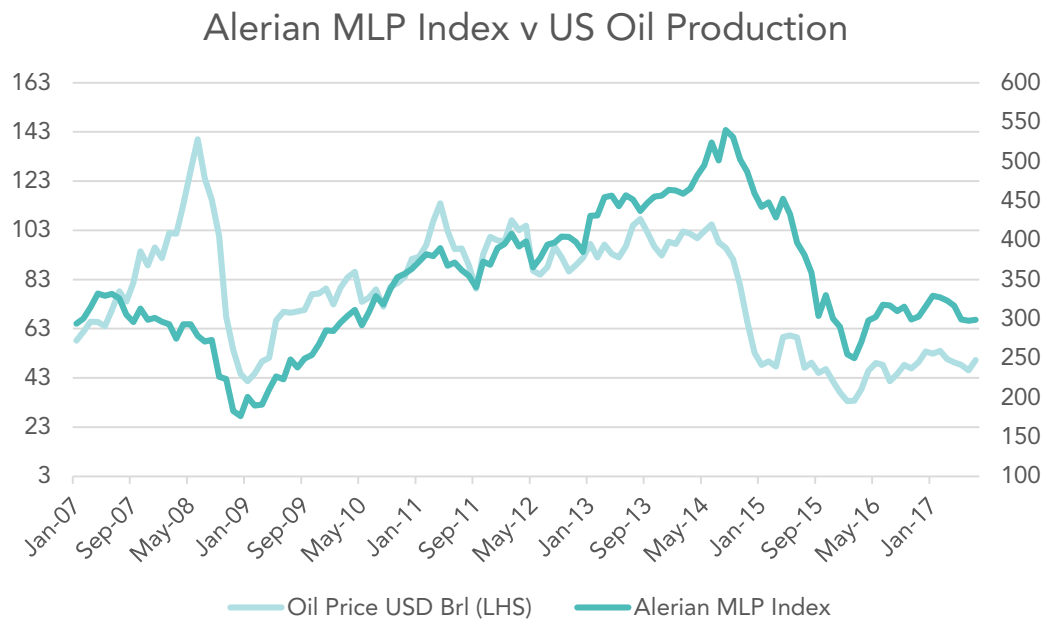
Short US MLPs

MACRO

MICRO

MARKET

- > US oil and gas production was revolutionised by the development of fracking techniques. US gas and oil production rose by half, making the US the world's largest producer of energy.
- > High oil prices led to increased production in the US and greater need for infrastructure investment via MLPs.
- > However, MLPs initially did not react to the lower oil prices.



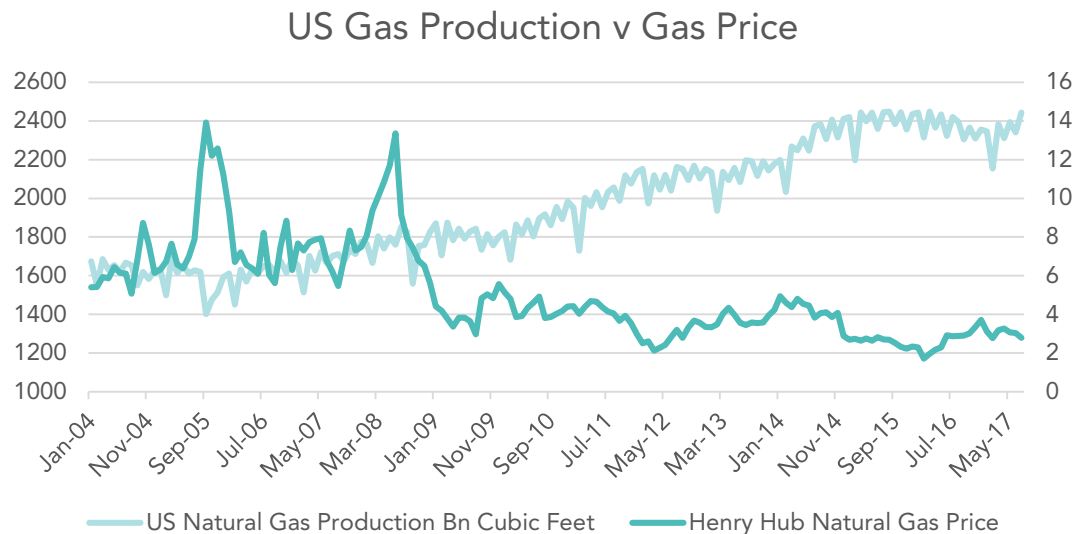
Short US MLPs

MACRO

MICRO

MARKET

- > The details of deals between US gas and oil drillers and their pipeline partners showed that the drillers need to pay fixed payments regardless of volume or prices.
- > This encouraged drillers to maximise volumes to reduce average transportation costs, but it also made it hard to cut production, leading to a glut which pushed prices down.
- > For this reason US gas production continued to grow even with low prices.



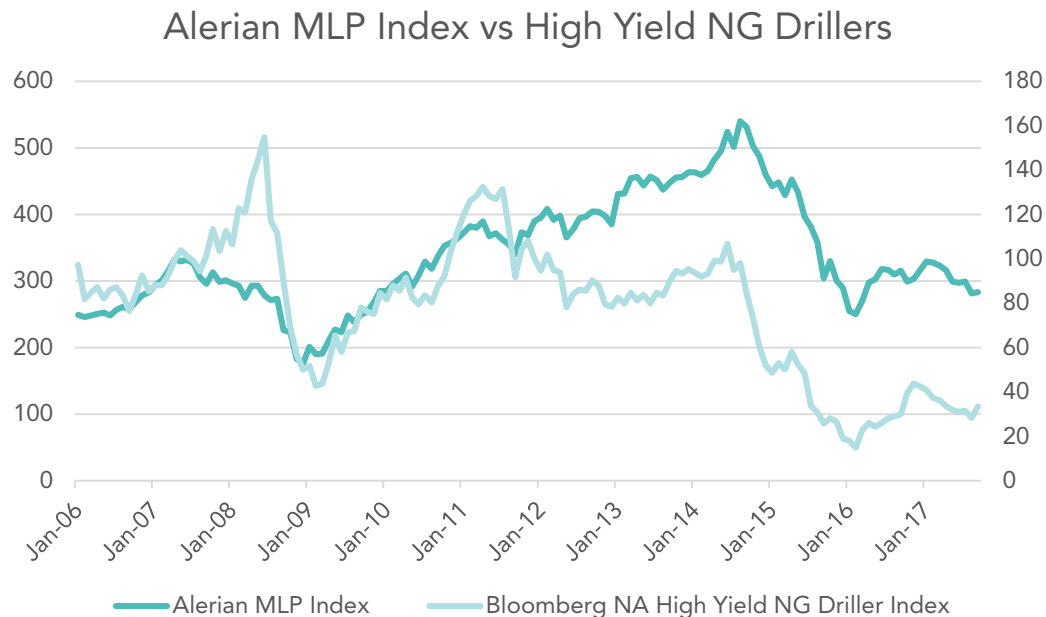
Short US MLPs

MACRO

MICRO

MARKET

- > Low natural gas and oil prices drove the major customers of the pipeline MLPs to near bankruptcy.
- > This created a classic unsupported bull market in MLPs.



See more at <https://www.horsemancapital.com/marketviews/russell-clark/2015/06/pipe-dreams>

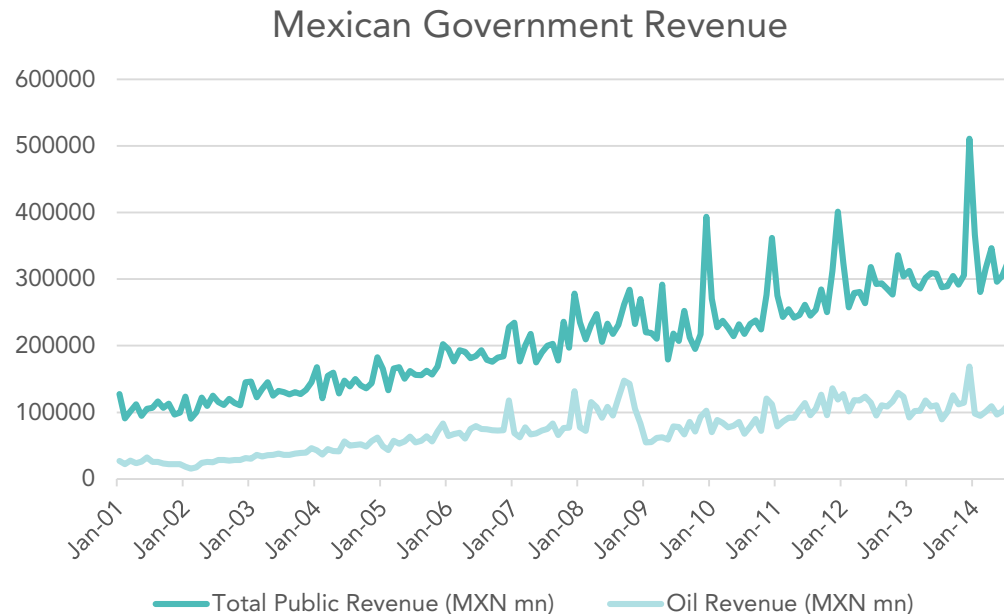
Short Mexican Peso

MACRO

MICRO

MARKET

- > Oil revenue makes up about a third of Mexican Government revenue.
- > Since the 1994 Tequila Crisis, Mexico has hedged forward the price it sells its oil production so that the government does not need to make sudden cuts to government spending. The idea is to reduce macroeconomic volatility.



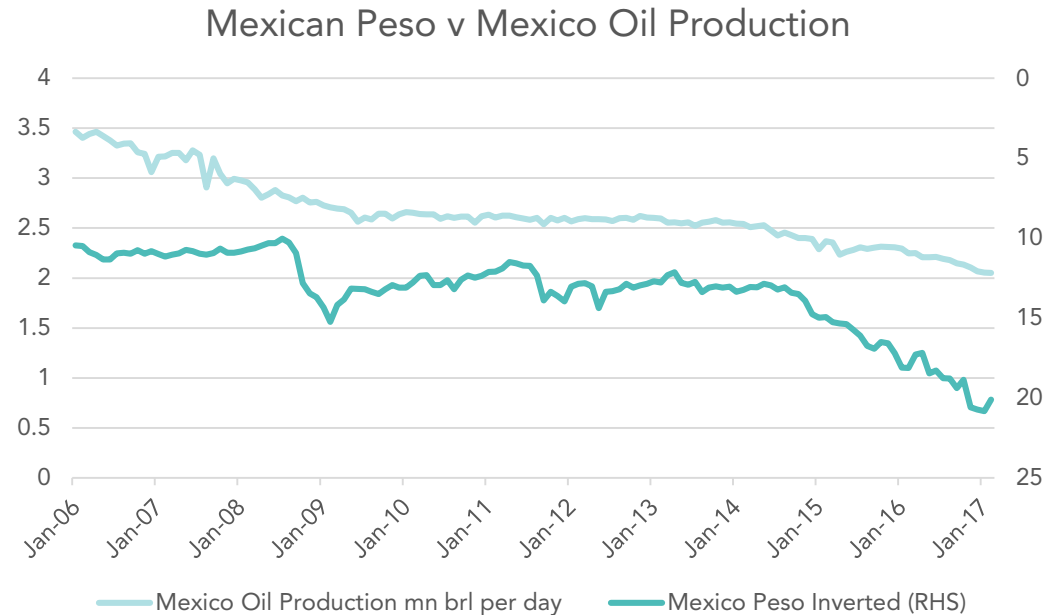
Short Mexican Peso

MACRO

MICRO

MARKET

- > Despite the Mexican government being reliant on oil revenue, Mexican oil production has been in decline due to a lack of investment.



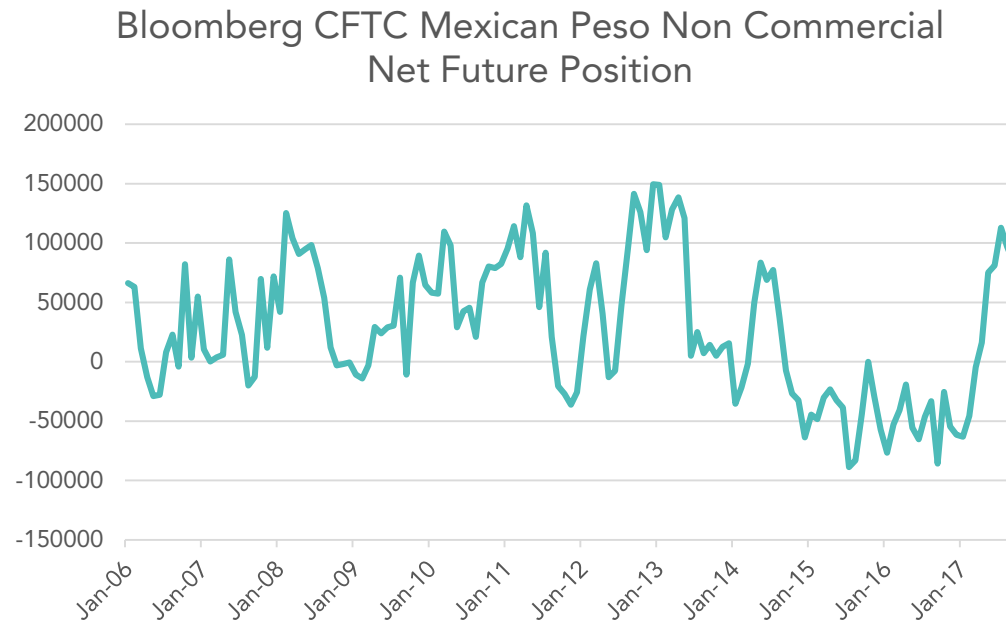
Short Mexican Peso

MACRO

MICRO

MARKET

- > For many years, the market had a long futures position in the Mexican peso. This finally went short after a sustained fall in the value of the peso.



See more at <https://www.horsemancapital.com/marketviews/russell-clark/2015/01/is-mexico-unhedged>

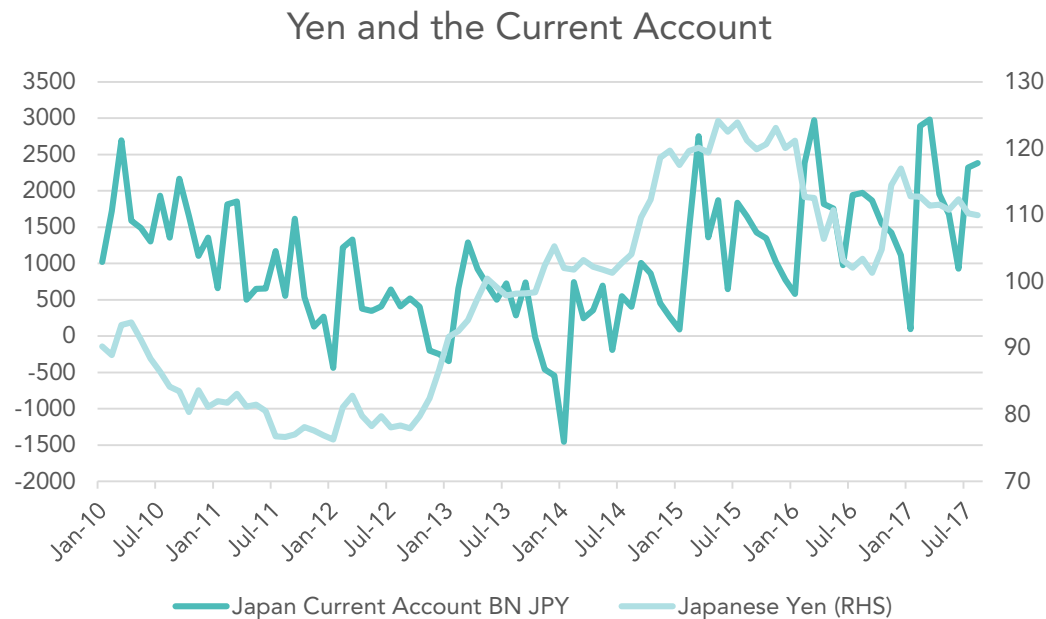
Long Japanese Yen

MACRO

MICRO

MARKET

- > When the Yen is overly strong its current account tends to be negative. When overly weak the current account tends to be positive.
- > The Yen was very weak through 2014 and 2015 but by the end of 2015 Japan was recording record current account surpluses.



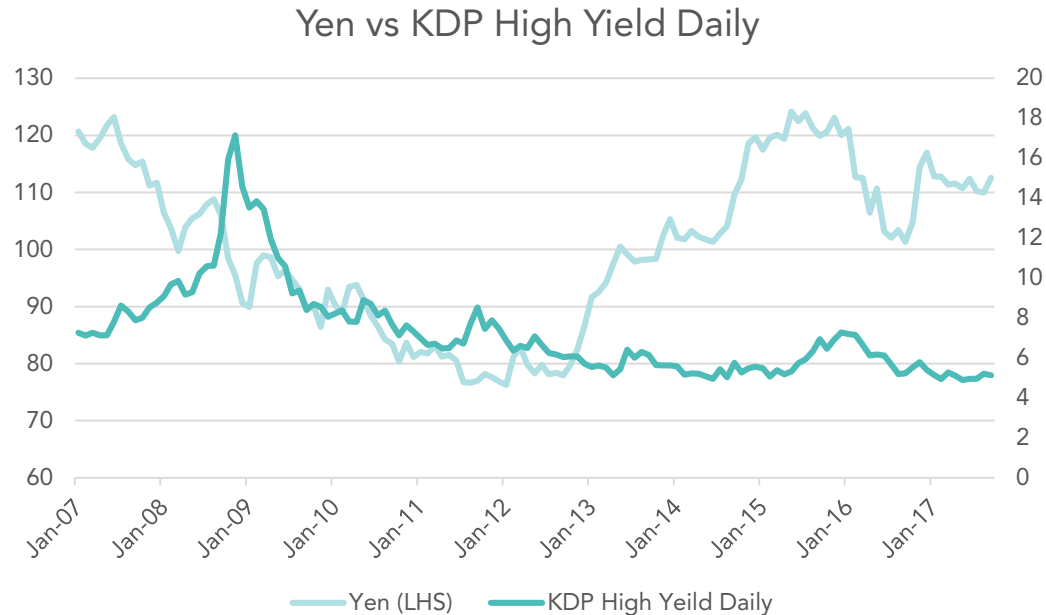
Long Japanese Yen

MACRO

MICRO

MARKET

- > Yen often acts as a safe haven currency.
- > Late 2015 saw rising yields for high yield bonds - a sign of risk aversion making a possible Yen rally more likely.



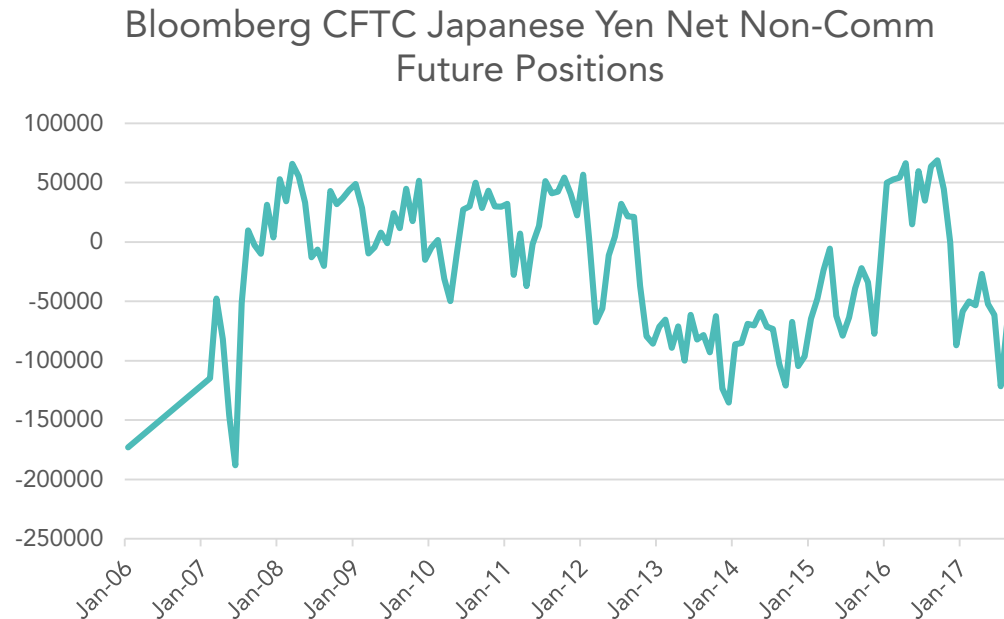
Long Japanese Yen

MACRO

MICRO

MARKET

- > In late 2015, CFTC future positions showed the market was heavily short yen, leaving little room for further decline in price and therefore indicating the right time to buy in.



See more at <https://www.horsemancapital.com/marketviews/russell-clark/2014/09/return-of-the-widow-maker-buy-case-for-jgbs>

Contact Details

For further information please contact:

Alain Zakeossian or Samantha Dunn

Horseman Capital Management Ltd,
9 Chester Close, London, SW1X 7BE, UK

Tel:+44 (0)207 838 7580

Email:

azakeossian@horsemancapital.com

sdunn@horsemancapital.com

info@horsemancapital.com

Website:

www.horsemancapital.com

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