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IN DEFENCE OF STOCK LENDING

Back in 2006 the Japanese government decided to set up a fund to help underpin the state pension system. This fund is now known as the Japanese Government Pension Investment Fund (GPIF) and it is the biggest pension fund in the world. As of end June 2019 it had assets of around $1.6trillion. Those assets include equity investments in many of the world's leading companies.

The Chief Investment Officer (CIO) of the fund, Hiromachi Mizuno, recently announced that the GPIF would no longer allow stock lending to take place on any of those stocks within the fund. This decision has given rise to an active debate as to whether they have done the right thing.

In this opinion piece I want to spell out my reason as to why stock lending is an important practice and why I would not support the GPIF decision.

For anyone not familiar with the practice of stock lending it is simply a system where somebody that owns a stock can lend it to someone that doesn't own it, for a fee. In other words, GPIF could lend some of the stock they own in Apple to someone that doesn't own it for a defined period and the borrower would pay GPIF a fee. Usually the borrower of the Apple stock would sell it in the hope that they can buy it back at a lower price, thus making a profit for themselves. Once they buy the stock back, they would then deliver it to GPIF and we end up where we started.

Here is how the GPIF explained their decision to stop stock lending:

As part of its stewardship responsibilities, GPIF requires its asset managers to enhance the long-term value of investee companies by conscientiously exercising voting rights for all the shares they hold, in addition to engaging in constructive dialog with investee companies - not only during the annual shareholder meeting season but throughout the year.

Conversely, stock lending, which GPIF currently conducts over the course of fund management, results in a temporary transfer of ownership rights to the borrower. This effectively creates a gap in the period in which the stock is held by GPIF, and can be considered to be inconsistent with the fulfilment of the stewardship responsibilities of a long-term investor. Moreover, the current stock lending scheme lacks transparency in terms of who is the ultimate borrower and for what purpose they are borrowing the stock.

I would like to take issue with the GPIF over the last part of their explanation. In particular I would like to make the case that there is one situation in which the purpose of the borrower in borrowing the stock is a very important one and that if everybody stopped the practice of stock lending, we would end up shooting ourselves in the foot.

If I had the opportunity, I would like to ask Mr. Mizuno if he has had a chance to look at what companies like Gotham City Research/Blue Orca Capital, Muddy Waters

Research, Glaucus Research, Iceberg Research and Citron Research have done and what they have achieved. A few years ago, I wrote an article about the importance of what these companies do on the Value Investment Institute website using Gotham City as an example (the article can be found at: http://www.valueinstitute.org/viewarticle.asp?idIssue=1&idStory=136).

A quick summary of that story would go along the following lines: based on their research Gotham realised that a Spanish company valued at over $1bn called Gowex was lying about their operations so they borrowed Gowex stock from somebody that engaged in stock lending, in other words they borrowed stock from an existing owner. They then sold that stock before they published their research. As a result of the Gotham research the Gowex CEO ultimately resigned, admitting the fraud, and the share price collapsed. Gotham made a profit and did everyone a massive favour by exposing this fraud.

If stock lending stopped (as the GPIF suggests) we would end up with a situation where Gotham could not borrow the shares to sell them. They would then be in a situation where they could not afford to do this research in the first place. I want, and I think we need, to give companies like Gotham the incentives to do this kind of work because it helps to catch criminals.

This aspect of stock lending might be a small proportion of all the stock that is loaned out but in my opinion that small proportion can achieve such important results, that nothing should be done to prevent it.

I have read an interview given by Mr. Mizuno to the Financial Times and nowhere in his article does he mention companies like Gowex, Enron, Worldcom, Tyco, Quindell, Valeant and all the other fraudulent companies that have existed over the years. The fight against fraud needs to be supported in whatever way works and one of the best ways is to allow quality research to be rewarded. The best away to do this is by allowing stock lending, without it we are shooting ourselves in the foot. I therefore call on the board of the GPIF to reverse this decision.

Hypothetically speaking, if the GPIF had owned Gowex and had wanted to fulfil their stewardship responsibility by voting their shares (at the AGM for example) they could have loaned out the shares for time periods that avoided missing the opportunity to vote. The GPIF could in this way meet their stewardship responsibility while at the same time supporting a justified purpose for lending the stock.

If the GPIF had also hypothetically wanted “constructive dialogue” with Gowex, while the shares were being loaned out, I believe that they should have still been able to have that dialogue. I would suggest to the GPIF that they should think long and hard about owning shares in a company that would not engage in a “constructive dialogue” with them in all circumstances. In my experience good management will engage in constructive dialogue with potential as well as existing shareholders. (I will never forget the “constructive dialogue” I had with Patrick Lam the CEO of ASM Pacific, even though I was not an existing shareholder, as outlined in Opinion Piece 15).

If Mr. Mizuno thinks that fraud detection should not be the role of private research organisations / hedge funds, I would like to hear him say so. I hope he isn’t relying on the auditing profession to do that job because all the evidence suggests that they don’t believe that is their job and even if it was their job, the evidence suggests that they would not be very good at it.

Conclusion

I think banning stock lending is far too blunt an instrument and could result in companies like Gotham struggling to benefit from their hard work. The GPIF should therefore reverse their decision because by engaging in stock lending they need not give up on fulfilling their stewardship responsibilities.