CHAPTER 1

What Is Short Selling and How Can It Help Your Investing?

Key Concepts

- Reasons for short selling
- What is short selling?
- How to short
- The history of short selling

One of the key tenets for money managers is to focus on investing for the long term. Over the years, the volatile swings will even out and your portfolio will steadily increase. By taking a buy-and-hold strategy, you should be able to generate 7 percent to 8 percent average returns—when including dividends. This is what history tends to show.

But is this really true? Can the markets be stagnant for ten or even twenty years? Yes they can. Keep in mind that the time between 2000 to 2010 is often referred to as the "Lost Decade," in which the Standard & Poor's 500 Index (S&P 500) averaged a loss of 0.5 percent per year (of course, it would have been even worse when adjusted for inflation). This did not even happen during the 1930s when the United States suffered from the Great Depression.

It is true that statistics can be misleading, as the first half of 2000 was the peak of the bull market. If the comparison was done

from 2002, the numbers would look better. Yet few would argue that 2000 to 2010 was not without extreme volatility. In all, there were two major declines in the markets, which included 2000 to 2002 and 2007 to 2008. The decade also saw a variety of negative events. There was the real estate implosion, the accounting scandals of Enron and WorldCom, the terrorist strike on 9/11, the wars in Iraq and Afghanistan, and two recessions.

But can there be two lost decades? Looking back at U.S. history, there are examples of this. For example, the 1929 crash led to a grueling bear market. The Dow Jones Industrial Average (DJIA) did not recover until 1954. Another case is the period from 1964 to 1982, which also saw a devastating bear market. There is also the terrible experience in Japan. Since the plunge in the Nikkei Index in 1989, the markets are still 75 percent off from the peak.

Unfortunately, the U.S. economy is certainly facing major headwinds, which could make it difficult for the markets to post strong gains. Consider the views of top money managers at Pimco like Tony Crescenzi, Mohamed El-Erian, and Bill Gross. They believe that the U.S. economy will have a muted growth path for the long haul. One reason is that many of the jobs lost in the 2008–2009 recession will no longer return. Industries like autos, housing, construction, retail, and finance have undergone tremendous structural changes. Corporate America has also learned how to manage with fewer employees by using productivity-enhancing technologies and outsourcing to economies like China and India.

There has also been a massive destruction of wealth. Since peaking at $66 trillion, the overall net worth of Americans has fallen by about $10 trillion. This will likely be a drag on consumer spending, especially as the Baby Boomers get older and start to retire. They will focus on more conservative investments because they do not want to run out of capital. Another major drag on the economy will be increased regulations. True, the near collapse of the financial system meant that it was inevitable that the federal government would get much more intrusive. Yet this will make it more difficult for companies to operate. Despite the regulations, it is likely that U.S. financial institutions will be restrained in extending credit. The fact is the consumers still have large debt loads. What's more, with lower growth prospects, there is not as much need for credit.

The costs of the bailouts will also lead to higher taxes. At some point, the federal government will need to take action to reduce the swelling budget deficit. And in light of the surge of retirements from the Baby Boomers—which will mean higher healthcare and Social Security benefits—it will be tough to find ways to cut costs.

In light of the potential challenges—and the complexities of global economies—investors are likely to face more risk and volatility in the future. This is not to say investors need to avoid stocks or put money into ultra-safe securities like U.S. Treasuries. Instead, it means that it is important to look beyond just the purchase of securities—and consider how to make money when the values of investments fall. And of course, one effective way to do this is to use the investment technique of short selling.

MORE BAD STOCKS THAN GOOD ONES?

While any investor can have a hot streak, it typically does not last. Only a handful of investors have been able to consistently beat the markets over a ten-year period, such as Warren Buffett and Peter Lynch. Even with those who have achieved this feat—like Bill Miller—there is often a period when the returns eventually fall off.

The key to getting above-market returns is to find a few stellar performers. Picking stocks like Starbucks or Microsoft in their early years would have more than offset the losers and average performers. Lynch famously called these investments "ten baggers" (since they increased ten times or more).

Consider Li Lu, who is a candidate to manage Buffett's $100 billion portfolio. Since 1998, his hedge fund has posted annualized compound returns of 26.4 percent. This compares to the Standard & Poor's return of 2.25 percent. However, a large part of the success came from an investment in BYD, which is a fast-growing Chinese battery maker.[1] Needless to say, it is exceedingly difficult to find these home runs. In fact, Li has found only one in his career. Actually, the fact is that—even for top investors—the chances are higher that a typical stock pick will fall in value. In other words, the odds tend to be in favor of short sellers.

[1] http://online.wsj.com/article/SB10001424052748703977004575393180048272028.html?dbk.

This appears to be the case from a study by Blackstar Funds. The investment firm looked at the performance of all U.S. stocks from 1983 to 2006. Given that this was during a large bull market, the typical return should have been strong, right? The conclusion is the opposite. About 39 percent of the stocks were unprofitable and 18.5 percent lost at least 75 percent of their value. Only a quarter of the stocks accounted for all the value of the market.[2]

REASONS FOR SHORT SELLING

Until recently, the topic of short selling was fairly obscure. It mostly made headline news when there was a major drop in the markets. As should be no surprise, the short sellers are easy targets to blame when things go wrong. Because of this, there are lots of misconceptions about short selling. In many investment books, the topic is rarely mentioned. And if it is, the coverage is spotty. Yet after the 2007–2008 financial panic, short selling has increasingly become a part of the investor's vernacular. As a sign of this, it has become a daily topic on CNBC as well as in top publications like the *Wall Street Journal* and *Barron's*. In fact, one of CNBC's top journalists, Herb Greenberg, often covers short-sale targets.

So even if you do not short sell a stock, it is still important to understand the conversation. You may not even realize that some of your investments may actually employ short-selling approaches. Or, by using the analytical techniques of a short seller, you may be able to avoid stocks that are vulnerable for a big fall. But if you do short sell—or want to do so—there are certainly important benefits. Perhaps one of the biggest is that short selling can lower the overall risk in your portfolio. If 80 or 90 percent of your portfolio has long positions, then a fall in the market will be partially offset by your short positions. This would have certainly been a big help to many investors during the 2007–2008 financial panic. Keep in mind, too, that some of the world's top investors, such as hedge fund managers, routinely use short selling because it can hedge the downside in a portfolio. Examples include George Soros and Julian Robertson, who are billionaires.

[2] http://www.blackstarfunds.com/files/TheCapitalismDistribution.pdf.

Short selling can also result in quick returns. It is often the case that a stock will fall faster and farther than when a stock increases. A reason for this is that investors may panic when there is bad news and dump large amounts of shares. When this happens, it can be tough to find buyers.

It is actually getting easier to short sell securities. Over the years, Wall Street has introduced a variety of new innovations like exchange-traded funds (ETFs). These allow investors to make money when stock indexes fall. It is also possible to short real estate, commodities, and even countries. Despite these advantages, investors are often reluctant to engage in short selling. The perceived risks are high and the process can be somewhat confusing. Interestingly enough, some investors think it is even un-American to short sell stocks. Consider that some thought the short sellers were the cause of the financial shock of 2008. Regardless, the fact remains that short selling is common in any modern market and attempts to make it illegal have often failed.

WHAT IS SHORT SELLING?

Short selling is pervasive throughout the world's stock markets. To get a sense of the activity, look at the short interest activity on the New York Stock Exchange (NYSE) in mid-June of 2010. The volume was 18 billion shares, which represented about 4.75 percent of the stock outstanding. Yet even though short selling is a big part of the markets, the fact is that many investors still have only a vague idea of how the process works. Perhaps the main reason is that it sounds counterintuitive. How is it possible to make money when a stock's value falls? This is actually possible because short selling *reverses* the process that people buy stock. That is, you sell the stock first and then you sell it later—hopefully at a lower price. If so, you will make a profit on the trade.

Let's look at this in more detail. First of all, an investor must find shares that can be borrowed. This is known as "the locate" or "the borrow." Just about any brokerage firm has a department that focuses on this type of security. Keep in mind that it can be difficult, if not impossible, to borrow shares. This may be the case if the stock is already heavily shorted and the brokerage firms are hesitant to engage in the trade. Or, it could be that a stock is lightly

traded and there are few shares available to short. Because of this, an investor may look at alternatives. One approach is to purchase a "put option." This is a security that increases in value when the underlying security falls. Or, an investor may short a futures contract on an index or even stocks.

These approaches can result in quick profits because of the leverage. That is, an investor need only put up 5 percent to 50 percent of the overall value of the contract. But, of course, if the trade does not work, the losses can be substantial.

Let's assume you can borrow shares in XYZ Corp., which you believe will fall in value over the next couple of months. To do this, you must first set up a margin account and have sufficient assets in your account. This is often $5,000 or more. You then borrow 100 shares of XYZ Corp., which have a price of $40. You will then sell the shares and generate proceeds of $4,000. The process is often done within minutes or even seconds. The proceeds from this transaction will then be kept in the account as security. Suppose a few months pass by and the shares of XYZ Corp. fall to $30. You can take your profit by "covering" your short. This means you will buy 100 shares for $30 and return them to your brokerage firm. In the end, you will have generated a $1,000 profit ($4,000 minus $3,000).

THE CONTROVERSIAL HISTORY OF SHORT SELLING

Short selling is far from new. It got its start when stock exchanges emerged in Europe in the late 1500s. One of the hottest markets was in Amsterdam, which saw a massive bull market. A top firm during those heady times was the East Indies Company. Even with all the excitement and bullishness, there were some investors who were skeptical, such as Isaac Le Maire. A top merchant, he had a good sense of the value of a company as well as how to detect troubles.

Based on his research, Le Maire believed that the East Indies Company was poised for a big fall. So he aggressively shorted the stock and even spread negative rumors about the company. He was ultimately proved correct in 1610 when the shares of the East Indies Company collapsed. The event was so significant that the bull market ended. Looking for a reason, investors pointed to Le

Maire and other short sellers. The upshot was that the Dutch government banned short selling. But this turned out to be useless as investors found creative ways to get around the rules.

This would not be the end of the controversy or the banning of short selling. The U.S. markets have also seen a variety of fights. The first ban came in 1812 when the country was embroiled in a tough war. But over time, investors found loopholes. It helped that the New York Stock Exchange was fairly inactive, with just a few dozen companies traded on the market. So by the late 1850s, the United States ended the short-selling ban.

After the Civil War, the markets in the United States boomed as the country became industrialized. Railroads raised large amounts of capital from Wall Street, as did other industrial companies. There were also new innovations, like the telegraph and the ticker tape. Increasingly, the United States was becoming an economic superpower. And, stock market trading was getting much more sophisticated. With few regulations, a variety of entrepreneurs—known as "Robber Barons"—amassed huge fortunes. Unfortunately, it was not uncommon for them to engage in market manipulation, false rumors, and even bribery. It certainly was a Darwinian environment.

An example was Daniel Drew. Despite being illiterate, he had an innate sense for making large sums of money. He eventually teamed up with Jay Gould and Jim Fisk. Over time, they would speculate on the stock market—in terms of buying stock and selling short. Their only goal was to make as much money as possible.

It should be no surprise that corporate executives would also participate in questionable activities. Consider John Gates, who was the president of American Steel and Wire Company. When he realized business was softening, he cut back production and laid off employees. At the same time, he shorted his company's stock and made a tidy profit.

Even with several major market crashes and depressions, the U.S. government did nothing to restrain short selling. One reason was the belief in free markets. Shouldn't investors be allowed to make money—even if the markets fall? But this attitude would change as the stock market crashed in 1929 and the economy sunk into the Great Depression. By 1933, the Dow Jones Industrial Average fell by a staggering 89 percent.

During these tough times, some traders actually did make a fortune by short selling. One was Jesse Livermore. He had a photographic memory for stock movements. In fact, because of this, he was able to see patterns in stock changes, which ultimately became the basis of "technical analysis." It was during 1929 that Livermore made his biggest trade. He made roughly $100 million by shorting the stock market. Yet it was somewhat of a Pyrrhic victory. The American public believed he was the cause of the crash and even the terrible economic problems. As a result, Livermore hired bodyguards and eventually committed suicide in 1940.

Besides Livermore, another great Wall Street trader made a fortune from the 1929 crash: Bernard Baruch. He actually wrote a book on the topic called *Short Sales and the Manipulation of Securities*. It was an attempt to show that short selling was not harmful. For example, he demonstrated that the concept is prevalent in many industries. After all, don't many farmers sell their crops before they plant anything? Or home builders sell homes before they are made?

Despite this defense of short selling, Baruch showed little progress in making his case. Instead, he tried to keep a low profile of his trading activities, which was definitely a good idea. Keep in mind that he would eventually become a top adviser to presidents Harding, Coolidge, and Hoover. In the aftermath of the stock market crash, Congress and President Roosevelt brought about substantial federal regulations of securities and created the Securities and Exchange Commission (SEC). What's more, the federal government imposed various regulations on short selling, including the "uptick rule" (which means it is not legal to short a stock when the price is falling) and margin requirements so as to reduce the risks and volatility. But these reforms did little to stop short selling.

Actually, by the 1950s, the emergence of hedge funds would make short selling a common practice on Wall Street. With volatile markets, these hedge fund managers skillfully shorted the market. Interestingly enough, they would target brand name companies like Coca-Cola, GE, and McDonald's.

Then by the 1980s, there was yet another important development in the evolution of short selling: short-only funds. The innovators were three brothers—Matt, Kurt, and Joe Feshbach. All they did was find short-sale opportunities—and they were certainly skilled at it. Then again, they engaged in a tremendous amount of research.

In some cases, the Feshbach brothers would uncover frauds. This was the situation with ZZZZ Best Company, which quickly went bust and generated a considerable profit for the brothers. With such successes, the Feshbach brothers were able to raise a $1 billion fund. But as the bull market resumed in the 1990s, the returns trailed off and the fund eventually changed its mandate to include long positions.

Another top short-only fund to come out during the 1980s was Kynikos Associates, led by Jim Chanos. He is considered one of the best short sellers of his generation. Keep in mind that he spotted such trades as Enron and Boston Market.

THE BENEFITS OF SHORT SELLING

Despite the rancor about the evils of short selling, the fact is that there are many benefits to the practice. If anything, it is essential for the functioning of a modern marketplace. Consider when the U.S. government placed a ban on short selling during late 2008; it was actually limited to roughly 800 financial stocks. At the same time, there were a variety of exceptions, such as for market makers who needed to facilitate trades for buyers and sellers. In other words, short selling is critical for providing liquidity to the marketplace. As Bernard Baruch once said, "To enjoy the advantages of a free market, one must have both buyers and sellers, both bulls and bears. A market without bears would be like a nation without a free press. There would be no one to criticize and restrain the false optimism that always leads to disaster."

Short selling can also help to dampen asset bubbles. In fact, if it was easier to short sell real estate, the impact of the real estate bubble may have been less severe. Although, some savvy investors, like John Paulson, were able to use sophisticated financial instruments—called derivatives—to essentially short the subprime real estate mortgage market. By doing this, Paulson generated billions in profits. Interestingly enough, some short sellers, like David Einhorn and William Ackman, uncovered companies committing fraud. Examples included Boston Chicken, Crazy Eddie, Sunbeam, and Enron.

What's more, short selling allows for "hedging" of a portfolio, which protects the gains when the market falls, and it is also an

effective way to employ advanced investing strategies. One approach is "arbitrage." This is a way to make a profit when the same security or similar ones have different valuations. These trades are often quick and require sophisticated computer systems.

NAKED SHORT SELLING

Although there are certainly many benefits to short selling, this does not mean it is without its problems. As with any large market, there are investors who engage in questionable or even illegal activities. This is the case with "naked short selling" (also known as a "fail to deliver" trade), when an investor shorts a stock without borrowing the underlying shares. An investor may do this because of difficulties in finding shares to borrow. Or, the cost of a short sale may be prohibitive. However, in U.S. stock exchanges—as well as many other foreign stock exchanges—naked short selling is illegal. This is according to SEC Regulation SHO. Why is this so? The belief is that naked short selling could potentially allow for an unlimited short position, which could ultimately drive down the stock. Actually, this was one of the complaints during the 2007–2008 financial panic.

Despite this, there is still much controversy. That is, various companies and traders believe that naked short selling is fairly common but the laws are rarely enforced. In fact, a sudden rise in failed-to-deliver trades may indicate that a stock is experiencing heavy levels of naked short selling. For example, Regulation SHO provides for a "Threshold Security List," which shows a stock where more than 0.5 percent of the outstanding shares have failed to deliver for five business days. Ironically enough, short sellers consider this a guide for companies that may be good short trades.

The controversies are likely to continue, as they have throughout history. But the fact remains that short selling continues to be an effective investment tool. As seen in this chapter, it helps with not only getting strong gains but hedging a portfolio. In the next chapter, we will take a look at the essentials of short selling, such as margin accounts and tax issues.