

Chapter 1

Ackman: The Activist Grandstander

It had taken William Ackman more than 18 months to get this far—with zero to show for it. Over that time, the founder of Pershing Square Capital Management, with more than \$15 billion in assets under management, had been hammering away at Herbalife, what can only be called a marketing machine that used so-called independent distributors to peddle nutrition and weight-loss products through a vast pyramid scheme. There was an enormous amount of money at stake—Ackman, who goes by Bill, had at one point borrowed some 20 percent of Herbalife's stock, worth more than \$1 billion, through his brokers and then sold it. His goal: Expose the company as a fraud and repay those borrowed shares for pennies on the dollar—or nothing at all.

That's how short-selling works—and Pershing Square had by now spent more than \$50 million in research and fees alone on the effort.

Now, in July 2014, the six-foot-three-inch-tall Ackman was wrapping up an impassioned, polished presentation for the media

and investors that laid out the details of how Herbalife entrapped its distributors through a system of so-called “nutrition clubs” that were meant to lure people into the base of the pyramid scheme and goose sales by foisting products on them. In the U.S., the lion’s share of distributors were low-income people, typically Hispanic-Americans, but Herbalife was pushing its weight-loss products in countries from India to Zambia.

Ackman singled out the Herbalife CEO. “Michael Johnson will go down in history as the best CEO of a pyramid scheme in the world,” he said, pointing out that the former Walt Disney and Univision Communications executive had extensive experience in marketing to Hispanic-Americans. He alluded to another famed notorious pyramid scheme, that of financier Bernard Madoff, who duped investors of some \$20 billion. He compared Herbalife’s marketing to that of the Nazis.

Then things got personal. His voice trembling with emotion, Ackman detailed his immigrant forbears’ history in the United States, his great-grandfather apprenticing as an assistant tailor, the family’s coat business, and his father’s own formidable achievements as a mortgage broker. “I am a huge beneficiary of this country, okay?” he said, choking up with emotion. “Michael Johnson is a predator. Okay? This is a criminal enterprise. Okay? I hope you’re listening, Michael. It’s time to shut the company down!”

“This is an ingenious fraud,” Ackman said and, wrapping himself in the Stars and Stripes, added that Pershing Square preferred to invest in companies that help America. “I said I’m going to take this to the end of the earth. We’re going to do whatever makes sense.”

Before taking a break, he fired off: “This company is a tragedy and it’s also a travesty.”

Whew! Pass the water.

Beyond the Ackman histrionics, his argument had merit.

The accusation was that Herbalife virtually forced its distributors to commit to buying more product than they could sell to earn a living wage, and Ackman, with the help of a contract research firm, had just furnished the evidence for his claim that Herbalife was a sophisticated pyramid scheme, illegal under U.S. Securities & Exchange Commission (SEC) and Federal Trade Commission rules.

The son of a successful commercial real estate broker, Ackman was born with a proverbial silver spoon in his mouth—and a highly polished one at that. He grew up in lush Chappaqua, New York—these days home to former President Bill Clinton and his wife, former Secretary of State Hillary—graduating from one of the nation’s foremost public secondary educational institutions, Horace Greeley High School. Ackman picked up both a B.A., magna cum laude, and an M.B.A. from Harvard. Immediately after graduation in 1992, with no formal training, Ackman launched his own hedge fund, Gotham Partners, which he eventually shuttered in the face of investor withdrawals—but not before making a high-profile, unsuccessful bid to gain control of New York’s Rockefeller Center. Even friends say the hyperambitious Ackman comes off as overconfident and a know-it-all—but one whose big bets and relentless drive have generated 20 percent-plus returns for investors in his current flagship fund, called Pershing Square Capital Management.

Ackman began his Herbalife campaign at a December 2012 event sponsored by the Sohn Conference Foundation—a charity that finances pediatric cancer research and care. Dubbing the presentation “Who Wants to Be a Millionaire?” after the television game show, he and colleagues spent an astonishing three-plus hours detailing a convincing case that Herbalife, which peddles nutrition bars, vitamins, and powdered smoothie mixes of soy, sugar, and protein, was a giant pyramid scheme with sales that year that would amount to \$4.1 billion.

The business model required that independent Herbalife distributors pull in more and more distributors into their network to make real money, pushing those newbies in turn to recruit other hapless friends, acquaintances, and relatives to do the same. The takeaway: Products went in large part to distributors themselves instead of end customers, with the lion’s share of the money paid to distributors for bringing in fresh candidates to the sales force, not selling the products.

That’s basically the definition of a pyramid scheme—in which an ever-growing number of recruits is duped into paying off the previous set. “Basically, the large numbers are such that if you go back to that pyramid, you need a bigger and bigger base at the bottom to support it,” Ackman explained. “Problem is, the money at the top is made from losses of the people at the bottom, and there are a very few people at the

top and a huge number at the bottom.” The arrangement works until it runs out of recruits.

By late 2012, Pershing Square was shorting Herbalife’s stock, borrowing millions of shares and then selling them, hoping that exposing the alleged fraud would prompt regulators—the SEC, the Federal Trade Commission, the Justice Department or perhaps states’ attorneys general—to step in and bring the stock crashing down, profiting Pershing Square investors. In the perfect scenario, the price would go to zero and the hedge fund wouldn’t need to repurchase stock at all.

Failing that, the accompanying publicity, much of it based on third-party analysis by a boutique research firm called Indago Group, might cause investors to dump shares, scare the company’s auditors who sign off on financial statements, or even rattle prospective Herbalife distributors who might have otherwise been attracted to the business scheme, effectively deflating what to Ackman was a blatant if fairly sophisticated scam.

For Ackman this was not just another investment gambit—it was a crusade.

Herbalife was also an extraordinarily risky bet, with Ackman borrowing and selling about one fifth of Herbalife’s total stock outstanding. The shares could be called back by their owners for any reason—meaning Pershing Square was on the hook if those he had effectively borrowed the shares from wanted them back. Yet, the shares dropped 8 percent in the days leading up to the initial December 19, 2012, presentation as rumors of Ackman’s upcoming speech began to swirl. He didn’t disappoint.

Ackman’s first rousing speech, which he made without prepared notes, hammered away at Herbalife products’ stratospheric pricing—three times as much as competing goods. He pointed out the lack of research and development (R&D) and marketing. And Ackman railed against Herbalife’s use of Nobel laureate advisory board member Lou Ignarro—not for research, but for touting Herbalife’s products at conferences. Former Secretary of State Madeleine Albright was a consultant too. Ackman showed a Herbalife video that the company played for its distributors, with one of the higher paid ones driving a Ferrari and living in a lavish Southern California mansion.

But it all came down to one simple accusation. “Participants in the Herbalife scheme, the distributors, obtain their monetary benefits primarily from recruitment rather than the sale of goods and services to distributors, not consumers,” Ackman told attendees back in 2012. That was, almost verbatim, the Federal Trade Commission’s definition of a pyramid scheme. In a perfect world, it would have been an open-and-shut case.

Initially Ackman’s bet looked like a winner. The day of the presentation, Herbalife shares tumbled a further 12 percent, hitting \$33.34, and they continued to fall thereafter. The day before Christmas 2012, Herbalife shares bottomed at \$26.06. It looked as if in Herbalife, Ackman had picked an enormous loser, or in the case of Pershing Square investors, a gigantic winner to the tune of more than \$1 billion.

Then, as is often the case in short-selling campaigns, the market began to turn. Somebody was buying, and Herbalife stock began to climb. As shares rose, a coterie of hedge fund managers and other investors jumped on the chance to initiate a short squeeze—buying Herbalife shares to drive up the price in hopes of forcing Ackman to cover, or buy back shares, at a big loss. A keenly watched metric in the short-selling game is called *days to cover*. That refers to the number of days, given average daily volume as a benchmark, it would take a short seller to cover a short position. And Herbalife’s days to cover metric was off the charts.

So while Pershing Square’s bet was huge, the size of his position left Ackman open to upward pressure on the share price if anyone wanted to buy shares and cause trouble by running up the price—a so-called “short squeeze” in Wall Street argot. And the prematurely silver-haired hedge fund manager—one acquaintance dubbed him the Yeti, after the abominable snowman—had plenty of enemies.

It’s easy to see why. In an industry known for its titanic egos, even Ackman’s stood out. According to those who have dealt with him, he constantly proffered unasked-for advice to friends and rivals and compared his record to that of Berkshire Hathaway CEO Warren Buffett. Ackman was also bluntly direct, passing on the name of his nutritionist to an acquaintance who had added a couple of pounds or setting up single colleagues on blind dates. A Pershing Square board member once inadvertently smeared a dab of cream cheese on his own jacket lapel during a

morning meeting and failed to notice it. While someone else might have taken the board member aside or whispered to him, Ackman bellowed across the conference table: “You’ve got cheese on your jacket there!”

It did not escape notice that when Pershing Square floated shares of a closed-end fund it manages on the Amsterdam Stock Exchange, in October 2014, that he joked about the fact that they sold off, ending down 12 percent that day. “The stock is down, which is good,” he quipped. “If it had gone up, we’d have sold too low.” Holders included Qatar Holdings LLC, Blackstone Group, and Rothschild Bank AG.

Still, some look at Ackman’s forthrightness and straight-shooting advice as just boldfaced honesty—commendable—while others do not. Even before the closed-end fund offering, Ackman managed Pershing Square like a disciplined governance-centric corporation with a board that includes former *New Republic* owner and editor-in-chief Martin Peretz; an ex-chief financial officer of McDonald’s Corp., Matthew Paull; and Harvard Business School management professor Michael Porter, who is both a mentor and colleague. That compares to other funds, which can often seem like alpha male-dominated frat houses. Employees meet with the board without Ackman present so they can express their opinions about him forthrightly and deliver complaints about how the firm is run.

He maintains some high standards: Ackman, after consulting with the board, fired an employee for expensing a dinner that hadn’t been on company time. (Of course, that was money out of his own pocket). More than anything else, though, what drove rivals of the 49-year-old hedge fund manager crazy was his knack for generating stellar returns, which, though volatile, were more than 20 percent annualized for his flagship fund—and with little leverage. That doesn’t, ahem, include his closed Gotham Partners fund or his side pocket investments.

Full disclosure: Ackman, who is widely known for assiduously courting the media to an unusual, sometimes unseemly extent, declined to be interviewed for this book. It may have had to do with an unflattering article in the monthly *Vanity Fair* by the author William Cohan that appeared shortly before I made my request.

One investor harboring particular vitriol for Ackman at the time was Carl Icahn, chairman of Icahn Enterprises LP—the onetime 1980s corporate raider and greenmailer; that is, someone who would buy up

shares in a company, threaten a takeover, and then sell them back to the target at above-market prices in exchange for simply going away. It was deemed a louché manner in which to earn a paycheck.

But Icahn had successfully refashioned himself into the more honorable profession of activist investor—shaking up corporate boards and enriching all shareholders, not just himself. And Icahn, a native of the rougher parts of the New York City borough of Queens, was pretty good at it—agitating for the sales, breakups, or restructurings of companies like Kerr-McGee, Time Warner, eBay, and Yahoo! Returns for his public investment firm were more than 20 percent annualized since 2000.

Ackman and Icahn shared a litigious history. Faced with investor withdrawals and illiquid holdings, Ackman in 2001 was winding down his first hedge fund, Gotham Partners, which itself had made some public short bets. He cold-called Icahn about buying the fund's 15 percent stake in Hallwood Realty Partners, a real estate investment trust.

The wily Icahn was amenable. Ackman had another, higher offer of \$85 to \$90 a unit on the table, yet he agreed instead to sell Gotham's Hallwood stake to Icahn for less, just \$80 a unit plus what Icahn termed "schmuck insurance," incorporating a Yiddish term for a part of the male anatomy. Under the contract, according to Ackman, Icahn would pay 50 percent of his profits, above a 10 percent gain, if he sold or otherwise transferred the REIT units within three years. Ackman's view was that Icahn might bid for the whole company himself, because he was in fact unloading his shares on Icahn at what he deemed a fire-sale price, barely more than half their true value.

Well, Ackman was half right. Hallwood cashed out a year or so later for \$136.70 per unit in cash, selling itself not to Icahn but to HRPT Properties Trust. Ackman called to congratulate Icahn and collect his "schmuck insurance." Icahn blew him off—refusing to pay—and the two investors ended up in court, where Ackman ultimately prevailed. The bitterness, however, had only festered over the years.

On January 25, 2013, in the kind of broadcasting melodrama that TV producers can usually only dream of, they both were call-in phone guests on CNBC's *Fast Money Half Time Report* TV program, hosted by Scott Wapner, by which time Herbalife shares were surging past \$43.

Ackman would soon be losing money on his short sale. And the televised exchange quickly became personal.

"I've really sort of had it with this guy Ackman," grouched Icahn, in his rough, outer borough accent. "He's like the crybaby in the school yard."

Icahn continued in a stream of consciousness-style rant of insults. "He's the quintessential example on Wall Street of if you want a friend, get a dog," he said. "Ackman is a liar."

Ackman returned the compliments—his diction crisp and Harvard perfect. "This is not an honest guy, and this is not a guy who keeps his word," he said, enunciating every syllable to perfection. "This is a guy who takes advantage of little people."

They spent a lot of time going over the Hallwood deal.

Icahn recalled having dinner with Ackman. "I couldn't figure out whether if he was the most sanctimonious guy in the world or the most arrogant," he said. "I was dizzy after having dinner with him."

The CNBC host struggled to bring the conversation back to Herbalife, but the two antagonists kept returning to the Hallwood deal a decade earlier. "I was concerned about dealing with Carl Icahn because Carl unfortunately does not have a good reputation," Ackman said. "Carl Icahn thought, 'this guy is roadkill on the hedge fund highway,'" referring to himself.

Icahn disputed the whole notion of the "schmuck" insurance. "I will swear to it on any bible you want," Icahn said. "I had a verbal agreement that he wasn't going to have any piece of the money on this."

Then Icahn launched into an attack on Ackman's strategies and tactics—lambasting them.

"Herbalife is a classic example of what he does," Icahn said. "He probably woke up in the morning and decided, 'What company can we do a bear raid on?'"

Icahn piled onto the dangerous nature of Pershing Square's Herbalife short and even suggested that the upstart hedge fund manager was intent on robbing retirees, that is, investors in the vitamin company, of their savings. Traders on the floor of the New York Stock Exchange stopped and stared at the televised duel, gaping at TV screens as the barrage of insults continued.

"I wouldn't have an investment with Ackman if you paid me to," Icahn declared. "Even if Ackman paid me." He even hinted at a possible buyout. "I will tell you, that I think HLF could be the mother of all short squeezes," he said.

Icahn declined to say whether he was buying Herbalife shares as part of a short squeeze strategy. He virtually invited investors to do so. "In a company like Herbalife, you can ask almost any pro, you don't go 20 percent short," Icahn said. "You go in and you get 20 percent, if there's ever a tender offer, which there well might be in Herbalife, what does he do? I'd like to get to ask, where does he get the stock? Let's say there's a tender offer for Herbalife and they call back the stock and if you know Wall Street, when there's a tender offer, everybody calls back the stock."

The consequences, with the stock trading at a bit over \$40 a share, would undoubtedly be dire for Pershing Square. "That stock could rush to a \$100, what the hell does Ackman do?" Icahn demanded.

Ackman was unflappable. "Number one, Carl's free to make a tender for the company," he responded succinctly. "Carl, you want to bid for the company? Go ahead and bid for the company."

Icahn sputtered with rage. "Hey, hey you don't have to tell me what I'm free to do," he responded. Ackman clearly had a way of getting under the septuagenarian's skin.

"Number two: We don't think there's going to be a tender for the company. We don't think this company is viable," Ackman said. "We don't think anybody's going to write a check for 4 or 5 billion dollars for a company that is fraudulent."

It was an astonishing airing of animosity and dirty linen—the kind of thing that generally isn't done on Wall Street, at least without the careful vetting of lawyers. After the on air-spat, Herbalife shares began to climb, actually piercing \$80 by year-end 2013. Ackman's paper losses—mark-to-market, in industry speak—were likely expanding.

Icahn disclosed a 13 percent stake in Herbalife in February 2013 and soon took three Herbalife board seats. Third Point LLC's Daniel Loeb, a former friend of Ackman's who had been burned by investing in a Pershing Square side fund that made a disastrous, all-in bet on discount retailer Target Corp. using call options, also piled in to drive up the Herbalife share price. It was payback time.

In October 2013, Ackman, with Herbalife shares trading at \$70, told investors in a letter that he had swapped 40 percent of his short position in Herbalife with what amounted to an equivalent exposure selling put options. Such options, give the seller to right to sell shares in the company at a set price, in this case likely roughly the price at the time the letter became public. If Herbalife tumbled Pershing Square would score, if not the firm would lose the premium it paid. “The restructuring of the position preserves our opportunity for profit—if the Company fails within a reasonable time frame we will make a similar profit as if we had maintained the entire initial short position—while mitigating the risk for further mark-to-market losses—because our exposure on the put options is limited to the total premium paid,” the letter said, as reported in the *New York Post*. “In restructuring the position, we have also reduced the amount of capital consumed by the investment from 16 percent to 12 percent of our funds.”

Ackman would make money if shares fell enough to hit the strike price and cover the cost of the options, usually a couple of bucks. It looked, almost, like he was heeding Icahn’s advice.

In July 2014, Ackman was back on a publicity campaign to trumpet his latest research—and to rescue his souring bet. He was losing money on Herbalife, yet doggedly hell-bent on bringing the company down. “I will follow this trade to the end of the earth,” he had said, taking care to say he would use his own money and not his investors’, if that was the more prudent course of action. For the record, in another televised spectacle, Icahn and Ackman eventually made up, at least publicly, at the CNBC Institutional Investor Delivering Alpha Conference that same month. There was an awkward hug, which brought applause from the audience.

Ackman certainly primed the publicity pumps the day before his speech. “This will be the most important presentation I have made in my career,” he boasted on CNBC as he made the rounds. “We are going to expose an incredible fraud tomorrow Come early. There is limited seating.” Ackman promised new evidence, suggesting that a “death blow” to Herbalife was in the offing.

The plush, 487-seat wood-paneled auditorium at the AXA Equitable Center in Midtown Manhattan was full, as media, investors, and assorted hangers-on piled in. Next, a sultry-voiced female announcer

introduced Ackman as if he were a talk-show host. “Ladies and gentlemen, please welcome founder and CEO of Pershing Square Capital Management, Mr. Bill Ackman,” she enthused. The billionaire hedge fund manager bounded onstage decked out in a dapper dark blue suit and began his fire and brimstone sermon.

The new, groundbreaking information concerned so-called nutrition clubs, details of which were provided by Christine Richards, a former Dow Jones and *Bloomberg News* reporter who had penned *Confidence Game* (Bloomberg Press, 2010) an exhaustive book on an earlier Ackman short, insurer MBIA, which eventually netted him millions in profits after a three-year battle that included suits and investigations into Ackman and his fund by the New York State Attorney General at the time, Eliot Spitzer, the SEC, and the Justice Department. MBIA eventually lost its AAA S&P rating.

The upshot was this: Herbalife, he had discovered, was using a vast, secretive network of so-called “nutrition clubs”—informal meetings run by distributors—to offload company products on its distributors and lure in customers. They had to buy products, offer samples to potential buyers in shady, anonymous locations, and pay for this themselves. Desperate mothers, Richards reported, were feeding the nutrition mixes to their newborns, probably to help make ends meet.

Combined with Ackman’s well-wrought pleas and references to his family history, it seemed a reasonably effective presentation. But the media and investors didn’t buy it. Shares began to rise steadily during the presentation and finished the day up 25 percent at \$67.77—its biggest one-day move ever.

The media was exuberant—perhaps deciding that Ackman’s losing bet, which after all affected only millionaire investors, was far more interesting than any of the frankly damaging information the firm had revealed about Herbalife.

“The ‘Death Blow to Herbalife’ Promised by William Ackman Falls Short of Its Billing,” the *New York Times* headline read.

“Herbalife Rallies in Face of New Attack by Ackman,” said the *Wall Street Journal*.

Federal investigators reportedly began looking into whether people hired by Pershing Square made false statements about Herbalife to regulators. The nutrition company, for its part, has been investigated by both the Justice Department and Federal Trade Commission. While

Ackman's short campaign against Herbalife remains a work in progress, it speaks emphatically to the dynamics of a financial system that seems to work relentlessly to punish those like Pershing Square that bet against stocks, rather than in favor of them. Ackman is no neophyte. In addition to MBIA, he has made successful wagers against the Federal Agricultural Mortgage Corp., or Farmer Mac, which makes loans to agricultural enterprises, as well as Realty Income, a real estate investment trust, and won big—at least as far as public documents can confirm.

Yet the vitriol heaped upon Ackman and his creed speaks volumes about the powerful forces that are aligned to defend even the most problematic companies—often helped as they are by a coterie of high-priced lawyers, like lobbyist Lanny Davis and Marty Lipton of Wachtell, Lipton, Rosen & Katz, and public relations powerhouses like Michael Sitrick's Sitrick and Company. It also shows a marked preference by many, though certainly not all, mainstream journalists to align themselves with established corporations rather than secretive Wall Street short sellers who can profit mightily when frauds are exposed. No matter that most so-called "dedicated" short sellers, those who, unlike Ackman, bet exclusively against stocks, seem inevitably to crash during extended bull markets.

James Chanos, for example, who went on to found the preeminent short-selling firm Kynikos Associates, was prominently mentioned in a 6,057-word cover story in the *Wall Street Journal* by reporter Dean Rothbart in 1985, as the decade's stock market bubble was rapidly inflating, quoting him extensively when examining the allegedly gamey tactics used to drive down share prices by short sellers. "They use facts when available, but some of them aren't above innuendo, fabrications, and deceit to batter down a stock," Rothbart wrote. Chanos was working at a Deutsche Bank subsidiary at the time—and was immediately informed his contract would not be renewed.

In March 2006, correspondent Lesley Stahl of CBS News's *60 Minutes* aired a segment accusing a research firm, Gradient Analytics, of working with hedge fund firm SAC Capital Advisors to drive down the stock of Toronto-based drugmaker Biovail Corp. by publishing critical reports on the company. Two years later Biovail settled an SEC suit alleging accounting fraud for \$10 million without admitting or denying the allegations.

More recently, and again in the midst of an expanding market bubble, *Bloomberg News*, in the September 2006 issue of its monthly magazine,

Bloomberg Markets, published “Games Short Sellers Play.” The article alleged that billions of dollars of phony sell orders were flooding the market and destroying promising young companies through the practice of n---d shorting—selling a stock without first locating an investor willing to lend it. It quoted a single short seller, Chanos himself, who dismissed the issue as a red herring—and relied on data that showed mostly that Wall Street settlement practices are sloppy, which they are.

But the story was notable in quoting an executive named Patrick Byrne, the CEO of a then-struggling e-commerce website called Overstock.com. The target of several short sellers, including David Rocker of Rocker Partners LP, it failed to note that Byrne’s company had repeatedly missed its own earnings and revenue targets by wide margins over the years.

Nor did it mention that Byrne had told a skeptical accounting analyst that “you deserve to be whipped, f----d, and driven from the land.” Or that Byrne had publicly declared on a conference call that an unnamed “Sith Lord” was orchestrating short-selling campaigns. Or that he had accused a female *Fortune* writer investigating Overstock.com of engaging in fellatio with various, unidentified Goldman Sachs traders.

Bloomberg TV used the story early the next year as the basis of a special report, hosted by Michael Schneider.

Other publications, especially those with limited expertise in covering Wall Street, were ready and happy to drive sales and circulation by blaming the shorts in a sort of bear-bashing cavalcade. Bryan Burroughs, co-author of the monumentally brilliant *Barbarians at the Gate: The Fall of RJR Nabisco* (Harper Collins, 1990), wrote a story for *Vanity Fair* in August 2008 laying blame for the collapse of investment bank Bear Stearns Cos. earlier that year at the feet of, predictably, unnamed short sellers. And Matt Taibbi—whose description of Goldman Sachs Group as a blood-sucking “vampire squid” would eventually go down in history—in October 2009 rehashed the same notion that it was n---d short-selling that had brought down both Bear and Lehman Brothers Holdings, failing to note their wildly extended balance sheets, with debt-to-equity ratios that topped 40 to one. Later, it turned out that Lehman had doctored its books each quarter.

The bad press may have prompted some monumentally dunderheaded regulatory moves. Amidst the collapse of Fannie Mae, Freddie Mac, Lehman, and American International Group, Wall Street

executives, including Morgan Stanley's CEO John Mack, knowing they might be next in line to be brought down by panicked sellers, implored the SEC to ban the short selling of their company shares. In conjunction with the U.K. Financial Services Authority, SEC chairman Christopher Cox did that, albeit on a temporary basis, singling out 799 financial institutions—later expanded—for special protection from short sellers starting September 19, 2008, and ending October 2. Institutional investors were also required to disclose all new short positions.

In a study entitled *Shackling Short Sellers: The 2008 Shorting Ban*, released shortly after the restrictions were lifted, Ekkehart Boehmer of Mays Business School at the Texas A&M University, Charles M. Jones, of Columbia Business School, and Xiaoyan Zhang of the Johnson Graduate School of Management at Cornell University showed that while prices rose briefly, spreads widened and price impact increased, as did intraday volatility. Subsequent studies backed their conclusions.

Cox himself called it a mistake. "While the actual effects of this temporary action will not be fully understood for many more months, if not years, knowing what we know now, I believe on balance the commission would not do it again," he told Reuters. "The costs appear to outweigh the benefits."

Still, it remains a shame that so many juicy but dubious anecdotes have been written about short sellers, since the practice, regardless of whether one believes it healthy or harmful to the markets, has a fascinating history as it stands on its own merits—with good guys, bad guys, and mostly, and here's where it gets interesting, a whole range of characters in between. These are tales of fanatically committed people who perhaps because of the enormous pressures they endure year after year sometimes evolve into emotionally aggrieved and embittered individuals. Or maybe it's their distressed personalities that drive them into this punishing line of work to begin with. I don't know. Other times, they are just people with strong opinions and insights who stick to their beliefs.

While *The Most Dangerous Trade* is not a history of short selling, the background is fascinating—certainly worthy of a book in itself. The real stories of present-era short sellers, though, are gripping enough.

Note well: Some of the terminology is a bit scattershot or misleading. Short sellers, for example, despite common parlance, don't actually "borrow" shares. They contact a broker who says he or she has located

an investor willing to lend shares, serving as a middleman for a steep price and taking an enormous cut—20 percent annualized or more of the amount borrowed in some cases. The shares are sold by the broker as well. The website of a now-defunct advocacy organization, the Washington, D. C.-based Coalition of Private Investment Companies, is still accessible and contains plenty of useful information on the subject.

Also, there are plenty of uses for short selling that have little if nothing to do with the focus of this book. Convertible arbitrage, for example, in its simplest form, involves buying a convertible bond and shorting the company's underlying stock—locking in the yield of the bond without the stock's risk—as a way to lock in gains with minimal volatility. That's no judgment on the company's management, viability, or even the priciness of its shares. One type of market-neutral investing balances out bullish bets on one industry stock, say General Motors Company, while shorting one of its rivals, such as Ford Motor Company, figuring the former is a better buy than the latter while netting out industry-specific risk. That's often called pairs trading and has been around for ages.

A strategy called capital structure arbitrage involves buying a particular class of bond or other corporate security because it looks relatively cheaper than, say, a shorter-term bond or preferred stock, which is shorted. And merger arbitrage often involves simply buying the stock of a takeover candidate while shorting that of the potential acquirer, which may be using its own shares as currency, benefiting when the spread between them disappears. The list goes on.

These are all legitimate strategies involving short selling that have little to do with most of the protagonists who are the focus of the book.

Full disclosure: I have, embarrassingly, failed to nail down, at least to any reasonable person's satisfaction, the precise origin of the term *short sale*. I can do what I usually do in such situations, however which is to repeat what I read or people tell me. Unfortunately, storied linguists like William Safire and Edwin Newman have passed on the subject.

The most obvious etymological derivation is that the term simply comes from the expression for selling someone short—that is, ascribing a value to a person or good that is below that of what is generally accepted, as in “Don't sell Snodgrass short.” But that just hints at a resolution—although one that conveniently has been in English language usage for hundreds of years.

Another, somewhat more farfetched, explanation is that while a bullish or long investment has unlimited upside, the profit on a short sale is limited to the amount invested—a bigger or longer upside for the bull, in other words, and a more limited or shorter profit potential one for the bear. A stretch? I think so.

Likewise, it could just refer to the predilection of bulls to hold on to their investments for longer periods of time than shorts, who tend to book their profits, if they have them, quickly and quit while they were ahead. The *English Language & Usage Stack Exchange* cites a definition from *The Bryant and Stratton Business Arithmetic* of 1872. (I couldn't find one myself). It says simply that selling short is to imply selling before buying—that is, selling what one doesn't have leaving one short of the asset in question. Think along the lines of, "Joe, I'm short few dollars."

That works reasonably well for me and has the benefit of informing the early 20th-century proverb regarding short selling, whose attribution has, alas, also been lost to time: "He who sells what isn't his'n must pay the price or go to prison." In years past, not being able to furnish the shares owed to the party from which they have been borrowed was indeed a criminal offense. In some cases it still is.

(As an aside, the term "bear" probably derives from an ancient proverb that warns of selling a bear's skin before it's caught.)

The history of the short sale is so similarly aged as to have been lost to time—farmers, bankers, and merchants must have been doing it in one form or another for ages. But some of the choice examples are sufficient to suggest it is worthy of further investigation.

For example, the Dutch East India Company, the sprawling trading company with vast governmental and military powers that extended throughout the Far East, had an extensive shareholder base of wealthy and middle class investors in Holland. The stock price rose in a bubble-like fashion as talk of enormous wealth in far-off lands circulated. Some skeptical Dutch investors initiated short positions in 1609, most notable among them a merchant named Isaac LeMaire—who had a nose for sniffing out trouble and was not above spreading rumors. Shares tumbled and directors of the company complained to the Amsterdam stock exchange that they were the victims of a short-selling attack, which was bankrupting widows and orphans. The exchange responded that "the decline in the corporation's shares has been due to

unsatisfactory business conditions,” according to *The Art of Short Selling* by Kathryn Staley (John Wiley & Sons, 1997). Nevertheless, regulations against shorting were imposed the next year, and soon abandoned. There was no lesson learned: Tulipmania followed, beginning in 1634.

Britain effectively banned short selling in 1734 following the bursting of the similar great South Sea Bubble, in which shares of the South Seas Company tumbled from 1,200 to 86 pounds and short sellers were naturally blamed. The ban was widely ignored; although a new one focusing on banks was enacted following a major bank panic of 1866. That too was repealed in 1878, after a commission determined the collapse of the principal bank involved was a result of poor management and lending practices, not short sellers. It's always a question of shooting either the messenger or the short seller. While most people know John Maynard Keynes as the founder of Keynesian economic theory, he was also an active short seller, betting against the German mark during Weimar Republic years of hyperinflation in the 1920s only to be wiped out. “The market can remain irrational longer than you can remain solvent,” he is said to have quipped. Keynes redeemed himself through his management of a Cambridge University endowment, the Chest fund, which returned more than 12 percent annually while he oversaw it from 1927 through 1945.

France experienced its own bubble decades before the French revolution. Much like the Dutch East India Company and the South Seas Company, the Mississippi Company, eventually called the Compagnie des Indes, generated enormous investor demand. A rakish Scotsman named John Law, one of the earliest proponents of paper, or fiat, currency persuaded the French government to issue bank notes backed by precious metals. As the power of Compagnie des Indes grew, it assumed greater power to collect taxes and print its own coinage. The French population was soon buying shares by the bushel full and prices soared, minting new millionaires daily. In 1720, as people tried to redeem the shares and the fiat currency Law had sold them, he devalued both. Compagnie des Indes shares collapsed to less than one twentieth of their peak value. Millionaires became paupers, short sellers were again blamed, and France entered a profound, extended depression that, according to some historians, was a fundamental cause of the French revolution. An anti-short selling rule was instituted in 1724.

Napoleon Bonaparte, incidentally, harbored a deep animosity toward short sellers because he believed they were interested in driving down the prices of government securities. That in turn would make it more difficult for him to finance La Grande Armée's campaign of conquest across Europe and was therefore treasonous. Once again, restrictions were enacted and later abandoned.

In America, the history of short-selling is more colorful still—dating back nearly to the days of Wall Street's famed buttonwood tree, under which the New York Stock Exchange's predecessor was founded. During the War of 1812 with Great Britain, for example, the New York legislative branch banned short selling as way to forestall panicked selling of bank shares. The prohibition was widely ignored, though it took until the late 1850s before the ban was formally repealed. As in other nations, it was a pattern that was to be repeated time and again over the decades.

Until the establishment of the SEC, in 1934, U.S. markets were, for all intents and purposes, unregulated—a Wild West free-for-all bereft of rules. That left the field open for blatant market manipulation—often by the renowned robber barons of the Gilded Age. This occurred in both inflating and driving down stock prices. In a so-called corner, one or two investors would buy up all available shares of a company, forcing the short seller to buy to cover at outrageous mark-ups. (A squeeze involves multiple participants.) There were a variety of shenanigans, including bribes and rumors, according to *All About Short Selling* by Tom Taulli (McGraw Hill, 2011).

Famed financiers Jay Gould and Jim Fisk teamed with Daniel Drew to flood the market in the late 1860s with new issues of Erie Railroad shares, driving its market capitalization to \$57 million from \$34 million, not to mention \$20 million in convertible bonds that were sold abroad. They then yanked millions from banks, creating a panic that drove down share prices, and secretly covered their short positions on the railroad. The pair then turned against Drew, who had remained short, and engineered a massive short squeeze that cost him \$1 million.

Corporate insiders also got in on the short-selling act. President John Gates of American Steel and Wire Company, a barbed-wire monopoly, shorted his own company's stock amidst a softening business and layoffs—cashing in as share prices fell. A storied gambler—known

as Bet-A-Million Gates—he eventually sold the company to John Pierpont Morgan in 1901, and it became part of U.S. Steel Corp.

The greatest stock short seller of the 20th century was undoubtedly Jesse Lauriston Livermore, the “Boy Plunger.” Born in 1877 into a farm family near Worcester, Massachusetts, he ran away from home at age 14 to take a job posting quotes at the Boston branch of the brokerage firm PaineWebber. He dabbled in dubious securities proffered by unsavory dealers known as bucket shops, yet somehow managed to profit.

In 1906, he is said to have shorted Union Pacific Corp, the San Francisco railroad giant, the day before the great earthquake. No one can explain why. The next year, he shorted the market during the panic of 1907, noting that speculators had overextended themselves and were subject to margin calls. Livermore only covered his short positions at the request of John Pierpont Morgan himself, realizing he wouldn’t be able to collect his gains if the brokerage firms he traded with went belly up. His net worth: an estimate \$3 million, or \$75 million in 2014 dollars, an amount he subsequently lost on cotton speculation, filing for bankruptcy in 1915.

Livermore was down but not out. He borrowed money and eventually left the stock market to trade commodities and eventually recovered. He codified his trading strategies in a 1923 book, *Reminiscences of a Stock Operator* by Edwin Lefevre, and claimed all of his mistakes derived from not following them. Investors today still refer to it. He made money in the bull markets of the 1920s, and became close friends with Bernard Baruch, the financier and philanthropist who served as an advisor to Presidents Woodrow Wilson and Franklin D. Roosevelt. Baruch was also a noted short seller himself—booking gains on Brooklyn Rapid Transit and Amalgamated Copper, while failing to do so on Radio Corporation of America. By 1929, Livermore had noticed many of the same market characteristics that had preceded the panic of 1907—rising margin debt, pricey stocks, exuberance. He shorted stocks and made \$100 million, or \$1.37 billion in 2014 dollars.

What happened next is, from what I can gather, unknown. Livermore was a famed womanizer, with a yacht, houses around the world, and an armada of limousines. He was on his fifth marriage, but by 1934 he had managed to lose the \$100 million. No one knows how, though trusts he had set up kept him from any real financial hardship.

He committed suicide with a revolver in the cloakroom of New York's Sherry-Netherland hotel on Fifth Avenue in 1940. His farewell note to his wife read: "Can't help it. Things have been bad with me. I am tired of fighting. Can't carry on any longer. This is the only way out. I am unworthy of your love. I am a failure. I am truly sorry but this is the only way out for me. Love Laurie."

There were other famed short sellers of the crash—"Sell 'em" Ben Smith and the president of Chase Bank, Albert Wiggen, who bet against his own bank using money he borrowed from it. Republican President Herbert Hoover believed that a cabal of Democratic short sellers were aligned against him, aiming to bring down the markets to support Franklin Delano Roosevelt—and railed against them. The Pecora Commission, headed by Ferdinand Pecora, counsel for the Senate Banking and Currency Committee, found that it was the government that was involved in double dealing and new disclosure rules were enacted.

The 1934 founding of the SEC under Roosevelt helped bring at least a semblance of order to the wild speculation, promotions, and manipulations of the stock market. Its first chairman: Joseph Kennedy, the former prohibition-era bootlegger and father of President John F. Kennedy. He too had been a successful short seller—and there was undoubtedly an element of Roosevelt hiring the fox to guard the henhouse. One often-cited but probably insignificant change: the *uptick rule*, which barred the shorting of a stock unless it had moved higher in its previous trade. That stayed on the books until 2007, leading some to conclude its repeal was a factor in the 2008–2009 collapse. I've seen no evidence to support that view.

The Investment Company Act of 1940 severely restricted diversified mutual funds from shorting. The 1949 launch by former *Fortune* magazine editor Alfred Winslow Jones of what is generally considered the first modern day *hedge fund*, which typically buys some stocks while shorting others, using leverage, was a game changer. "The Jones that Nobody Keeps Up With" was what Carol Loomis, a now retired *Fortune* writer, dubbed him in a deliciously revealing article. Slowly at first and then in increasing numbers, others emulated Jones and shorting became, if not pervasive, at least an established part of the sophisticated investors' arsenal.

Today there are more than 8,000 hedge funds, according to Hedge Fund Research, a Chicago firm that tracks them. Most engage in some form of shorting.

Short selling was continually investigated as a source of market volatility—or at least downward movements in stocks, since nobody ever seems to protest when stocks rise sharply. The October 19, 1987, crash was fueled by a bubble of optimism, in part because of the spreading popularity of so-called portfolio insurance, which promised to short stock indexes in the event of a market sell-off, thereby locking in gains. Institutional investors threw caution to the wind. Following the crash, a House of Representatives Committee looked into the impact of short sellers on the meltdown. The ultimate conclusion was that their contribution was negligible. So-called circuit-breakers were instituted to halt trading when the market plunged precipitously—the triggers have been updated periodically.

In 1992, George Soros, with billions of dollars in his Quantum Fund, believed a sharp currency move was in the offing. The British pound was part of the so-called European Rate Mechanism—designed to keep European currency exchange rates in narrow ranges. Prime Minister Margaret Thatcher was bent on keeping the pound pegged to the German deutsche mark at a rate above 2.7 marks to the pound. Yet the U.K. inflation rate was three times that of Germany.

While the U.K. raised interest rates to entice investors to buy the pound, some investors, notably Soros, believed such a move was unsustainable. In what became known as the *Black Wednesday Currency Crisis*, the U.K. raised rates from 10 to 12 percent and then promised 15 percent to entice investors to buy pounds. The move failed. Soros shorted an estimated \$10 billion in pounds in the market and ultimately forced the U.K. to withdraw from the ERM. The fund pocketed more than \$1 billion from the trade—costing the U.K. government many times that. The move earned Soros the sobriquet “The Man Who Broke the Bank of England.”

The move didn’t earn Soros many friends. When Malaysia’s currency collapsed in 1997 amidst the Asian contagion, the country’s Prime Minister, Mahathir bin Mohamad, accused Soros—a Holocaust survivor with a history of championing human rights and open societies—of targeting the nation. “It is a Jew who triggered the currency plunge,” he said.

The technology bubble of the 1990s eviscerated short sellers or even just value-conscious investors—despite Fed chairman Alan Greenspan's 1996 warning of irrational exuberance. Famed hedge fund manager Julian Robertson of Tiger Management mothballed his business as stocks like Microsoft, Intel, and Sun Microsystems soared, not to mention Internet companies with more dubious business models like theglobe.com, Pets.com and Etoys.com, which often did not generate earnings all. Being correct brought little satisfaction. Loews Corp, headed by famed value investor Larry Tisch, initiated a giant short bet against the S&P 500 beginning in 1996. He finally closed it out in March 2000, the very month the NASDAQ Composite Index reached its peak. The bet cost the storied conglomerate some \$2 billion.

Following the terror attacks on the World Trade Center and Pentagon on September 11, 2001, which shut down the U.S. stock markets, Wall Street brokerage firms asked short sellers not to seek profit from the anticipated selloff in share prices when markets opened, which they did three days after the attack. It would be an interesting exercise to see who did or did not.

There were reports, including some in major media publications, that Al Qaeda-linked groups may have shorted stocks or used put options in advance of the attacks, with some less-established outlets asserting that they had specifically targeted the airlines involved and insurers that had underwritten catastrophic claims against the towers. Nothing I have read lends credence to this notion.

In 2004, the SEC approved a new rule, Regulation SHO, designed to reduce naked short selling, that is, selling a stock without first having a broker locating a holder willing to lend it within a three-day window, or settlement period. The rule requires that the SEC publish a list of the stocks with the most violations of this settlement matter. Again, whether this rule has had any impact remains dubious.

There was a major irony in the temporary ban on shorting financial stocks on September 19, 2008. The move was taken at the behest of investment banks that had been making hundreds of millions of dollars from hedge funds lending them the stocks they were shorting, including their own. The banks argued it was short sellers, not genuine market fear of their outrageous leverage, driving down share prices.

The SEC also required institutional money managers to report new short positions—another way to quash short sales.

Short sellers will never be in the clear. The Financial Crisis Inquiry Report ascribed the 2008–2009 financial crisis to regulatory failures, poor corporate governance, and, of course, widespread excessive borrowing. Short-selling isn't mentioned even as a contributing factor to the crisis. Yet, it's a truism that such investors will be blamed in any market pull back.

On a clear chilly morning in December 2012, Dave Davidson, a continent away from Ackman, is in his smallish, bare one-room office in Greenbrae, California, tucked under the 101 Freeway that leads from San Francisco through undulating hills and mountains to points in northern Marin, Sonoma, and beyond. It's just a rented desk from a firm called Banyan Securities, where partner Claudio Chiuchiarelli seems to have a soft spot for taking in orphan contrarian market thinkers.

There is a view under that dark ribbon of asphalt and concrete across Larkspur Creek to Corte Madera. Davidson is an aging jock. He has given up rugby but still believes competitiveness is the key to success on Wall Street. Davidson wears a fleece-lined vest, shorts, and sneakers as he focuses intently on his computer. His \$66 million fund is losing money as the market climbs relentlessly in late 2012. How could it not? The Federal Reserve has interests at about 2.0 percent and is furiously buying up Treasuries and mortgage-backed securities as part of its quantitative easing program. This infuriates Davidson; it's an example of financial repression, in his view—deliberately keeping rates low as a means of forcing investors to buy stocks. "Where is the sanity?" reads the greeting on Davidson's Bloomberg terminal page. The future embodies devastating deflation and financial collapse.

Davidson graduated in 1977 from the University of Southern California in Los Angeles and worked as a medical technician before hitting Wall Street as the bull market shifted into high gear in 1984, taking on a string of sales positions—first in retail at PaineWebber and Donaldson, Lufkin & Jenrette Securities and then in institutional sales at Montgomery Securities and Volpe & Covington. He co-founded Pacific Growth Equities and then decided to manage money for himself and others through his own firm, SC Capital Management.

In 2000, he briefly hooked up with short seller Bill Fleckenstein of Fleckenstein Capital's R.T.M. Fund in 2000, playing the macro expert, he says, to his colleague's fundamentalist approach—as the technology bubble collapsed. The two split over a disagreement about R.T.M.'s management fees. Davidson started Shoreline Fund I with \$10 million in assets under the SC Management brand in December 2004.

Davidson's process, which he refreshingly talks about at length and in depth, is elegantly simple—which may be precisely why he has trouble pulling in money from big name investors, who sometimes prefer reams of fundamental research from an analyst team. Davidson focuses on those stocks with the largest market capitalizations of \$5 billion or more, and generally requires short candidates have 1 million shares a day in trading volume to ensure liquidity. It isn't brain surgery, but may require more of a stomach.

Davidson looks at former market leaders whose technical charts, 100-day moving averages, say, are falling amid strong daily volumes. Momentum is a positive force. "It's my belief that price and volume predict change," he says. He points out that he also takes heed of fundamentals like earnings and sales growth.

At his desk, he excitedly points to brightly lit red companies that fit the descriptions. He typically focuses on a list of 70 to 100 companies, in six to nine sectors. Today, it's Apple and Micron Technology, for example, that are sells for the moment. That can change, but Davidson believes it is a good indicator of future share prices. "My process is a predictive system," he says.

Broadly speaking, Shoreline I actually does what it is supposed to do—it is up when the S&P 500 is down, sometimes by a far greater amount than the inverse would suggest it should be. Since inception it has lost to the benchmark HFRI index of short-biased hedge funds in just 2 of 10 years. Overall, Shoreline I has returned 2.62 percent versus a loss of 20.6 percent for the short index. In 2008, the worst year of the financial crisis, Shoreline I gained 56.9 percent, double the 28.4 percent gain for the short index—versus a 37 percent plunge by the S&P 500.

Shoreline I also sometimes rises when the S&P 500 does, because of Davidson's willingness to cut and run. By remaining in liquid stocks, he can get out quick. "I can take my positions out to the trading desk and be out in 30 minutes," he says with an air of satisfaction. One of

his adages undoubtedly helps. He says he won't fight the general market trend, major economic indicators, or Federal Reserve moves. Davidson covers his shorts and waits. "When things don't work, just take your exposure off," he says. "You wait until something turns your way. If I'm wrong, I just get out of the way."

Investors, though, aren't so patient—they seldom are with short selling strategies. Shoreline assets were down from \$200 million, and that in itself is an added pressure for Davidson. "We had a 40 percent redemption in 2010," he says, as investors pulled out in the midst of a rollicking bull market. In 2012 he predicted another 20 percent redemption for the year.

And 2013 brought still worse news. A big Shoreline investor, a fund of funds, got tangled up in an unrelated management scandal and withdrew millions from the various funds it invested in. Much of that was pulled out in 2014 from Shoreline. And so despite such monster years as 2000, 2002, and 2008, when Shoreline posted returns of 46.5 percent, 37.2 percent, and 56.9 percent, respectively, Davidson is now down to just \$2 million in assets in early 2015, essentially his own money.

Davidson, and other short sellers, for all their steely determination, will have their mettle tested daily. After all, they ply the stock market's most dangerous trade.

