



Taking a Bad Rap

“What we are doing is really conservative,” says one short seller

BY NANCY OPIELA

Short sellers need a tough skin. They have been called market manipulators, unpatriotic, even thugs. In the Enron Corporation trial, company executives continually contended that short sellers drove the company into bankruptcy. “Investors like hearing bad news about as much as I like the ostracism I receive from its conveyance,” says Doug Wakefield of Best Minds in Dallas. Regarding the public trashing of short sellers, Wakefield believes, “Short sellers are taking a bad rap. They are not the bad guys most people think they are.”

In addition to being used to benefit from an expected downward price movement, short selling is employed to hedge the risk of a long position and benefits the market by providing liquidity and pricing efficiency. Short selling opponents, however, insist that betting on price declines makes them happen. “Opponents of short sellers view them as apple-cart-upsetting contrarians,” says Larry Ribstein, professor at the University of Illinois College of Law. “Short selling seems to be mere speculation, therefore zero-sum, not socially productive.”

In fact, it's the highly publicized speculative nature of short selling that keeps most financial advisers from employing the strategy. “Short selling contradicts an adviser's central message, that clients should be invested for the long-term,” says Jay Freeberg of JRF Asset Advisors in Garden City, NY. “To short makes a bet against the market, which rises over time. What's more, individual investors never understand when to sell; and it's much more difficult to ask them to sell first, then look to buy.”

Wakefield's research paper “Riders on the Storm: Short Selling in Contrary Winds” takes the opposing view. “Careful study of the historic record reveals that long-term investing is a myth created by statistical manipulation and obfuscation of plain truth,” he states. “With mutual fund turnover rates, the buying and selling of assets that comprise a fund's holdings, ranging from 70 to 300 percent, it is obvious that mutual fund managers see the impracticality of the long-term, buy-and-hold philosophy so many espouse.”

Adds Robert Lang, CFA, of Lang Asset Management in Atlanta, who has managed short-biased managed accounts for his clients since 2000, “Some think what we do is very speculative, but given today's negative macroeconomic factors, what we are doing is really conservative. We think our short portfolios can make money for clients; risk control is more of a by-product of the strategy.”

However, the majority of advisers use shorting as a temporary tactical risk management tool. For example, to reduce some of the exposure of clients who have a large allocation to long bonds, Michael Boone, CFA, of MWBoone & Associates in Bellevue, WA, has used the Rydex Inverse Government Long Bond fund that shorts the 30-year Treasury.

Advisers are also embracing long-short mutual funds that can be up to 20 percent short. Louis Stanasolovich of Legend Financial Advisors in Pittsburgh, uses several long-short mutual funds—and in one case, a short-only fund in conjunction with a long-only fund—to construct the firm's own long-short fund to mitigate risk for the firm's lower-volatility portfolios. “We tell our clients diversification is crucial to our success, and today that means more

KEY POINTS

- Critics of short selling say the practice is counterproductive, and so-called “naked short selling” has attracted the most negative attention.
- To combat naked short selling, SEC Regulation SHO requires broker/dealers to identify a source of borrowable stock before executing a short sale.
- Short selling is also an important source of independent research, and as the number of short sellers dwindles, the quality of available research may suffer.

than buy and hold,” he says. Stanasolovich's message has been embraced by fund companies and investors alike. American Century Investments, Franklin Templeton Investments, and Janus Capital Group recently have introduced funds that reside in the new Morningstar long-short style box. And according to a November 2005 report by Cerulli Associates, “Hedge Funds: The Market for Absolute Return,” these funds grew 23.8 percent in the last five years and now total US\$10.5 billion in assets.

“Naked Short Selling”

Interestingly, as long-short funds and funds of funds have made shorting strategies available to a wider pool of investors, the negative press on short selling has intensified. Recent market-manipulation attacks have focused on “naked short selling,” where a trader shorts a stock without first making arrangements to borrow shares in time to deliver to the buyer within the standard three-day settlement period, resulting in a “fail.”

“Done right, short selling is legal and appropriate,” explains John Finnerty, managing principal of New York-based Finnerty Economic Consulting and professor of finance at Fordham University. “The problem occurs in naked short selling when people or institutions not only don't borrow the stock, but have no intention of ever borrowing the stock. Their sole purpose in selling is to try and drive the price down.”

Finnerty cautions the critics of

short selling. “We need to make the distinction between legal short selling and illegal manipulation so we don’t throw the baby out with the bath water.” For example, a market maker who needs to provide shares in a fast-moving market, especially for a thinly traded security, does not need to locate shares before executing short sales. “In these cases, there is no intent to deceive or manipulate; the market maker is simply trying to enhance the quality of the market,” he says. “It’s the persistent naked shorts that are the problem.”

Regulation SHO

To control abusive naked short selling, since 3 January 2005, the SEC’s Regulation SHO has required broker/dealers to identify a source of borrowable stock before executing a short sale. Regulation SHO also requires the stock exchanges to provide a daily report of stocks that had failures to deliver of 10,000 shares or more and at least 0.5 percent of the issuer’s outstanding shares for five consecutive settlement days; these stocks are called “threshold securities.” And for fails that persist for 13 consecutive settlement days, Regulation SHO requires that the broker/dealer take immediate steps to close-out the fail.

For all the publicity and regulation, however, the extent to which naked short selling is a problem remains a mystery. In *Naked Short Selling and the Stock Borrow Program*, an online Q&A published by the Depository Trust & Clearing Corporation (DTCC; a holding company that clears and guarantees almost all trades in the United States), First Deputy General Counsel Larry Thompson admits, “While naked short selling occurs, the extent to which it occurs is in dispute.”

Further, Finnerty says that gauging the extent to which Regulation SHO is containing the naked-short-selling problem is difficult because the data that NYSE and NASDAQ issue as a result of Regulation SHO does not include trading on electronic exchanges. “If you were engaging in something very aggressive or questionable, are you going to do it in a market that is very open or are you going to do it in market that pro-

vides some anonymity?” he asks. “We find the volume of short selling much higher on Chicago or Archipelago. A lot of that is perfectly legal, but a lot is naked short selling; that data is necessary to determine just how significant the naked-short-selling problem is.”

Another challenge in evaluating the impact of Regulation SHO, says Finnerty, is that some trades settle through Ex-Clearing, where two dealers make an arrangement to settle trades between them outside the clearing system and keep the records on their own books. “In some stocks, the volume of Ex-Clearing can be substantial, so we can’t conclude there is less naked shorting without Ex-Clearing data. I think Regulation SHO may just have pushed naked shorting outside the clearing system.”

In fact, as noted in Congressional Research Service’s *Regulation of Naked Short Selling*, Regulation SHO also may have unintentionally created opportunities for a new type of market manipulation, referred to as the “short squeeze,” where traders make large purchases of stocks identified on the threshold securities list in an attempt to drive the price up and put pressure on the short sellers.

Wakefield points out that companies, too, are increasingly attempting to squeeze the short sellers into a position where they must close out their trades at a loss. Management might use company funds to hire lawyers to file suit against short sellers for libel or slander, or they might launch a public relations campaign to promote their stock, hoping to cause the price to climb.

Smaller, more illiquid companies often use more aggressive tactics. “Since short sellers cannot act without the ability to borrow shares, some companies try to get investors to basically call in the loan,” writes Wakefield. “This can be accomplished by writing stockholders and asking them to take their stock out of margin accounts, where their shares can be loaned, or by asking large, institutional owners not to lend out the stock. The company can also reduce the float, the number of shares available for public trading, by buying stock for the company or company retirement account.”

The Final Irony

The regulatory spotlight, in conjunction with an increasing number of hedge funds looking for the same opportunities, means that the always stress-packed, highly risky strategy of short selling has become more difficult in recent years. And that’s turning short sellers into a shrinking niche community. Notes Lang, “The Strunk Short Index used to follow 25 short managers; now it has 8 or 9. That’s amazing when [you] look at the thousands of mutual funds and hedge funds.”

In fact, many short managers now invest on the long side as well because it’s easier and less controversial. “Jim Chanos has referred to Wall Street as a ‘giant positive reinforcement machine,’ and behavioral psychology tells us it’s easier to go along with the herd. It’s tough being the lone voice of dissent,” says Wakefield.

However, as the number of short sellers dwindles, the market misses their hallmark thorough, independent research. Concludes Wakefield, “David Tice warned investors about Tyco and then testified before [the U.S.] Congress after Tyco fell. In the same way, Chanos warned investors about Enron and then testified before Congress when Enron fell. Congress asked these men to testify because they were among the few who actually knew what was going on and spoke out. Where were the long analysts?”

The final irony may be, as Ribstein laments, “As we step up liability to get out the truth about securities, we stomp down an important mechanism for getting the truth out about securities.”

Nancy Opiela also writes for the Journal of Financial Planning and Focus, Fidelity’s magazine.

RECOMMENDED RESOURCES

“The Short Perspective in Today’s Markets”
Analyzing, Researching, and Valuing Equity Investments
2005 CFA Institute Conference Proceedings
(cfapubs.org) = 0.5 PD Credit

“Short-Sellers, Fundamental Analysis, and Stock Returns”
Abstracted in the CFA Digest (February 2002)
(cfapubs.org) = 1 PD Credit