CHAPTER 1

The Schadenfreude Component of Your Portfolio

German is a rich language that has many expressions and words that do not translate with the vigor and depth they hold in their original form. One is schadenfreude, the German word for "taking delight in the misery of others."

In this book, I am going to teach you how to profit (and at parties and other places you can brag, revel) from financial schadenfreude. My definition of schadenfreude is simple—"making delightful profits in the misery of stocks." I know this sounds awful, and is a play on words, but successful shorting is nothing short of fun. You may be happy when a company has great earnings or gets an FDA approval for a new wonder drug to treat bald men with erectile dysfunction but there is nothing like the rush when some dog of a company misses big time, or does something else stupid and blows up completely . . . especially if you have money in the right place at the right time.

I was sitting on the Washington set of Fox Business News when Bear Stearns began the last stage of its volcanic meltdown on Friday, March 14, 2008. My recommendation to short Bear was just seven trading days old. It was about 9:55, the producer was speaking in my ear and giving me a five-minute warning; I looked up at the monitor and saw the stock was absolutely melting. I pulled out my Blackberry, typed an alert to subscribers, sent it to my editor, and closed the position with a 287 percent gain. And when the anchor began asking me about Bear, about seven minutes later, I was on fire—in a true state of financial schadenfreude. Why? Because I was right—Bear was a dog, a dog among many Wall Street dogs, and it had just completely blown up.

Why did this feel so good?

Because **stocks fall a lot faster on bad news than they climb on good news,** excepting a little biotech getting a major FDA approval or a company being acquired at a ridiculous price. Short positions work a lot faster—when they work. In fact, I closed Bear too early. The following Monday the stock went from $25 to $2 and the puts I closed would have been up 800 percent. Many of my subscribers did hang on and made that 800 percent in less than two weeks.

Growth in the Shorting of Stocks

Shorting is now a common occurrence and variations such as naked shorting have been in the headlines for many months. In mid-2007 the SEC ended the uptick rule, and one year, lots of volatility, and $100 billion in shares later, shorting became as natural to many investors as going long. In the past years dozens of Exchange Traded Funds (ETFs) designed to short (or double short, more on that later) have come into being. Put volume has exploded in the last year and, the last indicator and my favorite indicator of the growing acceptance of shorting, my newsletter *ChangeWave Shorts* has added a great many subscribers. It isn't just the profit opportunities presented in a volatile and down market—it is people coming to understand that there are two sides of a trade and what is so wrong about playing the downside of a stock movement? If you have never shorted a stock or bought a put, and are about to do so, you are not an explorer or pioneer—you are an early settler on a new frontier.

What sent you to this frontier? You want to make money and fast profits based on great trades.

The Contrarian View

Most investors and traders going short are contrarians—they do well going against the grain. You may not view yourself this way but you have already bought the book so take another look in the mirror. What really is a contrarian? It is the person looking at the bounce in homebuilding stocks in January 2008 as analysts cried a bottom must be near—the contrarians drove around in their cars and saw abandoned home sites and more and more for sale signs. It is the trader saying I don't care if the stock is down 50 percent and that is a historical trough, the damned restaurant is giving away coupons left and right and the parking lot is empty most of the time. And it is the newsletter writer—moi—who hears analysts saying Citigroup will never cut its dividend but spends time with überanalyst Meredith Whitney (totally brilliant, now with Oppenheimer), reads the SEC documents and says those guys at Citigroup are toast (a formal analytical term for being in deep trouble), the other analysts are wrong. Thirty-five points to the downside later, the position had made a great deal of money showing the great value of being in early, ahead of the herd on Wall Street.

If you have only invested on the long side, remember that many great long side investors are also contrarians—a fellow by the name of Buffett calls it value investing but the deep value he finds is only found in stocks other people hate, making him the ultimate contrarian.

The corollary to being a contrarian is to **avoid the crowd**. The madness of crowds. The momentum players. The headline traders. This does not mean you avoid a great opportunity because other people may see the same thing—or if it has downside momentum—I just think you should avoid going short simply because momentum is there. I know, some of the great trading systems of the past few years are built around momentum indicators—go for it if you will—but that is not what true shorting is about. Momentum trading is agnostic to the long or the short side and because the relative value of indicators changes as the market changes, momentum systems work and do not work based on market conditions. On the other hand, going short is about lousy companies—and lousy companies and declining market segments—as measured by fundamentals. Momentum passes; fundamentals are forever.

Instead, think contrarian, against the crowd, against and ahead of wrong Wall Street expectations. Ah, yes, those famous Wall Street expectations. If you keep reading, I will show where and how to gauge those expectations to better measure your own, hopefully contrarian and therefore profitable views. The bottom line: There is a great deal of money to be made investing against the Four Hs that drive Wall Street: headlines, hysteria, hype, and hope.

Getting Started—Where in Your Portfolio?

What percentage of your portfolio should you allocate to shorting? Sorry, the question is not that simple. The funds you use for shorting stocks should be from your trading account and/or high risk capital—and that means it lies somewhere between 0 percent and 100 percent of your capital. When allocating capital, remember, you are not shorting the market, you are shorting lousy companies or lousy market segments that will fall regardless of or in spite of the market.

Getting started involves certain tasks:

- Determine what part of your portfolio will fund short investing.
- Determine what percentage of your capital goes to the short side.
- Determine how big each position will be.

I cannot and should not recommend to you how much money should be in the high risk or trading part of your portfolio. That being said, I ask you to look at the market itself as an asset subject to traditional asset allocation. What exactly do I mean? Traditional portfolio allocation says to diversify your portfolio along traditional lines—small cap, big cap, aggressive growth, domestic markets, foreign markets, emerging markets, income stocks, and so on. What is missing from traditional asset allocation formulas is the market itself. The market is always there; trading is always going on; there is a potential winner and loser for each trade; the trading of the market generates huge revenues every day. So consider the playing of the downside as playing the market itself, and this is a new slice of the asset allocation pie.

The first task is to determine where the capital you use to short stocks comes from—what part of your portfolio. One view is since you short a stock based on fundamentals, using the same logic as going long, you should use any funds you currently allocate toward buying equities. Another view is that since I am recommending you use puts—and, as you will see, without sell stops in most situations—you should only be using high risk or trading funds for shorting stocks. My view: **Start with funds you would normally allocate toward the higher risk component** of your portfolio, funds from a trading account, or funds you are currently using to trade options. As you get comfortable with the process, you can add funds from other parts of your portfolio as long as you remember puts can expire worthless.

The second task is to determine how much of your portfolio—your high risk funds—goes to the short side. It all depends on the opportunity. But since my first rule is to play defense, and the second is to wait for the great trade, it is best if each position is no more than 5 percent of the capital you have allocated for the short side, preferably less. Since you are shorting lousy companies, markets, or market segments, each judged to be going down for unique reasons, your decision to invest is based on the opportunity, not on a portfolio allocation mechanism, or some abstract decision about how the general market is moving. If you follow my lead, you don't or should not really care, except in extreme circumstances, where the market is going. You are exploiting an individual opportunity to make a profit, end of story.

Apart from this advice, **always let common sense take over**. Many successful investors and traders balance their portfolios with short positions in recognition that there is as much bad news and downside weakness in equities, bonds, and markets as there is upside. Warren Buffet does not short stocks but he made a massive bet against the U.S. dollar with a variety of investing instruments, in essence creating a short position against the greenback. If he can go short to exploit an opportunity or to provide some balance to his holdings, you can as well.

When to Short?

Your delight, your profits, your early retirement, your ridiculous case of wine—they come from being agnostic about the direction of the market and being right about a stock or market segment when most other investors are wrong.

When should you short a stock? While each trader has his own preferences for going short or long, several rules of thumb will help you get started and ultimately drive how you spot potential opportunities.

- **You short when you see bad news and disaster coming for a specific company or market segment, not based on a view**

of the overall direction of the market. Ahead of most of the folks on Wall Street. The bad news? Starbucks lowering guidance; the FDA reining in Amgen's drugs; Apple destroying Palm with the iPhone; and so on. All of these happened in the real world and all happened with the market going up.

- **You short when a great opportunity arises based on both the underlying fundamentals**—negative fundamentals—and a lack of unfavorable short-term technical indicators, which is different than looking for favorable indicators. This is different—far different—than looking for favorable technical indicators to initiate a trade.
- **Your best trade, the perfect trade is when the great opportunity—the weakening company—lies within another great opportunity—the sliding or crashing market segment.** The Bear Stearns meltdown is a great example of the near perfect trade.

My last point—you don't make a trade because you have not traded in a week or it is time to pay for Redskin season tickets (maybe for Giants season tickets, not the Redskins)—**you wait and wait and make a trade because it is a compelling opportunity**. Not when the market is going down or up, but when you find yourself with a compelling story Wall Street does not yet see.

Swing for the Fences

You are not in this game for a 10 percent pop over six months—you are in it for far more—and for this reason you also have higher risk. My method for creating and managing short positions has two elements: minimizing risk while swinging for home runs, not singles or doubles. Yes, you should cash out when all you can make is single or double but **the creation of a position should have an initial goal of hitting a home run—a position that doubles**. This approach creates risks—shorts can run away from you, puts can expire worthless—and this risk/reward ratio is what you need to keep in mind when shaping your commitment to short positions. You should take profits in the misery of others—but you should not make yourself miserable while doing it.

Speaking of balance, I am recommending, in the upcoming chapters, a fairly unbalanced approach to making profits. You will see that I urge you to be extremely patient, wait for great opportunities, and to look for home runs. And once you invest in these opportunities, you have to wait out volatility and movements against your position if you are still convinced your logic is sound going forward.

This method follows the practice and the words of many great traders and investors who have shown or told us three things: They made their most money when they stuck to their beliefs, even through tough times and volatility; they played their hand hard when profits appeared; and they told themselves to be disciplined and patient, there is always another trade or investment. Always. When things are looking great, people go long on a stock; when things look bad, they can go short. But there is no compelling need to make any investment or trade if it is not a great one—there is always another opportunity. Always. And the inverse means you do not chase things, you do not invest because you are restless or you need to make a car payment—you invest, you go short, because it is a great opportunity to make a very large profit.

The 5 Percent Solution (Preferably 3 Percent)

The flip side of all this preachiness about hitting home runs and waiting for great opportunities is the need to play defense and to be careful how you allocate your risk capital to one position. Many of you already have systems or rules in place—use them, do not change them because you are shorting a stock with a put. If you are new or undisciplined and do not have these rules for yourself, keep it simple—**never put more than 5 percent of your high risk or trading capital toward any one trade and less than 5 percent is preferable**. You may want to overweight some positions but you should never underweight a position; that means you are uncertain, which means you should not be making the investment.

You may think limiting your positions to this size will limit profits. It may—but the first rule is to do no harm, play defense, limit losses, and preserve capital. We are swinging for home runs, and you need a lot of at bats to get your fair share of home runs.

As part of limiting risk the 5 percent solution is not enough. You also need to be mindful of something people often forget—**you need to establish links between positions**. What does that mean? Well, if you got real jazzed seeing Bear Stearns blow up and quickly established 10 positions in banks, any big exogenous move—such as a lifeline to Fannie and Freddie, the suspension of shorting financial stocks, the bailout package, all government moves—could temporarily hit all 10 positions and they will trade as if they are one giant oversized position. There is nothing wrong in having more than one position in a market segment, but you need to make sure you are not accidentally overweight in one area due to correlations you may not have seen when you first created the position.

You also need to keep capital in reserve to make sure that, if the going gets good and the position is running, you can put more kerosene on the fire. I will discuss managing positions at much greater length in Chapter 11. And don't be arrogant; managing short positions, specifically put positions, is quite a different exercise, especially when using a fundamental approach, than other things you may have tried before. So keep reading.

Conclusion

The profits you make from short side positions typically happen faster than profits to be made from stocks moving up. The best way to do this is through puts—and with the use of a trading instrument that can expire worthless, you need to manage risk as tightly as you can, playing defense first and swinging for the fences only when the great trade is in front of you. And you need to accept the home run and take it off the table when you hit your goals.

Let me give you an example: In September 2008 I predicted that after Lehman the next to go would be WAMU and then Wachovia. This happened— and I closed the position in Wachovia the day before it totally blew up. The position more than doubled—and I closed it not willing to risk profits in the face of potential exogenous events, in this case government action, that might take these profits away. The next trading day the bulk of Wachovia was sold via the FDIC to Citigroup and the stock blew up. I left profits on the table—but I did not care. This discipline is what you need to succeed, consistently, when using put positions. Please remember—**there is always another great trade out there for the patient investor**.

Q&A

Q1. If I have an existing system for sizing a position, should I still start with your 5 percent solution?

Yes and no. Yes, if something is working stick with it. No if that system or set of rules is for something other than high risk or option positions. Systems for allocating capital to individual positions that are longer term or equities are not appropriate for managing higher risk put positions.

Q2. How do you define home run?

Profits are in the eye of the beholder—but in my service I establish put positions with leverage that can get me to a double: a 100 percent gain—a doubling of your initial investment—if the underlying stock moves the way I believe it will. I have closed positions with modest gains, others with gains as high as 287 percent; no set of rules or targets should lock you in. I use the term home run as part of an overall approach of conserving capital but going for big winners, not a series of small winners.

Q3. I understand an individual position can go down while the market is going up. But do you really believe you can consistently make money from short positions in an up or bull market?

Yes. It may sound simplistic but you just need to select a series of positions based on their own merits, which should succeed independent of almost anything but a roaring bull. And I mean a roaring, irrational bull that lasts more than a few weeks, the kind we have only seen once in the past 20 years.

Q4. I have made the most money from trading with momentum. You preach being a contrarian. Should I stop here?

No. As I wrote, contrarian and momentum are not necessarily opposites. You would need to follow my method—core fundamentals plus technical indicators—and then add your own flavor by investing in positions that have an additional indicator, some form of momentum. Several of my more successful picks in banking in the first half of 2008—notably Citigroup and Bank of America—had already come down a great deal, hit a temporary bottom as value investors thought they were cheap, and I urged subscribers to go against this view and buy puts. The long-term trend was down, the current opinion was positive, the contrarian view was to go against the value investors and this proved to be highly successful.

Rules

- Stocks fall much faster on bad news than they climb on good news.
- Avoid the crowd.
- Start with funds you would normally allocate toward the higher risk component of your portfolio.
- Always let common sense take over.
- You short when you see bad news and disaster coming for a specific company or market segment, not based on a view of the overall direction of the market.
- You short when a great opportunity arises based on the underlying fundamentals.
- Your best trade, the perfect trade is when the great opportunity—the weakening company—lies within another great opportunity, the sliding or crashing market segment.
- You wait and wait and make a trade because it is a compelling opportunity.
- The creation of a position should have an initial goal of hitting a home run—a position that doubles.
- Never put more than 5 percent of your high risk or trading capital toward any one trade and less than 5 percent is preferable.