## Foreword

The main cause of financial crisis may be found in the over-optimistic investing of buyers that leads market prices away from fundamental values. However, in the aftermath of "excess" when stock markets tumble, it is usually the pessimists or short sellers who get publicly blamed. Despite the longstanding controversy on short selling activities, this market instrument remains a widely misunderstood concept by the public while it is an essential tool used by hedge funds for speculation and arbitrage. That is why it is important to investigate short selling for its different motivations and the resulting effect on stock returns, a subject whose empirical study is in its infancy.

In his doctoral thesis, Sebastian examines convertible bond arbitrage, which is a typical hedge fund strategy that involves a long position in a convertible bond and a significant short position in the underlying stock. The short selling is employed as a hedge against movements in the stock price. With every change in the stock price, the hedge needs to be continuously readjusted, a practice which should lead companies with convertible bonds outstanding to have on average higher short selling activity than companies without convertible bonds. Furthermore, fundamental information should be processed differently in stocks with convertible bonds as stock price reactions based on the information are accompanied by the short selling of the convertible bond arbitrageurs. Developing and investigating these predictions, Sebastian focuses on events of extreme stock price changes and short selling activity when the presence and differences in the effect on stock returns of arbitrage and speculation based short selling should become most apparent. The results document the predicted patterns and are strongest for firms with convertible bonds whose embedded equity options trade at-the-money. These insights hold important implications for the interpretation of aggregate short selling activity. They are also relevant for the explanation of the stock price pattern of firms that have issued similar instruments of external financing or that are subject to the issuance of derivative products such as in the case of structured retail products.

With his innovative research framework, excellent presentation of the empirical analysis and insightful discussion of the dynamics of short selling and convertible bond arbitrage, I wish that researchers, regulators and practioners will acknowledge Sebastian's contribution to the ongoing debate of the role and effect of short selling activities in financial markets.

Johannisberg, April 2009 — Prof. Dr. Lutz Johanning