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Short Selling and Market Mispricing

Eunju Lee

Abstract

We provide evidence on short sellers' exploitation of temporary mispricing in the equity market. Using a mispricing indicator that measures deviations from a stock's fundamental value, we find higher levels of short selling for temporarily overvalued stocks. The result is robust to controlling for short sale constraints and illiquidity, and it is more pronounced when short sale constraints do not bind and stocks are illiquid. We also find that informed short sellers are able to distinguish temporary overpricing from upward return momentum. However, when fundamental news is released, short sellers focus on exploiting negative fundamental changes rather than temporary overpricing. Short sellers contribute to market quality by correcting overpricing quickly over time, but they do not destabilize the market.

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