

— — — *Part One* — — —

**FACTS AND
PRACTITIONERS**



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Overview: Wealth with Risk



When Media Vision finally went belly up, when Scoreboard matched its spectacular ascent with an equally spectacular descent, when Bank of New England took major bites from its equity capital with real estate write-offs, a small group of people on Wall Street benefited. This is a book about the people who profit from collapse and who specialize in detecting disaster and about the methods those people use to track the demise of companies, like equity seismographers watching for the first tremors of an earthquake.

Short sellers unearth facts from financial statements and from observation to ascertain that a stock is overpriced. They act with conventional wisdom—they buy low and sell high, but they sell before they buy. When the stock of Crazy Eddie, a retail electronics chain, expanded like a balloon gone berserk, short sellers studied the company and saw that inventories were growing faster than sales, that management made more money than the stockholders, and that competition was brutal in retail electronics in New York City. Wall Street continued to puff up the Crazy Eddie balloon in a frenzy of enthusiasm, so the short sellers sold at a high price—\$40 a share—stock they did not own. When the stock collapsed and Crazy Eddie Antar himself (founder and ex-corporate chief) disappeared, the short sellers bought the stock for \$2 a share to close the trade and to make a profit of \$38 a share in less than a year.

◆ Who Sells Short?

Selling short is selling a security that the seller does not own but promises to deliver by borrowing it from someone else, in order to profit from the subsequent price drop. *Selling long*, the opposite, is selling a security that the seller does own and that is, thus, long in the account of the seller. Like sellers of stock who own it before selling it, short sellers expect the price appreciation to be limited. They also bet that the price will go down after the stock is sold.

Specialists on the exchanges, market makers, and block traders all sell short to provide market liquidity. When a large order causes temporary trading imbalances that would result in volatile prices, trading professionals create supply by selling short.

Arbitrageurs also buy one security and sell another one short to realize profits on temporary price disparities in markets or like securities.

Institutions, money managers, and individuals sell short to speculate on price declines. Short sellers who sell in anticipation of price declines are generally *information-based traders*—traders whose valuation studies show that a security is overpriced and who trade on that information. Their bets contribute to pricing efficiencies in the market.

Portfolio managers also sell short to hedge another holding. If the outlook for the airline industry is mixed, the managers might sell one airline stock and buy another to hedge the outlook on the industry while profiting from individual security characteristics.

Bernard Baruch, Joseph Kennedy, and many other financial titans of the first decades of the twentieth century were adept at selling short; in fact, they used the technique as casually as buying and selling stocks and bonds. Before 1983, no solely short funds existed, and short selling was primarily the venue of hedge-fund managers and sophisticated individuals. Short selling—fundamental, information-based, non-computer-motivated short selling—is practiced as a full-time profession by only 10 or 15 people in the United States. From 1988 to 1992, additional short sellers expanded the ranks after the 1990 market correction. The ensuing bull-market years have served to reduce the number of full-time short sellers to a handful. The mystery that sur-

rounds the group is increased by an occasional ground swell from executives who malign both the practice and its cabal of disciples as unpatriotic, destructive, and self-serving.

Short selling is perceived by professionals, as well as by casual investors, as risky and speculative. A frequent criticism of short selling as an investment alternative states that stocks can go only to zero on the way down, but to infinity on the way up. Short sellers respond that they have seen a lot more stocks at zero than at infinity. Because they take greater risks than other investors, short sellers must be confident that their conclusions are correct, and they must have strong evidence to support cases for price declines. Because reverses are terrifying and sudden, the burden of evidence rests on a solid, careful analysis completed before the stock is shorted.

Short sellers are usually hard-working, creative people who enjoy going against the grain and competing with the mind of Wall Street (represented by the prices of stocks). They enjoy solving puzzles that other people find frustrating, confusing, or unsolvable.

◆ *Why Opportunities for Short Selling Exist*

Money managers and individuals alike find that it is tough to make consistent profits in the financial markets. Why, then, do short sellers always find broad gaps in stock valuation that can lead to dramatic price drops?

Clearly, short selling is a niche, and a small one relative to the stock market as a whole, and that situation creates inefficiencies in stock pricing. Several studies in security-price behavior suggest that there is theoretical justification for short selling. Brokerage houses add to pricing discrepancies with buy-side vigor and with reliance on computer analytical models.

Edward M. Miller, professor of financial economics at the University of New Orleans, proposed an amendment to the efficient market theory when he suggested that "prices are bounded by limits set by the buying and short-selling of informed investors."¹ The upper limits of securities prices are set by short sellers who

will stop the ascent of the price if the potential return is great enough to augment the costs of being short. The short seller's ability to sell becomes the critical variable in the upper-price boundary. Because, Miller argued, there are many restrictions on short selling (institutional prohibitions, transaction costs, borrowable shares), stocks trade not at one efficient price but within a band of prices. The dynamics of Miller's theory of the bounded efficient market suggest that portfolio managers are well advised to look for mispriced stocks to sell because more overpriced than undervalued stocks can be identified.

Paul Asquith and Lisa Meulbroek went several steps further in "An Empirical Investigation of Short Interest." In a study that tracked stock prices on high short-interest stocks from 1976 to 1990, they found that there was a strong negative correlation between stock price and high short interest and that abnormal excess returns of 120 percent (or 5.5 percent a year) could have been earned by shorting stocks with *high short interest* (defined as "short interest greater than 5 percent of shares outstanding") from 1976 to 1990. They commented that this study "provides a foundation for the view that stock prices reflect positive information more efficiently than negative information."² Large short-interest ratios, therefore, appear to be more bearish than the common wisdom predicts.

Research studies by Henry Latane, Charles Jones, and Richard Rendleman, Jr., provide evidence that negative-earnings surprises affect stock prices to a greater degree than positive-earnings surprises and that the effect persists over time.³ The common wisdom that there is no such thing as one bad quarter has a statistical basis. Robert Hagin coined the phrase "torpedo stocks" to describe the effect on a portfolio of a negative earnings surprise. "Stocks become torpedos when very high earnings expectations give way to earnings disappointments. . . . The higher one's expectation for earnings growth, the deeper the disappointment if the expectation is not realized."⁴

Academic research on speculative bubbles shows what short sellers have known for centuries: Evidence exists that bubbles form and then collapse. Cohn Camerer reviewed the research, both theoretical and experimental, on bubbles in an article for the *Journal of Economic Surveys*.⁵ Economists are attempting to discover why prices

vary from intrinsic value. One theory suggests that fads linger in the security market because institutional investors are too averse to risk and too aware of short-term relative performance to bet against the fad and sell.

A bias against selling that exists in the market allows pricing disparities to remain; brokerage houses add to that bias. Most brokerage stock recommendations range from *buy* to *hold*, with few analysts willing to rank stocks as *sells*. Analysts are constrained by corporate finance relationships or by their need to maintain communication channels with company executives.

Donald Trump's March 1990 attack on analyst Marvin Roffman and Roffman's subsequent firing by Janney Montgomery Scott, Inc., gave credence to an analyst's fear of honesty. Company executives have gotten more aggressive in defending their stocks against adverse sentiment, and lawsuits have proliferated in response to the occasional Wall Street analyst's frank statement of negative opinion. Sy Jacobs at Mabon, Nugent & Company was placed in "investor relations Siberia" because of his sale recommendation on Household International, Inc.⁶ Charles Peabody at Kidder, Peabody & Co., Inc., was cut off by Valley National Bank and NCNB after offering negative opinions. David Korus at Kidder Peabody raised the ire of executives at Dell Computer with his sale recommendation. Some executives apparently feel an open market should not provide a forum for discussion or dissent, so the quality of analysis and information declines with the restrictions on speech.

Brokerage-house estimates also tend to be over optimistic, thereby providing potential for negative surprises with greater regularity than positive surprises. The concentration on optimism makes for more inefficiency in short-term stock prices and gives prices a positive bias.

◆ *Analytical Techniques: How to Detect the First Tremors of the Quake*

Terminal short sellers (as they are called to distinguish them from technical or computer-model short sellers) spend their days identify-

ing publicly traded companies with flaws that might cause bankruptcy or major income reversals, companies that are overvalued relative to the present value of their potential stream of income. Securities sold short in their portfolios are sometimes not bought back for years—until the prices in the market reflect the perceived condition of the company or the flaw becomes apparent to Wall Street.

How do short sellers work? What signs do they look for so they can capture the price anomalies? How do they then analyze the securities and where do they find the data?

Short-sale candidates cluster in three broad categories:

1. Companies in which management lies to investors and obscures events that will affect earnings.
2. Companies that have tremendously inflated stock prices—prices that suggest a speculative bubble in company valuation.
3. Companies that will be affected in a significant way by changing external events.

Short sellers are always alert to publicly traded corporations that fall into these three categories. No computer screen or set of screens and no consistent mechanical method can capture this universe. And that is what makes short selling lucrative: It takes too much work for most people to fool with it.

So how do short sellers find the stocks? They read hundreds of financial statements. They talk to everybody about everything: to baby-sitters about tennis shoe trends, to children about toy purchases, to doctors about new equipment or drugs. They talk to brokers, money managers, and company executives about competitors and suppliers. They read newspapers, business journals, and trade papers like the *Poultry Times* and *Gaming and Wagering Business*. They listen for stocks about which people are excited and pay attention to trends in regional real estate and retail purchases.

When they find an industry that appears to be overvalued, they begin to look for more specific company evidence. Clues that some-

thing is amiss in a corporation are the starting point of a short seller's quest. These trail signs are grouped around several characteristics:

- Accounting gimmickry: clues that the financial statements do not reflect the true state of corporate health.
- Insider sleaze: signs that insiders consider the company a personal bank or think the stock should be sold.
- Fad or bubble stock pricing: usually marked by a stellar price rise over a short period.
- A gluttonous corporate appetite for cash.
- Overvalued assets or an ugly balance sheet.

If one or more of those characteristics is apparent in a company, short sellers proceed in the quest for comprehensive information. To piece together the story of a corporation, short sellers do labor-intensive work. A framework for stock analysis follows this rough outline:

1. Short sale analysis is dependent on financial analysis—cash-flow pro formas, balance-sheet strength, and the quality of earnings. Start with at least two years of company financials and analyze the numbers by using the fundamentals of financial analysis: balance-sheet and rate-of-return ratios, income-statement analysis, cash-flow breakouts. Overlay traditional analysis with an especially tough look at quality of assets and earnings. Work from the 10Qs and 10Ks because these versions of the quarterly and annual reports that are filed with the Securities and Exchange Commission (SEC) have more data and less puff.
2. Use the proxy and the SEC insider filings to track management's salary, stock activity, and attitude toward the company and its stockholders.
3. Check in the marketplace to see what the execution of the business strategy looks like—look at the products, the competitors, the suppliers of production inputs.

4. Follow the trading patterns, the short interest, and the ownership by watching price and volume, 13D filings (investor filings with the SEC when the investor attains a 5 percent or greater position), and institutional ownership.
5. Read anything in the media—magazines, newspapers—and the Wall Street research pool to determine consensus.
6. Watch everything about the company over time to see what happens, how earnings and price progress, what changes.

The main precept of short-selling analysis is bulk. Short sellers accumulate volumes of disparate facts and observations, then they make an intuitive leap based on the information at hand. Frequently, the signs point to large problems that will not be revealed in total until after the collapse. Crazy Eddie had slowing inventory turnover. Short sellers did not find out until after the stock collapsed that the building inventory was bogus. So short sellers have to be able to make a logical leap without complete information. They have to trust their experience and judgment. They have to know where to look for signs and what the impact of those signs might be.

Where does the material come from? The financial documents and proxy can come from the company, from a service that microfiches SEC documents, or from a library that subscribes to a microfiche service.

Insider transactions and 13Ds are also reported to the SEC. *Barron's* and the *Wall Street Journal* print the largest of them. Several newsletters, such as *Vickers* and the *Insider Chronicle*, copy all of them from the SEC and have on-line computer subscriptions as well as weekly or monthly hard-copy subscriptions.

Short interest is disclosed in the *Wall Street Journal* and *Barron's* around the 20th of the month for the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX) and around the 25th for the National Association of Securities Dealers Automated Quotation System (NASDAQ). The exchanges report this information as of stock-transaction settlement day, the 15th. These lists do not include all short positions—just positions over a certain arbitrary cutoff point, currently greater than 250,000 shares short. Standard and Poor's *Daily*

Stock Price Record and the *Quarterly History Tape* also provide short-interest data.

Brokerage reports, the least useful information on the list, can be obtained from the brokerage houses (sometimes) or from the company. Some business-library databases also include brokerage reports on-line.

Any major public library has tremendous research resources, including computerized searching by company name for article citations and summaries, industry information, and price history. Dow Jones and Dialog on-line computer services also can search for articles and price histories through a large pool of business publications.

The accounting-based analysis is not difficult to do, but it takes time, patience, and a suspension of belief. A Wall Street pundit recently commented that this level of fine-toothed work is too costly for brokerage analysts or institutional managers to perform because of the time and skill required. The lack of attention by other professional investors to these financial details provides the inefficiency in information dissemination that is so central to the short seller's art.

Insider information is never a problem with short sellers because management rarely talks to known vociferous critics. Typically, short sellers have an adversarial relationship with corporate insiders. One of the maxims of short analysis is that public information should provide all an analyst needs to know: Careful reading of SEC-filed documents and observation of the execution of the corporate business plan in the marketplace should tell the story of the company.

There is a certain measure of the moralist in short sellers. As detectives on Wall Street, they enjoy revealing the emperor without his clothes and relish the collapse of an overvalued empire. Some short-seller targets in recent years have been highly touted corporate giants with well-developed personal-selling skills, secure in their ability to finance shaky businesses with public funds. Charles Keating, Jr., of American Continental (see Chapter 9), the Zises brothers of Integrated Resources (see Chapter 7), Morley Thompson of Baldwin United (see Chapter 2), Fred Carr of First Executive (see Chapter 7), Gene Phillips of Southmark (see Chapter 13), and Frank Lorenzo

of Texas Air (see Chapter 8) were all the gratifying quarry of short sellers.

Short sellers normally disagree with Wall Street and enjoy beating highly paid, highly visible Wall Street analysts. The conflict of interest inherent in the job description of a Wall Street analyst strikes short sellers as a consistent reason for flawed information. Analysts are paid to follow stocks, yet many rarely read financial documents with care. Short sellers are contemptuous of analytical skills that primarily regurgitate the management line.

◆ *Who Can Benefit from the Wisdom of Short Sellers?*

Any student of the markets should find the analytical techniques of short sellers interesting, particularly during a period when fundamental analysis is supplanted by computers and technicians and when research departments are understaffed and overrun by investment bankers.

Anyone who buys stocks, loans money to corporations, or runs a company can benefit from the collective wisdom of short sellers. Identifying the tragic flaw in a business long before the company's demise is a timely skill in any economy and an irreplaceable one in a recession.

Institutional managers should find the discipline enticing on several levels: as an analytical methodology, as a means of enhancing returns through avoidance of torpedoes, and as a hedging technique. As a methodology, short-sale analysis is not significantly different from classic fundamental work. It places heavier emphasis on cash-flow dissection and on the reality underlying reported earnings. It attempts to identify the long death rattle of a company in decline. In security analysis, managers are rarely trained by using examples of poorly run companies. Yet it is easier to identify trouble spots if education includes examples of corporate mistakes. Short selling is, therefore, another tool in a tradesman's bag.

In his essay, "The Loser's Game," Charles Ellis wrote, "Almost all

of the really big trouble that you're going to experience in the next year is in your portfolio right now; if you could reduce some of those really big problems, you might come out the winner in the Loser's Game." As an equity research skill, short selling gives analysts the ability to avert disaster in good times as well as in bad. And it gives them the ability to enjoy the joke when a sham is discovered because the fun might not be at their expense. The art of short selling trains analysts to avoid torpedo stocks or to profit from them.

Short sales should be considered by portfolio managers who want to hedge or to decrease the volatility of total returns by setting the market sensitivity of their portfolios with more precision. Because short positions have a negative correlation with a stock portfolio, a balanced portfolio of shorts and longs can even out the market effect, reduce risk, and afford returns based purely on stock selection.

Individuals can employ the analytical techniques of short selling to avoid owning stocks that will explode otherwise well-conceived portfolios and to escape the new-issue frenzy of rabid retail brokers. Knowledge of professional methods of short selling saves money in the long run.

The main weakness of professional short sellers—an inability to judge the timing of collapses—is a strong argument for attention to short selling by any entity that owns stocks. Short sellers are consistently years too early when they sell stocks. Stockholders are always slow to sell even when the evidence is irrefutable and the future for profit bleak. The years of irrational price behavior in a deteriorating company provide stock owners with years to sell a problem stock. Portfolio managers or individuals who attempt to educate themselves about the reasons for escalating short interest in stock holdings can radically improve the returns by avoiding torpedo hits—they can use the weakness of the discipline as a strength.

◆ *Mechanics and Risks*

Short sellers of common stocks borrow stock from a brokerage house to sell in the organized markets. They must put up 50 percent of the

short-sale price to satisfy the current Federal Reserve requirement. The broker, in turn, gets the to-be-borrowed stock from customer margin accounts or from another broker dealer.

If the short sale is made on the NYSE, the AMEX, or NASDAQ, the trade can be executed only on an uptick or on a zero-plus tick—the stock price must move up before a short sale can be made.

After the short sale is made, the brokerage house uses the closing security prices to compute a daily or weekly gain or loss on the positions. If the price has moved down, the seller has use of the funds for security purchases, short sales, or money market purchases. If the price moves up, the seller must put up more collateral (see Table 1.1).

Although most brokerage houses do not pay interest on the short-sale proceeds, a few do pay interest at a negotiated percentage of the broker call rate. Most managed short funds or hedge funds receive 60 to 90 percent of the broker call rate on short credit balances. The borrower is also charged by the broker for all cash and stock dividend payments on the short positions.

To close a position, the seller must buy the stock and deliver the shares to the broker, who then returns them to the original owner. (The Appendix has a detailed explanation of the brokerage and margin requirements.)

The short seller of common stocks runs two risks:

1. The price moves up after the stock is sold, thereby requiring more cash infusions into the account.
2. Or the lender demands the return of the stock.

The brokerage house can ask for the return of the stock if the client who owns the stock sells it or wants physical delivery or if the lending broker requires it for similar reasons. At that time, if the broker cannot find another position to loan to the short seller, the customer will be forced to buy it at the current market price (a buy-in).

Short sellers fear most a sustained rally in a stock followed by a forced buy-in of their position, resulting in a loss out of their control. For that reason, short sellers tend to be secretive about positions in stocks with *small floats* (shares available for purchase, or outstand-

Table 1.1 A Simplified Example of a Short Sale

A client sells short 100 shares of XYZ @ \$100:

Sell 100 shares × \$100	=	\$10,000	
Reg T* requirement 50%	=	<u>+ 5,000</u>	client deposit-equity
		\$15,000	credit balance

If the stock declines to \$80 per share:

\$15,000	credit balance
<u>- 8,000</u>	current market value
\$ 7,000	equity

If the client chooses to cover the stock by buying it at \$80 per share and to close out the margin account, the client would make a \$2,000 profit plus the return of the initial investment of \$5,000, for a total of \$7,000, excluding commissions:

\$7,000	equity
<u>-5,000</u>	initial deposit
\$2,000	profit

If the stock increases to \$120 per share:

\$15,000	credit balance
<u>-12,000</u>	current market value
\$ 3,000	equity

If the client chooses to cover at \$120, the client would incur a loss of \$2,000.

*See Appendix.

ing shares minus insider and 5-percent positions), particularly in companies with floats below 10 million shares. Despite popular fears that short sellers band together to pound small companies into the ground, the reality is that a good idea is closely held by its originator. Any action that forces owners to sell can create a shortage of stock to borrow if the new owner takes delivery of the position. When short sellers go public with a stock-sale idea by communicating the story to the press and the stock has fewer than 10 million shares outstanding, they are betting on an immediate collapse to give them the opportunity to cover the borrowed shares at lower prices. Generally,

however, publicity accompanied by only a slight downturn in price can create more problems for short sellers than it solves because the limelight might trigger buy-ins.

To avoid the risk of buy-ins, some short sellers short only *large cap stocks* (stocks whose market price times the number of shares outstanding is greater than \$500 million), and some never discuss positions or talk to reporters. The published short-interest columns are the only public sources of information about short sellers' activities.

◆ *Current Market Statistics and Growth Prospects*

Short selling is a small percentage of the overall market. *Short interest* (defined as "the total of all shares sold short and not covered as of a given date") as a percentage of NYSE shares outstanding for December 1995 was 1.30 percent, up from 0.07 percent in December 1960. Figure 1.1 shows short interest as a percentage of outstanding shares

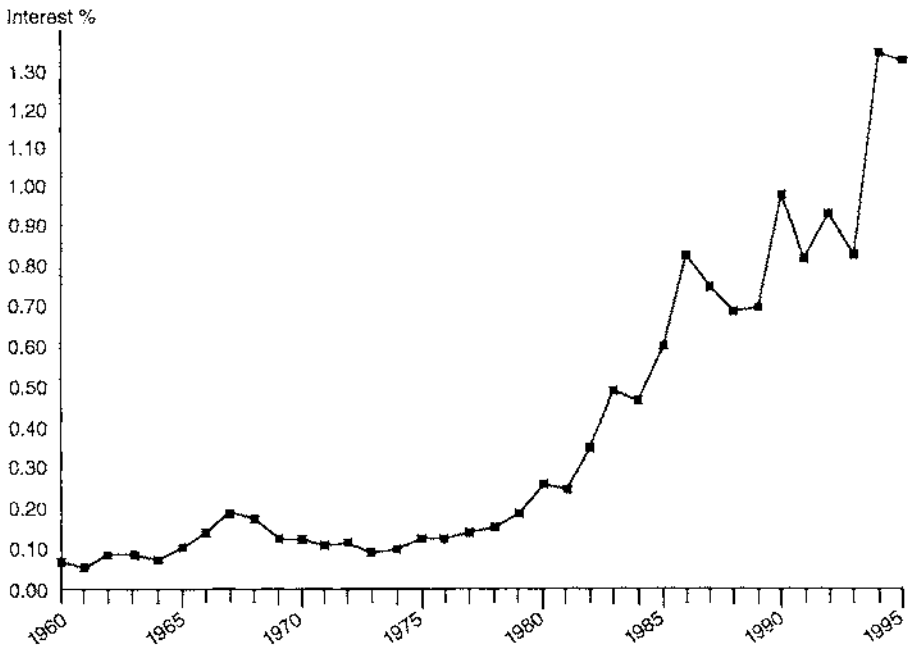


Figure 1.1 New York Stock Exchange Short Interest

on the NYSE. In December 1960, the NYSE had an aggregate of 6.15 billion shares listed, versus 4.4 million short. In 1995, those figures were 154.8 billion, versus 2.05 billion short.

The AMEX short interest went from 0.06 percent in 1960 to 1.07 percent in December 1995 (see Figure 1.2), with 10.49 billion shares outstanding and 112.4 million short in December 1995.

Short-interest statistics were not available for NASDAQ until December 1986: Short interest was 0.6 percent in December 1986 and 1.46 percent in December 1995, when short interest was 921.23 million, versus total shares of 62.95 billion.

Analysts have said that a high short-interest number is bullish because short sellers must cover and prices rise as the short sellers rush to cover shares. The short indicator as a market predictor has been under attack in recent years, however, because of the use of short sales in arbitrage positions and by institutions to hedge portfolio risk, as well as by brokerage houses to hedge put transactions by insiders locking in stock profits. Some analysts feel that this new

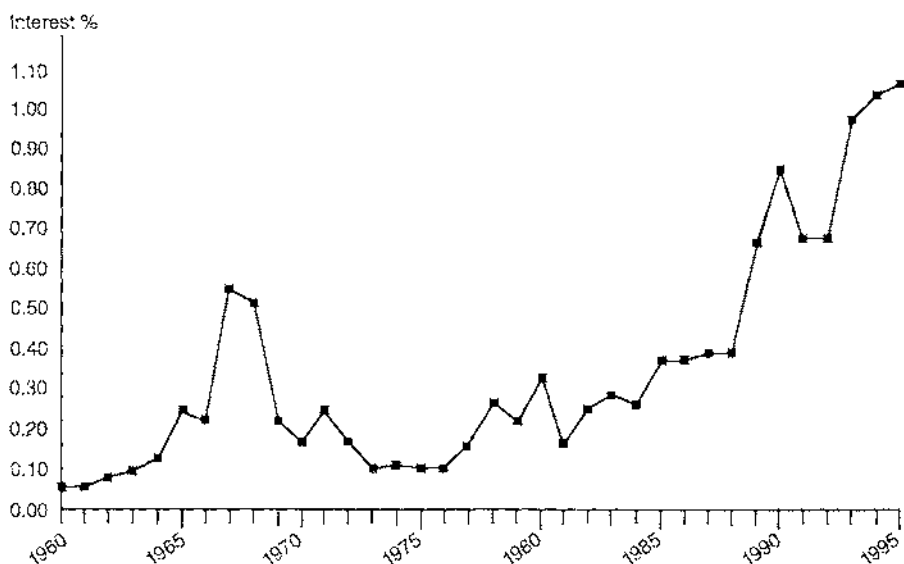


Figure 1.2 American Stock Exchange Short Interest

dimension has skewed the historical relationships. Short interest is also higher in December as a result of year-end tax strategies.

Managed funds dedicated to short selling totaled roughly \$1 billion at the end of 1989. After a spike upward in 1991 to as high as \$2 billion, the total had dropped well below the \$1 billion mark by 1996 due to disastrous performance years in 1991, 1992, and 1995. Most of the growth in short interest has come from sources other than dedicated short management. Stock funds managed for mutual funds alone were \$1.37 trillion in February 1996, so short selling continues to be a tiny niche in the investment world.

The size of short positions is expected to grow for three reasons: (1) the protracted bull market, (2) the interest of institutions in hedging or capturing market inefficiencies in portfolio returns, and (3) the growth of the *fund of funds* concept (diversified use of limited partnership funds with different investment styles).

A private-letter ruling allowing a pension fund to participate in short sales was handed down in 1988. A private-letter ruling applies only to the entity that asks for it, but it does establish a precedent. Two issues previously kept pension funds out of the short market: unrelated debt financed income and unrelated business taxable income.

The "unrelated debt financed income" question meant that tax-exempt funds could not borrow money without jeopardizing their tax-free status. If borrowing stocks was construed as "acquisition indebtedness," pension funds could not short. But the Internal Revenue Service (IRS) ruled that the short sale in an arbitrage transaction did not give rise to acquisition indebtedness if the trade was collateralized by cash or Treasury securities excluding the credit balance from the sale. If the manager did not short an amount in excess of the cash in the account, the short sale would not be considered a form of leverage.

The "unrelated business taxable income" issue questioned whether any income arising from short sales could be considered unrelated business taxable income. Interest on credit balances is generally thought to be excluded from this category. The recent rulings seem to put both issues to rest, therefore allowing pension funds access to another asset class.

The IRS issued Rev. Rul. 95-8 on December 30, 1994, which further clarified the issue. It said that a tax-exempt organization would not be subject to tax on unrelated business taxable income on short-sale gains, even when leverage is involved, or on the rebate fee. It failed to specify, however, whether short sales collateralized with stock or Treasuries would give rise to the tax.

The protracted bull market of the 1980s and 1990s, together with the increasing volatility of price swings, turned the interest of portfolio managers toward short sales. The advent of computer screens also made short selling easier as managers discovered that the firm's normal earnings momentum or value screens could be inverted for short sales.

The institutional quest for inefficient sectors of the market supports the growing curiosity toward short portfolios. Computer models that once generated equity portfolios are now spitting out short and long portfolios with zero betas and maximum alphas, portfolios that attempt to capture incremental company return without market risk. The growth of the futures and index options market, no doubt, has changed conservative investment thinking. For example, exposure to portfolio insurance and to hedging programs has increased manager and client comfort levels with more diverse asset classes and quantitatively driven strategies. It is part of this trend that short sales are no longer considered radical.

The growth in computer-driven short management for institutional investors is expected to exceed the growth in fundamental short management by a fair percentage. Some observers estimate current funds under management at close to \$1 billion already. The implication for fundamental short sellers is that, although stocks might become harder to borrow, these programs also readily lend long positions for rebates.

◆ *Caveats*

Short selling is not for the faint of heart or for the inexperienced investor. If a stock moves against the position holder, the effect on a

portfolio and net worth can be devastating. Short selling for the amateur can be as hazardous as selling uncovered puts or calls. Investors need to understand both the impact on their accounts and the consequences of getting bought-in before they indulge in short selling.

Simple selling, however, is a discipline for even the faint of heart, and the skills are the same. How to make money by shorting and how not to lose money by selling are different sides of the same coin.

There is a certain sense of power, of being in control, of being, somehow, smarter or more independent that comes with successful short selling. The discipline gives the truly addicted stock gamesperson the ability to play and to win in any economic environment: Muddled corporate strategic plans are always evident, bubbles of hope exist even when the market is undervalued, and villains are always somewhere nearby. Short selling is a game of wits, with the odds in favor of the analysts who do hard work and think for themselves, who turn jaundiced eyes on what passes for Wall Street wisdom.

◆ Notes

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