

2013

Short Selling and the Price Discovery Process

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Abstract

We show that stock prices are more accurate when short sellers are more active. First, in a large panel of NYSE-listed stocks, intraday informational efficiency of prices improves with greater shorting flow. Second, at monthly and annual horizons, more shorting flow accelerates the incorporation of public information into prices. Third, greater shorting flow reduces post-earnings-announcement drift for negative earnings surprises. Fourth, short sellers change their trading around extreme return events in a way that aids price discovery and reduces divergence from fundamental values. These results are robust to various econometric specifications, and their magnitude is economically meaningful.

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Recommended Citation

Boehmer, Ekkehart and Juan (Julie) Wu. "Short Selling and the Price Discovery Process." *The Review of Financial Studies* 26, no. 2 (2013): 287–322.