Why Short Sellers Are Afraid of Canopy Growth Corp (TSX:WEED)

Description

If you'd shorted shares in **Canopy Growth** (TSX:WEED)(NYSE:CGC) on August 14, you'd be in a world of pain today. After news that **Constellation Brands** was about to invest $5 billion in the company, Canopy went on an epic month-long rally and is still up over 100%, despite losses earlier this week.

Fortunately, it appears that most who were short Canopy in August got out early. According to data from IHS Markit, short positions in Canopy fell after the news of the big acquisition was announced. On August 15, there were approximately 19 million Canopy shares short. By August 30, that figure was sitting at 11.2 million — down 8.1 million from the August peak.

So, why are investors so wary of taking short positions in Canopy?

First, we should look at the risk associated with shorting in general.

Short-selling risks

Short selling is a way to take a "negative position" in a stock. It works like this: you borrow a stock you want to bet against, sell the shares right away, wait for the stock price to fall, then return them at the new (ideally lower) price.

Why is this so risky?

It's quite simple: when you buy a stock, unless you buy on margin, the worst that can happen is it goes to zero and you wind up with worthless shares. If you spent $1,000,000 on stocks that fell to nothing, that would be quite a loss, but you wouldn't be in debt. But when you short a stock, there's no "floor": the more the stock goes up, the more you ultimately owe. So, you could find yourself in a position where you owe more on a short sale than you have in *total* assets. In this situation, you'd have to borrow money to cover your loss.

Why Canopy is a bad short

Canopy is a classic example of a stock that you should not short. I'm not saying that because I think it's a great stock or that it will go up indefinitely. Rather, I'm saying it for one simple reason: Canopy is an *extremely* volatile stock.

Volatility is a measure of risk and refers to how much a stock swings up and down over time. Volatility is measured with a metric called beta. A beta lower than one indicates low risk; a beta higher than one indicates higher-than-average risk. Currently, Canopy has a beta coefficient of 2.52 — more than double the market average. That means that this stock tends to swing dramatically up and down over time. High-beta stocks are bad for shorters, because a dramatic upward spike — like Canopy's big August rally — can put them severely in debt very quickly.

Another factor that makes Canopy a bad short play is its media cachet. This is a company that gets a lot of media coverage, and it's often positive. While shorters might look at the company's negative earnings and think it's a clear dud, enough media hype can keep a financially unhealthy stock trending up for a long time. And with legalization coming on October 17, we can expect more positive media coverage for Canopy.

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andrewbutton