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Failures to Deliver, Short Sale Constraints, and Stock Overvaluation

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Abstract

Studying a large sample of publicly available data on failures to deliver, we find that stocks reaching threshold levels of failures become significantly overvalued. Where short sale constraints are especially binding, we report extreme overpricing and subsequent reversals. These findings support the overvaluation hypothesis, although the mispricing is likely to be difficult to arbitrage because of extreme shorting costs. In addition, threshold stocks with low short interest become more overvalued than threshold stocks with high short interest. This suggests that the level of short interest reflects supply-side effects when the examination conditions on the difficulty of borrowing shares.

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