Short Selling Mechanism, Investor Sentiments and Enterprises' Investment Behaviors

Qing Tian

University of Bristol；Senate House, Tyndall Avenue, Bristol 21751, England.

Abstract: Our current short selling mechanism is generally seen as an important external influence mechanism that affects the transmission of information by enterprises and is therefore able to influence the process by which investors make judgments about modifying market buying and selling information through a Bayesian learning process. So, will the introduction of the short selling mechanism impose some pressure on investors to analyze and choose stocks more rationally, and thus influence corporate managers' investment practices through fluctuations in the stock market? Based on the above analysis, this paper further examines the short selling mechanism and investor sentiments, as well as their effects on enterprises' investment behaviors. This paper also tries to find out whether investor sentiments can play a regulatory role, and whether the short selling mechanism can work, with the aim of eventually better explaining influences of the short selling mechanism on investment behaviors of enterprises.

Keywords: Short Selling Mechanism; Investor Sentiments; Enterprises' Investment

Introduction

This paper mainly discusses in depth whether the overall introduction of short selling mechanism at home and abroad will generate certain impacts on sentiments of domestic and foreign investors and ultimately affect the actual investment behaviors of companies. Moreover, with an in-depth analysis, this paper hopes to find out the paths through which the short-selling mechanism can influence the specific investment of companies, thus helping to attract the government's decision-making department as well as regulatory agencies in charge of the market to pay certain attention to the factors affecting investors' behaviors in the stock exchange market.

1. Impacts of Short Selling Mechanism on Investment Behaviors of Enterprises

1.1 Change the short-term investment model

Given the many factors that influence the various investment activities of enterprises, behaviors of enterprises are not only the basic driving force for the increase of cash flow in the future, but also the constitutive basis for the continuous development and growth of enterprises, which can also be measured in terms of both the efficiency of investors' investment and their specific investment scale. In regards to the analysis of investment efficiency, China has not yet established a complete market for fund managers, resulting in the current remuneration of professional fund managers being primarily tied to their short-term business performance. The risk-averse professional managers, in order to avoid the occurrence of negative performance of funds in the short term and the decline of performance in the medium and long term, will over-invest in projects with a relatively short return cycle, and that means they will abandon some investment projects with better returns in the long term, which seems very unreasonable in a free flowing market, and this in turn also results in a generally low actual investment efficiency of most companies. A large number of studies have shown that short sellers can identify the gloomy prospects for the development of enterprises due to poor investments by investors, and can promptly stop losses by selling the stock to gain profits [1].

1.2 Rational behavior of managers

Obviously, this is because the trading market represents a certain risk signal to the market from the change in volume over a short period of time, and the presence of basic margin makes it possible for a short sale to occur with the leverage principle leading to a greater decline in the stock price. Therefore, we can conclude that the pressure brought to the market by short selling can, in the first place, motivate shareholders seeking to maximize economic efficiency to strengthen the monitoring of the decision making of the management of companies, thus alleviating the conflict between agents, which can effectively reduce the risk of a decline or even a collapse of share prices of their companies. In addition, if the manager of a listed company holds a portion of the company's equity or options associated with it, a decline in the company's share price will directly reduce the manager's operating income. Moreover, because of the prevalence of large and small mergers and acquisitions in the Chinese market, a sharp drop in an individual company's share price in a short period of time may present an economic opportunity for other companies to create opportunities for other companies to profit, often by acquiring a large number of the company's remaining shares in a hostile takeover and changing the de facto management of the company when the acquisition is finalized[2].

2. Short Selling Mechanism Promotes the Investment Efficiency and is Negatively Related to the Non-Efficient Investment of Enterprises

Regarding the scale of various corporate investments, according to the available research data, most of the listed companies in China are suffering from serious agency contradictions, which makes them spend much more on management than their calculated optimal level of 30.6%. On the one hand, share prices of Chinese listed companies have, for the most part, reflected the judgmental thoughts of optimistic traders over the long term due to the massive restrictions on short selling constraints in the market. This leads to short selling mechanism and investor sentiment, as well as the actual investment behavior of enterprises, and the investment sentiment of some pessimistic traders cannot be truly reflected in the movement of share prices, resulting in the overvaluation of the share prices of listed companies, the so-called stock market bubble. Whereas we can infer from the financing channels of equity that the overvaluation of share prices for companies significantly reduces the cost of running capital of enterprises and allows them to obtain a large amount of capital at the lowest cost in the market, leading to the occurrence of over-investment in the market; on the other hand, due to conflicts of agencies, managers of listed companies are usually keen to expand their investments, i.e., to build a "corporate empire" through the investment-profit-expansion-reinvestment model. This is because they can control more productive resources by investing heavily, thus allowing themselves to gain more benefits from their expanded holdings in the company, including higher mismatched wages, as well as human capital and professional reputation, and solidifying their professional status. Therefore, the introduction and implementation of the short selling mechanism can not only improve the efficiency of stock pricing, but also diminish the current stock price bubble and decrease the access of companies to investment in the channel by raising the cost of raising capital for companies and reducing their financing among different equity interests.

3. Analysis of Short Selling, Investor Sentiments and Corporate Investment Behaviors

Based on the theory of market economy, the current stock price is actually a combination of all production and operation information of enterprises according to the hypothesis of efficient capital market, but due to the inadequate trading mechanism of the stock market and the existence of various trading frictions, there is an incomplete response of the stock to the information of market operation, which also leads to the nominal price of the stock to deviates far from its actual internal value, indirectly leading to capital market anomalies such as stock price drift, herding effects, and weekend effects. Investor sentiment, on the other hand, is a false expectation of the future value of a stock due to differences in their personal psyches or their professional perceptions. Moreover, in the capital market, the higher the quality of information investors receive, the better it is for them to make the right investment decisions through market analysis. However, in most cases, short selling is often an informed transaction, so short sellers often have an incentive to uncover negative information about a company's production and operation process [3].

On the one hand, for investors who want to profit by shorting the stock, they are willing to spend more to collect negative news about the production and operation in their companies because of the existence of the short selling mechanism in the market, which to some extent helps to greatly reduce their irrational behaviors. In the other hand, for other investors who seek to profit from the rise of share prices of companies, the existence of a market short selling mechanism also helps companies' share prices to quickly absorb negative information about their production and business processes, thus improving the efficiency of stock pricing. Awareness of the existence of the short selling mechanism helps companies to squeeze out the bubble that exists in the share price, reduce the threat of the share price collapsing if it falls because of the inflated share price, thus minimizing market speculation and enabling investors to be willing to spend more time as well as effort to really investigate the true value of the share price of the company. And in general, the implementation of a short sale mechanism allows investors in the market to be more cautious in investing in the business as well as in selling the stock short. Compared with non-short selling stocks, it can reduce irrational investment behaviors of investors to a certain extent. Moreover, the more rational management behaviors of corporate investors will undoubtedly contribute to the further improvement of stock pricing efficiency, which makes the price of stocks closer to their internal real value, contributing to a more efficient production management of companies.

This means that investor sentiment is no longer subject to passive feedback from various production and operational information about companies. Thus, when their own legitimate governance rights are not guaranteed, investor sentiment can become another channel for ordinary investors to participate in pairing with governance of that company, and this also strengthens the external monitoring function of investors, forcing the management of companies to reduce the acquisition of self-interest, i.e., by reducing investments in projects that are beneficial to their own interests but would reduce the value of the company’s operating stock, so as to promote continuous improvement in the efficiency of their investments in the long run.

Conclusion

Combined with the above studies, it can be found that regulators should take into account the specific composition of Chinese investors and the actual characteristics of their investment behaviors. On the one hand, relevant departments should promptly strengthen the education of investors in the capital market in a timely manner and vigorously advocate a reasonable investment management concept, which is not only conducive to the further stability of China’s financial capital market, but also beneficial to the government's timely formulation of a more comprehensive as well as reasonable market management policy system and market deceleration system, ultimately promoting the long-term development of the domestic capital trading market.

References

[1] Deng, Xuebin &Hu Fan. *Margin Trading System, Investor Sentiment and Systematic Risks in Stock Market*[J]. Journal of Jinan University (Philosophy and Social Sciences Edition), 2021,43(09):54-67.

[2] Xie Lixu, Zhang Xindong, Wang Dong. Study on the Mechanism of Short Selling Mechanism on Volatility of Underlying Stocks - An Empirical Test Based on ARMA-GARCH Family Model[J]. Contemporary Economics, 2021(08):22-25.

[3] Yu Yue. Research on the Impact of Short Selling Mechanism on Corporate Inefficient Investment[D]. Shandong University of Finance and Economics, 2021. DOI:10.27274/d.cnki.gsdjc.2021.000086.