Arbitrage and Shorting Stocks

When you buy a stock, it is a good price as far as most people are concerned. Maybe the stock will go down or maybe it will go up, but given the information people have today, it is priced highly accurately to what people think it should be priced. This phenomenon is not true with most other assets.

When you buy most things in the market, you are not likely to get a great deal. Why? Because various market actors desired to take more profit than what was necessary. People take the profits they are able to get through every step in the production process. Sometimes it is marked up highly and other times it isn’t. I don’t believe this is wrong. It is natural and fine. Sometimes someone wants to sell something and they just think it is more valuable than the market generally would believe it is.

The stock market is different, largely because of short sellers. By some people being able to short a stock they believe is over inflated, it keeps prices down in the same way that someone buying a stock they believe is undervalued raises the price. In the end, what we get is a price that millions of actors believe is about right.

I don’t believe in the Efficient Market Hypothesis. I think it is highly flawed in some major ways. However, there is some thoughtful points that can be derived from it. If an asset is over or under valued in a major way, market actors can profit from this inaccurate information. Ergo, prices will be highly in line with people’s general sentiments of what it is worth to a certain degree.

We shouldn’t hate people who short stocks. We should desire this activity in more realms of our lives. Arbitrage and shorting stocks are ways that people profit from getting us valuable information and products at lower prices. Yes, they profit, and that is great. We all profit, but like people who short stocks, hopefully we also profit from benefiting our fellow man.