

# **Riders on the Storm**

**Short Selling in Contrary Winds**

**Section 4: Traits of Excellent Managers**

**Doug Wakefield  
with Ben Hill**

**January 2006**

**All contents copyright © 2006 Best Minds Inc. All rights reserved. This research paper should not be forwarded to other individuals or posted on other websites. However, it is our desire that many people learn about our research and have the chance to download our work. For that reason, feel free to quote, cite, or review if full credit is given.**

**Best Minds Inc is a registered investment advisor whose objective is to educate investors on what the best minds in the world of finance and economics are saying and doing. To be a true advocate, we have found it necessary to go well beyond the norms in financial planning today. We are avid readers. In our study of the markets, we research general history, financial and economic history, fundamental and technical analysis, and mass and investor psychology. If you wish to contact us, our contact information is:**

**Best Minds, Inc.  
3010 LBJ Freeway, Suite # 950  
Dallas, TX 75234**

**[www.bestmindsinc.com](http://www.bestmindsinc.com)  
[info@bestmindsinc.com](mailto:info@bestmindsinc.com)  
(972) 488 -3080 or (800) 488 -2084**

## Disclaimers

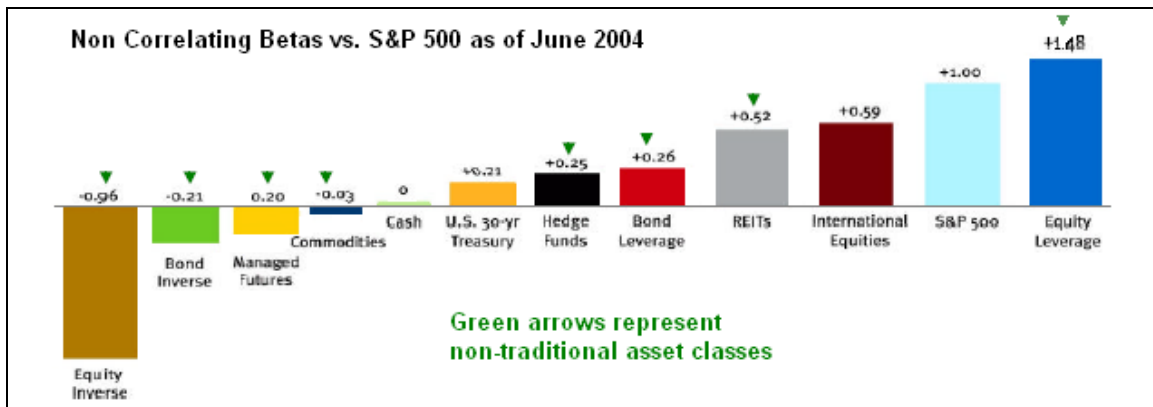
1. This paper is explicitly designed for educational purposes. As such, it will not give the reader simple answers as to which managers or platforms to use. In fact, no performance data on any manager or investment product is discussed. Past performance is often the first criterion that investors review when looking for a product or manager. In that it is only indicative of how a manager or product performed in the recent past, and that the next time period is likely to be much different, in others and my own opinion, it should come up later in the due diligence process and should be less highly regarded. Note that no particular hedge funds or account styles are discussed. Mutual fund types are touched on only as they relate to the mechanical aspects of various shorting products.
2. Conclusions regarding selecting specific managers or particular platforms can only be reached after a thorough review of a variety of aspects pertaining to an investor's specific situation. As such, none of the information in this paper should be construed as investment advice, either from Best Minds Inc. or from any of the managers interviewed herein. Best Minds Inc. assumes no liability for readers' investment returns or outcomes should they choose a specific manager, newsletter, or product after reading this paper. Since the managers mentioned herein are under different regulatory agencies, each investor should request the appropriate disclosure information as part of their own due diligence process.
3. Throughout this paper you will see the constant thread of ethics. Since ethics has such a profound effect on our public and private institutions, it is at the core of our discussion. Ethics cannot be handed out at professional meetings, or signed into existence as part of a governmental process. Ethics come on a person-by-person basis. As we look to the future of our capital markets, this issue will determine our long-term success or demise.
4. In the United States, we pride ourselves on our freedom of speech. Without it, this paper could never be released. While the opinions of those who read this paper will vary widely, it is this God given freedom that allows each of us a place in the public forum of ideas. I thank God for His blessings in allowing me to grow up in, and participate in, this grand experiment, the United State of America.

## The Need for Non-Correlation

One way to reduce risk is through diversification, but not in the customary sense of the word. The College of Financial Planning describes diversification as follows:

“Diversification and the reduction in unsystematic risk require that assets’ returns not be highly positively correlated. *When there is a highly positive correlation, there is no risk reduction.* When the returns are perfectly negatively correlated, risk is erased. This indicates that combining assets whose returns fluctuate in exactly opposite directions has the effect on the portfolio of completely erasing risk.”<sup>30</sup> (Emphasis mine)

Yet, we are facing systemic risks, which require that we go beyond the normal idea of diversification and find assets that have a highly negative correlation so that we might truly reduce risk. The slide below shows the positive correlation of traditional asset classes such as equities, international equities, and bonds and the varying degrees of correlation of non-traditional asset classes, noted with arrows.



Source: Rydex Investments<sup>31</sup>

In keeping with our desire, and for some our fiduciary responsibility, to seek assets that fluctuate in exactly opposite directions, let us turn from the crowd of long-only managers in the marketplace today to managers who are well positioned to help investors by using tools that are “perfectly negatively correlated” and address many of the systemic risks addressed in sections one through three.

The greatest degree of diversification is found in managers who can go inverse or opposite of the stock market, namely short sellers.

Yes. I know, “Short selling is un-American. It is done by rogues, thieves, and especially pessimists, who are, of course, the worst of the lot. It is a terrible, terrible thing and must be stopped in our lifetime. We should halt it, restrict it, or at the very least revile those who make it their vocation. These sentiments are sadly not imaginary or rare. Rather, they genuinely reflect much of the investing public’s view of short selling.”<sup>32</sup>

The above comment, taken from the foreword of Dr. Fabozzi’s book, Short Selling: Strategies, Risks, and Rewards, makes it clear that many who have become specialists in short selling have often done so at the expense of public approval.

## **Section 4: Traits of Excellent Managers**

Yet, if we can get beyond our biases and look at this group of managers that have learned to stand outside the crowd, we are likely to see the same traits we admire in those such as Warren Buffet and John Templeton. These investment icons made it their career to stand outside of the crowd. In fact, one of John Templeton's most oft quoted maxims is "Never Follow the Crowd."

Speaking of the crowd, consider that according to Harry Strunk, developer of the Strunk Short Index, the only short-only index available today, there are only eight short selling managers listed through November 2005. <sup>1</sup> On the other hand, according to the Investment Company Institute, as of the end of July 2005, there were 7,929 mutual funds. Now, that is a crowd.

Yes, I am very familiar with the handful of companies in the mutual fund industry that offer inverse funds. However, since these funds comprise less than one percent of the industry, our crowd posit is still quite tenable. <sup>2</sup>

Though we will address some of the mechanical and technical aspects of selling short, it will likely prove more useful to you, the investor, to concentrate on the common character traits of successful short sellers, again, many of which are the same traits displayed by our revered American investment icons.

### **Pattern 1 – Fierce Independence**

In a relativistic world it is hard to accept a viewpoint that declares itself right and others necessarily wrong. So at first glance these managers appear arrogant and close-minded to many. But are independent-minded managers a detriment to your long-term investment success or do they increase your odds of protecting and growing your capital?

An interview with Manuel Asensio quickly reveals a manager with a strong, independent mindset. In reflecting on his dedicated short-only strategy that ran from 1996-2003, he states:

“Our experience was different. The fundamental difference was that we were concentrated. It's not that we just didn't diversify; we purposely placed large

percentages of our capital into a small number of positions. Nor did we diversify over time. So again, we had no diversification over securities and no diversification over time. From a portfolio standpoint, some would say that was a poor position.

But we saw ourselves as businessmen and operators. Since we knew we had to invest large amounts of our time and an important amount of money to gain a research edge, we calculated the risk and consciously placed positions in order to concentrate our capital over time and over securities. That was the strategy and it worked well, extremely well.

What made it difficult of course was that when you are a successful short seller, it creates societal problems, and that's why we exited the [short-only] business. [Asensio & Company currently offers a long-short platform.] The regulators, media, and industry players weren't willing to deal with an extremely confident operation that consciously and deliberately took very concentrated bets. And we were deliberate about what we did. That combination was what I believe made us successful, and the success created problems because the markets prefer that a short seller not be so vocal, not be so severe, and not be so concentrated.”<sup>3</sup>

This bold independence is also an earmark of legendary short seller, Jim Chanos, who began the business of short selling in 1982. That year Chanos was doing research work for Gilford Securities, a small boutique firm in Chicago. While doing his research, Chanos came across Baldwin United, a company that was headed for the trash heap of history. By gobbling up insurance companies and selling single premium annuities, Baldwin United had transformed itself from a company that sold pianos to one of the fastest-growing financial services companies in America.

“I started reading their financial statements and I couldn't understand how they made their money. They were issuing annuities at 12-14 %, and I couldn't figure out what they were investing in that was possibly earning that. Other than all their acquisitions, their portfolios were mostly bonds bought years before that were basically underwater.”<sup>4</sup>

Shortly thereafter, he received a call from an analyst telling him to look at the Arkansas' insurance files on Baldwin United. After doing some digging, Chanos found out that after

the state of Arkansas realized they had been had, they hired a consultant to check into Baldwin United. What they found was outright fraud. Baldwin United had been double-pledging assets, masking it with massive paper shuffling between itself and its subsidiaries and had made wild assumptions about the future valuations of the annuities it sold, booking it as immediate profits. Chanos put out an eight page documented recommendation to sell Baldwin short at \$24. But the stock kept going up and was approaching \$50. It wasn't long until Forbes wrote a piece saying Baldwin was a house of cards. Amazingly, the day the story ran, Merrill Lynch's analyst came out basically denying and refuting major aspects of the story – even the part that Baldwin had admitted.<sup>5</sup>

“When I saw that go across the tape it hit me: So many people had bought the stock on an analyst's recommendation and the analyst had not even looked at the Arkansas statements I'd written about months before.”<sup>6</sup>

Chanos continues,

You had this multi-billion-dollar company – which you'd think would have to be efficiently priced – with this glaring fraud that was out there for anyone to see but wasn't seen. That, coupled with the fact that I was getting calls from all over about what else I didn't like, got me thinking further about the business opportunity. If nobody wanted to do this type of thing, and I was willing to take the heat, there was a real opportunity to build a business as a young person.”<sup>7</sup>

This was the incident that launched Chanos' international career as a short seller. In a recent interview with him, his view on the heat that short sellers are taking is different today.

“Our image used to be that of buccaneers roaming the seven financial seas. That has changed to where it is too easy. Alternative investments are accepted today, and the tools are more sophisticated than they were a number of years ago, particularly with the advent of [Exchange Traded Funds] ETFs. Broadly speaking, the tools are more comprehensive and easier to use in terms of hedging or profiting from a declining market.”<sup>8</sup>

Today, we see two worlds. On one hand, with the use of ETFs and hedge funds, short selling is becoming more commonplace and more broadly accepted. On the other hand, focusing on one company or accepting the role of “activist short selling,” the epitome of which was Manuel Asensio, has become much more challenging. When we get to the section on naked short selling, this fact will become clearer.

Yet, one thing is certain: As the direction of the markets forces investors to seek absolute, rather than relative, returns, we want fiercely independent managers at the helm. With the amount of risk that our markets and economy are facing, a day is coming when we will *insist* on it.

### **Pattern 2 – Strong Resolve**

Each year, thousands of people pour into seminars on how to make more sales and be more successful in business. Financial professionals are basically told that presenting positive messages and making our clients feel comfortable is the road to success and wealth. So, when long or short managers bring a voice of dissent to the markets, it should come as no surprise that they often encounter severe cost for stepping outside the herd.

To illuminate the unobserved resolve of short-only managers, I offer the following anecdotal evidence. As we ponder the precarious situations their position all too often puts them in, their emotional fortitude becomes increasingly apparent.

In 1988, David Tice began his independent sell-side research firm, Behind the Numbers, from a spare bedroom in his modest Dallas-based home. Given the inherent conflicts of interest that go hand in glove with traditional sell-side research, Tice recognized the need for independent research. After years of recommending the sale of some of Wall Street’s favorite companies, his resolve had grown strong. Perhaps the clearest picture of Tice’s tenacity can be seen in his dealings with Tyco. In the fall of 1999, Tice noted Tyco’s extensive and repetitive use of “one-time” write-offs, and his firm, Behind the Numbers, issued a sell signal to its institutional clients.

In October of 1999, the media seemed all too quick to rush to Tyco’s defense:

“The biggest write-off-related news, though, has to do with Tyco, which until this week has been one of the hottest companies and hottest stocks in America. This is

Tyco International, not Tyco Toys. Along with GE, it's one of the few truly successful industrial conglomerates left in this country, with lines of business ranging from disposable medical products to underwater telecommunications. Tyco has turned itself into a \$30 billion company through an aggressive program of acquisitions (a total of 110 in the last seven years), acquisitions that it has done a rather remarkable job of integrating into its broader management structure.”<sup>9</sup>

As a \$30 billion company, Tyco provided substantial underwriting fees. Further, with its aggressive acquisitions, Tyco generated great incomes for those that helped put these deals together. Clearly, Tyco was no small fish in the Wall Street pond.

The article continues,

“Companies take one-time write-offs because they're better than having to write off a little bit each year. Investors and analysts tend to treat large write-offs as one-time events, and therefore disregard them. Skeptical investors, like Tice, don't like this, especially when--as in the case of Tyco--a company is taking large write-offs year after year. The write-off, in the minds of bears, can be a way for companies to hide the costs of acquisitions.”<sup>10</sup>

Clearly, this writer did not want to throw himself in the bear camp of skeptical investors.

Next, the columnist continues – stating that Tice is accusing Tyco of the same type of shenanigans as Sunbeam. Unwittingly, the columnist misses the fact that Tice had made the same call for Sunbeam at least a year before Sunbeam's demise.

“This, for instance, is exactly what Sunbeam did when Al Dunlap was CEO. And although Tice hasn't come out and said it, this is what he's implying may (or could) be happening at Tyco. The charges have had a dramatic effect, driving the stock down 6 percent on Wednesday and another 10 percent on Thursday, even though the company's CEO denounced the charges as utterly baseless and just about every Wall Street firm reiterated "buy" ratings on the stock.”<sup>11</sup>

The columnist goes on to give his “expert” opinion on the topic of write-offs.

“This critique of write-offs is completely wrongheaded. If the cost of acquisition is hidden by a write-off, it's hidden in plain sight, since the company announces it quite publicly. And while it's possible that there are investors who get tricked by write-offs into believing that an acquisition was free, it's also true that there are people who still believe their fates are governed by the stars. Companies are no more responsible for the former than the latter. The market as a whole cannot be systematically deluded by accounting gimmicks, as long as the gimmicks are publicly disclosed.”<sup>12</sup>

With the support of Wall Street analysts and articles like this, in the spring of 2000 Tyco rebounded from the sharp drop it experienced the year prior. By January 2001, the glowing reports abounded anew.

“A year ago, it looked as if Tyco's chairman and CEO, L. Dennis Kozlowski, was on the ropes. An analyst had alleged that Tyco had hyped its results, leading the Securities & Exchange Commission (SEC) to launch an inquiry. By December 1999, the controversy had nearly halved the price of Tyco's once-highflying stock and was threatening to derail one of corporate America's most aggressive dealmakers.

But in 2000, Kozlowski came charging back. In July the SEC, in effect, gave the company a clean bill of health by ending its inquiry. And since then, Kozlowski has kicked his deal making machine back into full throttle, snapping up some 40 companies in 2000 for a total of \$9 billion, while profits have soared. Even though Tyco is trading some 12% off its record high, it still has a market cap of about \$93 billion--more than General Motors, Ford, and Sears combined.”<sup>13</sup>

The company had been “alleged” to have done something wrong, but they had come “charging back.” This article seems less like investigative reporting, and more like a biased presentation of a re-emerging hero. Further, the SEC is stated to have, “in effect,” given the company a “clean bill of health by ending its inquiry.” From twenty years of industry experience, let me say that if Tyco were vindicated, it was not the SEC, but rather an overzealous reporter who pronounced absolution. The SEC never endorses any company, and a “clean bill of health” is certainly an endorsement.

So how did this situation turn out?

The SEC Litigation Release of September 2002 read as follows,

“The Securities and Exchange Commission today filed a civil enforcement action against three former top executives of Tyco International Ltd. charging that they violated the federal securities laws by failing to disclose to shareholders the multi-million dollar low interest and interest-free loans they took from the company.”<sup>14</sup>

In January 2001, Tyco stock traded around \$60 a share. After hitting a low of \$6.89 in July of 2002, by September of 2005, the stock traded near \$17 a share.

And today, the headline from October 4, 2005, reads:

“Kozlowski Denied Bail during Appeal. Former Tyco International Ltd. executives convicted of stealing hundreds of millions of dollars during their tenure were denied bail while awaiting their appeals and will remain in custody, according to a published report.”<sup>15</sup>

Historically, like Tice’s situation with Kozlowski, short sellers have been attacked most by those that stood to lose the most by having the truth come out.

### **Verbal Attack**

In the world of money, it seems someone is always trashing someone. Some could think that since verbal berating is so common, it has no effect; yet being on the receiving end of a verbal abuse can be unnerving. These are not the trivial exchanges between cross-town rivals, but vehement words that come from national and international sources.

In 1988, Jim Chanos and other short sellers were verbally attacked by some of major stockholders, who stood to benefit the most, of the Home Owners Savings and Loan Association. “Short selling is one dirty business. These people rape the system.” At least, so said Mr. Larouche, a stockholder with 9.9 percent of the interest in Home Owners. He omitted the fact that the falling share price of Home Owners had negatively affected his brokerage account, and that in order to cover his \$5 million margin call, he had to sell his waterfront property and mortgage his 60-foot yacht.<sup>16</sup>

While bringing to light the fraud that was going on in Solv-Ex in 1996 and '97, Manuel Asensio received the following emails:

“Thieves and liars like you should be in jail. I hope they nail your balls up!”

“Be sure and let me know which prison will be your new home. I’ll send you some pictures of the Miami docks to remind you of home.” [Asensio is a Cuban born American whose family fled during Castro’s take over.]<sup>17</sup>

### **Career Risk**

And, if that weren’t enough, short sellers often face career risk. Jeremy Grantham, chairman of GMO, a privately held global investment management firm managing \$90 billion for their clients in the corporate, public, endowment, and foundation marketplaces, has written an excellent explanation of career risk.

“The problem with bubbles breaking and going back to trend is that some do it quickly and some slowly. So at extremes you will always know what will happen but never when. Not knowing the timing creates critical career and business risk, which has molded the business of investing. If you are smarter than most and want to take no career risk, then anticipate other players and be quicker and slicker in execution or as Keynes said, ‘beat them on the draw.’ Refusing on value principles to buy in a bubble will, in contrast, look dangerously eccentric and when your timing is wrong, which is inevitable sooner or later, you will, in Keynes’s words, ‘not receive much mercy.’ Today, the challenge is not getting the big bets right, it’s arriving back at trend with the same clients you left with.”<sup>18</sup>

Grantham is speaking from experience. As investors left to stay up with the mania, GMO saw their asset base decline by 33 percent in 1998 and 1999. However, his tenacity and principles paid off. As 2000 to 2002 unfolded, his value management style began to look a whole lot more attractive and assets began to come back in. By 2005, GMO has seen their asset base almost quadruple from where it was 5 years prior.

As for Asensio, his aggressive and concentrated shorting style placed him in a position where he took on career risk of another form.

“The way the system is set up, if you take a large [long] position in a company, that companies’ management likes it, the securities analysts behind the company like it, and the press and the regulators like it.

Conversely, if a short seller with strong convictions takes a large [short] position, it is quite different. Because you are not supporting the companies’ management, saying things that oppose their position, they do not like it. The non-government regulators, with whom that company is listed, who need to make fees from the company, do not like it. Understandably, the press normally prefers to listen to a company complain about short sellers, especially a large short seller, and speak well of their own business. Complaining about short sellers and speaking positively of one’s own company is well received by the media and regulators. You see, you have a conflict of interest with them all. That is why there is a difference between having a large concentrated position on the long side versus the short side.”<sup>19</sup>

Seeing himself as an “activist short seller,” Asensio’s style was amongst the most aggressive of short sellers in recent history. This certainly required a great amount of resolve, which was undoubtedly forged and strengthened by the great deal of research he did on each company that he shorted.

### **The Short Squeeze**

But the risks are not limited to verbal abuse and filed lawsuits. Some try to crush the short seller in what is often called a short squeeze. To better understand a short squeeze, it is necessary to give an abbreviated explanation of the workings of a short sale. Then, we can go through the mechanics of how and when a short squeeze can happen.

When selling short, or shorting, an individual stock, a person finds another who is willing to loan their shares of a stock. The short seller borrows the stock and then sells it, and the proceeds of that sell are kept in the short seller’s brokerage account. Ideally, the stock price moves lower and the short seller buys the shares back at the lower price. He or she then repays the borrowed shares to the one who loaned them. In this scenario, the profit is the difference between the original sale price of the stock and the price the short seller pays to buy the shares back, less applicable fees and interest on the loan. This can also go against the short seller. If the short seller sells the stock and the stock price goes up and

the short seller buys the stock back at a higher price, then he or she has suffered a loss. This is the natural risk that is inherent to short selling.

However, sometimes companies deliberately take actions to exert pressure on, or “squeeze” the short sellers into a position where they must close out their trades at a loss. The following are some of the methods companies use to bring this about:

- Management uses company funds to hire lawyers to file suit against short sellers for something, perhaps libel, slander, or defamation of character. Often with much less capital to expend, the short seller must try to keep up with the costs associated with a legal battle.
- Management launches a campaign to promote their stock. As already addressed, the fact that many of Wall Street’s fees are closely tied to the business they receive from large companies creates an incentive, and conflict of interest, whereby Wall Street wants the stock to continue to do well. Thus, in seeking to drive the price up, they often seek to promote the stock or at least not address its faults.

While most stock squeezes attempt to force short sellers to close out their positions for fear of mounting losses as the stock continues to climb, smaller, illiquid markets lend themselves more easily to 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.” 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 accounts, or by placing large blocks in friendlier hands.<sup>20</sup>

Solv-Ex, a company Asensio had shorted, engaged in this type of behavior.

“Short sellers claimed that Solv-Ex was a fraud. On 2/5/96, the management of Solv-Ex faxed a letter to brokers and shareholders: ‘To help you control the value

of your investment...we suggest that you request delivery of the Solv-Ex certificates from your broker as soon as possible.’ This suggestion was essentially an attempt at market manipulation.”<sup>21</sup>

Eventually, all of the aggressive and illegal activity that Solv-Ex engaged in caught up with them.

“In May 2000, the Solv-Ex suit against Asensio & Company and other short sellers (a classic short squeeze) was dismissed. Once again our fledgling little firm had to endure, at great cost, the misguided legal scuds of a \$100 million scam.”<sup>22</sup>

As seen above, Asensio has experienced various forms of the short squeeze. When I asked him about it, he replied, “There have been times when I would have preferred not only to stay short, but to add to my short position. Yet I was forced to cover, and it is more common today.”<sup>23</sup>

While any stock, especially in a mania like the late 1990’s, can place short sellers in a position where they face significant losses, there are ways to mitigate the tactics of the short squeeze. The lack of liquidity in smaller issues makes it easier to push stock prices upward. As such, short sellers most often target stocks with larger market capitalization and more liquidity.

Julie Kirkpatrick of Lang Asset Management states, “While theoretically a short squeeze can occur in any stock, it usually occurs when short sellers take positions in stocks that are much smaller and lack the liquidity found in larger stocks.”<sup>24</sup> Since 2000, when Lang Asset Management began their short-only strategy, they have never been closed out of a position due to the lender demanding the stock back.

While short selling, especially individual companies, can be described in academic terms, the real world is much harsher. In many ways it resembles guerilla warfare. This is why I wince when I hear retail investors talk about shorting a stock. As the disclaimers so often note, “Don’t try this at home.”

### **Pattern 3 – Hard-Wired Differently**

In the process of interviewing Jim Chanos and Bob Lang, both dedicated short sellers, and David Tice, contrarian, bearish mutual fund manager, and sell-side research consultant, I saw another character pattern emerge. These managers are hard-wired in such a manner, that they are not only unaffected by the crowd, but actually draw strength from resistance to their stances. Perhaps it spurs them to additional research or they find it emotionally rewarding or they draw on past experiences. Whatever the reason, they seem to have an innate ability to stick to their strategies and not be swayed by the noise of the masses.

Jim Chanos discusses the differences between dedicated short sellers and value managers in terms of the different psychological environments and the managers' ability to deal with the dissonance, or noise, which that environment creates.

“When it comes to actual investment prowess and technique, the managers' skill sets are symmetric. But when it comes to investment psychology, on the short side, the skill sets are asymmetric.

Most human beings perform best in an environment of positive reinforcement. We like to be told we are smart, we're on the right track, we're doing the right thing, and that the stocks we bought are cheap and are going up and that their earnings are going up as well.”<sup>25</sup>

Chanos continues,

“Wall Street is a giant positive reinforcement machine. That's why it exists. If you're a short seller, you're coming in everyday, and any out fifty names in your portfolio, you can count on ten names where there will be some noise. Stocks recommended, re-recommended, earnings estimates raised, CEO on CNBC; whatever it is, you'd be facing that noise. And, a lot of very good value managers completely break down when confronted with the fact they have to invest against the grain in front of all that noise.

The best short sellers I know have an innate ability to drown out the noise – to not let it affect them. They use the noise to their advantage; they don't let it get to

them. I tell managers, find out who you are first and then you'll find out whether or not you'll like the short side. Some of the very best value managers, with terrific long-term records, are the worst short sellers I have ever seen. Again, it comes back to investment psychology.”<sup>26</sup>

With forty-two years in asset management, Bob Lang, chairman and CEO of Lang Asset Management, which offers short-only and long-short products, makes a similar observation.

“Clearly there's what I call the ‘diversification’ argument. We think that short managers are more capable of selling short and less capable of buying long, and long managers are more capable of buying long and less capable of selling short.

To some extent, it's a matter of experience and doing it over and over again. Nevertheless, the greater part of your ability depends on where your heart is. If you are a long-short manager, the odds are that your heart is with buying long. You may know you have to short, which is your usual process in reverse, but your heart isn't in it, because your tendency is to be a long manager.”<sup>27</sup>

Julie Kirkpatrick, president of Lang Asset Management and Bob Lang's daughter, has worked with him since 1985. She notes,

“You can usually see the difference between a value manager and a short manager play out when either attempts a long-short platform. Typically, when looking at a value manager, you don't see as strong of a performance on the downside as the upside. The reverse could also be said of a short manager.”<sup>28</sup>

One can barely envision what it must have been like for David Tice to premier his Prudent Bear Fund in 1996, the same year of Greenspan's “irrational exuberance” speech. The Dow was still under 6,000. For four years, irrational behavior would continue to move the markets higher. Think of the tenacity he displayed as the bullish buzz of the daily news continued throughout the late 90s. How often did he convey to investors the need to stick with a strategy that experienced irritating losses as the mania persisted? Somehow, Tice stayed the course.

In speaking with me about that period of time, Tice recalled:

“Defying all our research, the market went up for four more years before it started its decline in 2000. Looking back, a lot of people asked how we stuck to our guns. Simply put, I was confident that the market would eventually decline.

We understood the market, we understood the economy, and we understood why Alan Greenspan made his famous ‘irrational exuberance’ speech in November of ‘96, when he felt the market was too high. Unlike a lot of people, although I wanted to see the market confirm what we were saying and I did question myself, I was just confident that the market would decline. It was a bubble that was being perpetuated. Still, eventually it had to fall.”<sup>29</sup>

Like Chanos and Lang, Tice was hard-wired differently. His decisions were not tied to the tape or affected by the media. Then, as now, his decisions were built on what he calls the three-legged stool.

Tice’s understanding of macroeconomics, the first leg of the stool, reveals why he does not follow traditional economic schools of thought.

“Understanding money and credit is crucial to the understanding of economics. And, as there is very little understanding of money and credit in traditional economics, we believe the traditional school of economics to be flawed.

While I have some issues with the Austrian school of economics, it represents the foundation of our understanding of economics. Essentially the Austrian school says if you create credit far faster than GDP [gross domestic product], it will result in inflation. This rapid credit inflation *can* result in asset price inflation rather than inflation in goods and services (CPI). When it does, the Fed often fails to take away the punch bowl. This excessive credit inflation is where traditional economics reveals a horrible weak spot.

However, there are very few enemies of asset price inflation. Think about it. People love to see their house and their stocks go up in price. Therefore, when the Federal Reserve chairman starts talking about asset price inflation, like Greenspan did in 1996, the media criticizes him. They say ‘what are you talking about Greenspan. There’s no inflation in the prices of goods and services.’ That is

where we think that the Federal Reserve chairman needs to be a better educator. And, in our opinion, that is where Greenspan failed us.

As the Austrians point out, the greatest busts occur not in periods of goods and services inflation. No, the greatest busts occur after reckless credit growth results in asset price inflation. These then led to excesses and imbalances such as current account deficits, negative savings rates, and economies geared toward luxury consumption. In both the US in the 1920s and Japan in the 1980s, you saw rapid credit growth, low goods and services inflation and thus low interest rates, and you saw strong asset bubbles that both resulted in great pain.

That was the primary understanding that gave me the courage and the patience to wait out the late 90s. However my three legged stool has two more legs.”<sup>30</sup>

The second leg of Tice’s three-legged stool is his understanding of markets.

“I also understood stock market history. If you look at the stock market since 1900, most of the gains were achieved in the three periods from 1921 to 1929, from 1948 to 1966 and from 1982 to 1999. These secular bull markets were always followed by secular bear markets, and 1982 to 1999 was by far the biggest bull market we have ever seen.

The reason that you have a secular bear market after a secular bull market is that you already have everyone in and you already have high multiples. You see, most of the boom occurs from increased participation and multiple enhancements. In the last bull, we took public participation in the market out to most Americans, and we went from 7 times earnings to 30 times earnings, and we’re not going to take those multiples from 30 to 160 going forward, so, at this point, we won’t see a bull market similar to the one we had before. Also, because you invested in virtually every reasonable business through IPOs, secondary offerings, and venture capital, you are going to have returns on capital fall. That’s why it becomes tougher moving forward in the bull and why secular bears last a long time.”<sup>31</sup>

The third and final leg of Tice’s three-legged stool is his understanding of microeconomics.

“The third aspect is our expert analysis of individual companies through Behind the Numbers. We saw a number of companies being reckless in their expansion plans, their utilization of accounting choices, their over-leverage and their acquisitions. We saw a lot of high stock prices that would not be able to be sustained at these high levels of earnings expectations.”<sup>32</sup>

As seen by Tice’s decision-making process, these managers are hard-wired differently. It makes sense that those who specialized in the sell side of the markets, would have to review their strategies on an ongoing basis in order to be certain about their stance and to have the fortitude that few investors or managers ever forge. It may be that the harsh environment created by contrarian stances spurs these managers to research.

What is certain is that these are not the “hurry up and get to the bottom line” managers or the investors who give cursory glance to the daily financial commentaries. They seem to realize the vast majority of presented information is designed to reinforce certain emotions and promote certain feelings, not challenge the thinking of the investor. Perhaps this knowledge makes them strive harder to screen out noise and look for patterns and gives them their ability to stick to their strategies and not be swayed. Whatever the reason, whether we are retail or institutional investors, we *must* understand that most of us are not hard-wired like the managers we want to hire.

That being said, let us look next at the research habits of excellent managers.

#### **Pattern 4 – Independent Research**

If I had a headache, an average physician would suffice. However, if I were going in for brain or heart surgery, I would want to know if that the operating surgeon was one of the most highly skilled in his or her field and that the surgeon was deeply committed to keeping up with the latest research. While making money may not be a life or death situation, it comes real close.

When it comes to investing, the environment is such that each buy and sell decision carries substantial financial ramifications. As such, avid research and attention to detail is extremely important. To examine this idea more closely, let’s take a look at three managers and how their painstaking efforts and attentiveness to the subtleties of their situations paid off for them and their investors.

## **Solv-Ex**

In his 2002 working paper titled, “Go Down Fighting: Short Sellers vs. Firms,” Dr. Owen Lamont makes note of Solv-Ex’s attempts to manipulate their stock price in February of 1996.<sup>34</sup> Though his first report and strong sell recommendation did not come until October 1996, renowned short seller Manuel Asensio, whom I consider myself quite fortunate to have interviewed, was also doing research on Solv-Ex at that time.

Solv-Ex had investor appeal. They claimed to have developed an environmentally friendly technology that would allow them to extract bitumen (which could be converted to oil) from New Mexico shale, and, later, tar sands in the northern regions of Alberta, Canada.<sup>35</sup> This was coming after the U.S. oil crisis of the 1970s, and promised to reduce our dependence on Middle East oil.

With this claim, it was easy for stock promoters to sell Solv-Ex, and as long as the stock price kept moving up, investors believed they had a good investment and never bothered doing in-depth research. Yet, Asensio did intensive independent research on Solv-Ex before he ever took a position.

In his book, Sold Short: Uncovering Deception in the Markets, Manuel Asensio makes it painfully clear why, whether bull or bear market, investor lose billions in capital every year. As we look at the highlights of the saga of Solve-Ex, note the all too familiar signs of corporate corruption.

First, consider the company’s history. Long before 1995, when Solv-Ex showed up on Asensio’s radar, the company and its leadership had already managed to scam the U.S. government and many investors.

“Solv-Ex Corp. was formed in 1980 in Albuquerque, New Mexico, when Samuel A. Francis teamed with John S. Rendall to arrange financing to commercialize certain patents allegedly owned by Rendall.

In Solv-Ex’s 1981 IPO, Francis was issued 1.75 million shares for approximately five cents per share and Rendall was granted 2.7 million shares in payment for rights to his ‘patents.’ In 1983 they sponsored the Santa Rosa (New Mexico) Tar Sands Project, claiming it could set up a \$24 million plant and extract 4,000

barrels of bitumen, which could then be refined to oil, per day from the sands. The scheme was tentatively offered \$42.6 million in federal aid.”<sup>36</sup>

On the promise of this aid, Rendall and Francis sold \$4 million worth of their stock at \$4.25 a share. Shortly afterwards, Representative Mike Synar of the House Government Operations subcommittee revealed that Solv-Ex had failed to disclose that an independent report, which stated that Solv-Ex had overestimated the potential amount of bitumen in Santa Rosa by a factor of two or three. The stock plunged from \$4.25 to \$1.75.<sup>37</sup>

Now, one might think that a blight such as this would so tarnish a company that it would immediately doom that company to failure. Yet, the Solv-Ex story continues, which brings us to our second point: Never let emotions or a desire for a positive outcome overshadow thorough due diligence. Asensio notes,

“Alberta’s optimistic provision of seed capital, along with its longing for the jobs that Solv-Ex was promising, caused its watchdogs to become emotionally invested in the company’s success, blinding them to the reality of this enormous scam.”<sup>38</sup>

When Solv-Ex was in Santa Rosa, the province of Alberta, eager for industrial development, had invested \$3.3 million in Solv-Ex’s New Mexico plant. Even after the previously mentioned fallout, in 1995, Alberta approved a plan for Solv-Ex to build a \$100 million plant capable of producing 14,000 barrels a day.

Yet, Rendall was not satisfied. After almost 15 years in business and having never produced a single barrel of oil at anything close to an economical cost, Rendall would shamelessly appeal to the province of Alberta for another \$600 million “in order to ramp up production to 80,000 barrels a day.”<sup>39</sup>

In January of 1996, David Snow, an oil industry analyst, gave the stock a *major buy* recommendation which included projected earnings per share in 1997 of \$2.50, \$20 in 1998, and in due course, \$98 a share – sustainable for 40 years! A few days later Morgan Grenfell’s senior oil analyst, Charlie Maxwell, who had attained a following in the 1970’s energy crisis, “unofficially” sent a positive recommendation on Solv-Ex, calling Solv-Ex the “Classic Growth Stock of Our Generation.”<sup>40</sup> Maxwell failed to disclose that he owned 100,000 shares of Solv-Ex at that time.<sup>41</sup> All this, of course, leads us to our

third point: Based on the inherent biases that currently exist in the securities markets, glowing reviews and buy recommendations from Wall Street analyst should be taken with (at least) a grain of salt.

When we contrast Wall Street analysts' reviews with those of independents, we come to our fourth point: Always look for independent research analysts to corroborate the findings of Wall Street analysts. If the findings of these groups differ, history has shown that independent research is far more accurate than that of Wall Street. In March of 1996, Vancouver-based Weir-Jones Engineering Consultants completed a technical due diligence report for a group of short sellers.<sup>42</sup> The report concluded,

“We do not consider that the bitumen extraction procedure is...particularly unique...For these reasons, we do not attach much credence to the Solv-Ex claim that they would be able to license their technology to the owners of other [oil sands] leases...The suggestion that Solv-Ex could become a significant producer of aluminum (another of Solv-Ex's claims) is at best highly questionable.”<sup>43</sup>  
(Parenthesis mine)

Further, the Weir-Jones report asserted that Solv-Ex underestimated difficulties and overestimated revenues at every turn.<sup>44</sup>

With such a preponderance of reasons to sell Solv-Ex short, we might think that as Asensio sold short in October of 1996, Solv-Ex careened into a ball of fire, rewarding short sellers like Asensio both emotionally and financially for their extensive research and tenacity. However, as mentioned several pages earlier, after posting the truth about Solv-Ex's shenanigans, Asensio began receiving vicious and violent emails.<sup>45</sup> He also had to endure the substantial cost of defending Asensio & Company against the bogus lawsuits that Rendall (with Solv-Ex shareholders' money) had filed against them. Asensio endured as the NASDAQ halted trading in the stock after Rendall announced that he was in possession of evidence of illegal shorting. An official of the exchange said that *trading would not resume until Rendall produced his evidence*. A couple weeks later, Solv-Ex was revealed to be in default for 67 days on a \$33 million loan from Morgan Grenfell.<sup>46</sup>

In the final days of Solv-Ex in 1997, Rendall claimed, “the whole plant is ready to start producing 100,000 barrels a day.” Asensio called Rendall's bluff by hiring a private

plane to fly over the area in question. The aerial photos of the “plant,” taken on the same day of Rendall’s announcement, revealed, “that not even the plant’s walls and roof had been fully erected.”<sup>47</sup> In July of 1997, trading was halted on Solv-Ex. Its final trade executed at \$4.25 a share.<sup>48</sup>

In the end, a class action suit was filed against Rendall and the others who colluded to help Solv-Ex. As well, the SEC filed against them for three claims of fraud, one claim of false SEC filings, and one claim of aiding and abetting false filings.<sup>49</sup> Asensio’s comments seem to sum up the benefits of his independent research and extraordinary resolve to overcome all the obstacles in his path:

“Solv-Ex was an ugly, ugly transaction, but for all the trouble it was immensely satisfying. The Asensio & Company trading fund did well. And we helped expose a 17-year-old swindle. In this business, you can’t ask for more.”<sup>50</sup>

## **Enron**

The story of Enron will certainly go down in the annals of history. While many know some of the damning details of this company’s demise, most do not know that when the debacle was over, Washington called on short sellers to get their needed answers. Jim Chanos testified before the Committee on Energy and Commerce in the US House of Representatives on February 6th of 2002 about the results of his research on Enron.

“We were troubled by Enron’s cryptic disclosure regarding various ‘related party transactions’ described in its 1999 Form 10-K as well as the quarterly Form 10-Qs it filed with the SEC in 2000 for its March, June, and September quarters. We read the footnotes in Enron’s financial statements about these transactions over and over again but could not decipher what impact they had on Enron’s overall financial condition. Another disturbing factor in our review of Enron’s situation was what we perceived to be the large amount of insider selling of Enron stock by Enron’s senior executives.”<sup>51</sup>

As an aside, Chanos’ comments resound one of Kathryn Staley’s discussions in her 1996 book, The Art of Short Selling. She elaborates on corporations’ employ of a technique whereby they create incompressible statements to hide material they do not wish to disclose in a chapter aptly titled, “If You Can’t Read It, Short It.”

“Experience suggests that if you cannot understand a report, officers are hiding something worse than you expect. It is almost an iceberg phenomenon; if you find five or six serious questions in financial statements, you can be sure that there are many more that you cannot see.”<sup>52</sup>

On the amount of insider selling at Enron, Dr. Howard Schilit, president of the Center for Financial Research and Analysis and author of *Financial Shenanigans*, points out that insiders unloaded \$1 billion in stock when Enron’s plan began to implode.<sup>53</sup>

Back to Chanos’ questions regarding Enron,

“Finally, we were puzzled by Enron’s and its supporter’s boasts in late 2000 regarding the company’s initiatives in the telecommunications field, particularly in the trading of broadband capacity. Enron waxed eloquent about a huge, untapped market in such capacity and told analysts that the present value of Enron’s opportunity in that market could be \$20 to \$30 per share of Enron stock. These statements were troubling to us because our portfolio already contained a number of short ideas in the telecommunications and broadband area based on the snowballing glut of capacity that was developing in that industry.

We were struck by how many [analysts] conceded that there was not a way to analyze Enron, but that investing in Enron was instead a ‘trust me’ story. One analyst, while admitting that Enron was a ‘black box’ regarding profits, said that, as long as Enron delivered, who was he to argue! It was clear that most of these analysts were hopelessly conflicted over the investment banking and advisory fees that Enron was paying to their firms. We took their ‘buy’ recommendations, both current and future, with a very large grain of salt!”<sup>54</sup>

Chanos’ comments about the Wall Street analysts are further supported in Dr. Frank Partnoy’s book, *Infectious Greed*. After a week of heavy selling in October 2001, Partnoy states,

“In October 2001, sixteen of seventeen securities analysts covering Enron called it a strong buy or buy. Given the recent allegations about [analysts] making unjustified buy recommendations in exchange for lucrative investment-banking business for their firms, they were even more upset than the investors. No one had

questioned the analysts' conflicts as stocks were rising, but now that prices were falling, investors and regulators were raising eyebrows." <sup>55</sup>

Whether we invested in Enron or some other company, it would be easy to feel gullible about investing in something so obviously fraudulent. Yet company communications and analysts recommendations clouded these issues to all but those who conducted their own research.

## **Sunbeam**

Before he retired, my father was in the timber industry. He remembers Al Dunlap as "Chainsaw Al" from his slash and burn days at Scott Paper. While at Scott Paper, Dunlap slashed 11,000 jobs, axed research expenditures and plant improvement expenses and then sold the company to Kimberly Clark, a major rival, for \$9.4 billion. Dunlap pocketed \$100 million for his "leadership" and made a reputation for himself as a turnaround king. And, Scott Paper became the sixth company that Dunlap sold or dismembered since 1983. <sup>56</sup>

Soon it was time for Dunlap to fire up his chainsaw again. The day Sunbeam announced that Al would be their new benefactor, their share price shot up 60 percent.

David Tice's independent research discovered differences between what Dunlap was promoting as a turnaround situation and what was actually happening. Tice points out in his testimony before the House's Committee on Financial Services,

"Wall Street research was euphoric about the restructuring, predicting rapid growth for this notoriously slow-growth business. The Street did acknowledge that the consumer durables business was inherently risky, but the primary focus was on Al Dunlap and the 'efficiencies' that were to develop from the synergies.

Sunbeam was forced to admit that its dramatic 'turnaround' and earnings recovery were the result of aggressive accounting procedures, that its growth was in fact an illusion. Eventually the short term accounting tricks ran out. The goals of the restructuring were not achieved, as the cost savings, debt-reduction, and actual sales growth never occurred. The over-leveraged company with little growth prospects was eventually overwhelmed by its debt." <sup>57</sup>

In her book, Bull: A History of the Boom, Maggie Maher says,

“Investors impressed by Dunlap’s press ignored the numbers. But those who had read Tice’s careful analysis in 1995 would recognize that Dunlap had little hope of success.”<sup>58</sup>

I think it is also interesting to note that most of short sales that Tice made in his Prudent Bear Fund were old economy stocks. This was not because companies like Sunbeam were “behind the times.” Rather, they were setting the pace in the use of creative accounting and corporate posturing to boost their companies’ stock prices.<sup>59</sup>

A final example of how independent research can be helpful to investors, comes from Al Dunlap’s early 90’s best-selling book entitled, Mean Business, in which he notes,

“The most important person in any company is the shareholder. I’m not talking here about Wall Street fat cats. Working people and retired men and women have entrusted us with their 401(k)s and pension plans for their children’s college tuition and their own long-term security.”<sup>60</sup>

The historical record of Dunlap’s actions stands in juxtaposition to these seemingly sympathetic words. Even with the \$100 million that Dunlap left Scott Paper with, evidently, he did not consider himself a “fat cat.” Axing 11,000 “working people” and expressing concern for working men and women seems a bit obtuse. Yet his unkindest cut of all was to those who entrusted him “with their 401(k)s and pension plans” when he headed Sunbeam. Those unlucky enough to invest in the Sunbeam “turnaround” in the fall of 1997 would have lost 90 percent of their “long-term security” by the fall of 1998. Ultimately, shareholders were wiped out in 2001, when Sunbeam filed for bankruptcy.

When I think of this pernicious display of unbridled greed and deceit, a saying of the old westerns comes to mind. “Hanging’s too good for him.”

#### **Pattern 4 – Perspective through History**

The financial world today is certainly not the world of Andy Griffith and Robert Petrie (Dick Van Dyke). In 1971, the dollar came off of the gold exchange standard, and we have not been able to balance the national budget any year since. The Chicago Board of

Options Exchange went live in 1973, opening our markets to the world of derivatives. The pension centered world of the 1970's, where decisions and risks were born by the employer, has been replaced by 401ks and IRAs, where the individual assumes these responsibilities. And credit is more readily available today than at any time since the founding of our nation. We do well to remember the early twentieth century poet philosopher George Santayana's warning,

“Those who cannot remember the past are condemned to repeat it.”

### **Why – the Question of Causation**

Unfortunately, because we do not see enough value in it, very little is taught about financial history. Probably more unfortunate is the fact that the emphasis of what is taught is placed on an events occurrence, but not *why* that event occurred. What processes could have caused long bull or bear markets? Further, periods like the Crash of 1929 or the Crash of 1987 are presented as phenomenon of such remote possibility that they do not merit commensurate study. Many an unsuspecting investor assumes that after each of these anomalies, the powers that be established fail-proof systems to make sure that these devastations would never occur again.

However, if we pay attention to the broader historical record, we begin to see many market periods where losses were substantial and sustained. Sometimes large losses occurred over a few days. Other times, processes were set in motion that caused losses to mount over the course of years.

The point is that if we look at specific periods in history, we find patterns and causal relationships between bull and bear markets and economic and social forces that lend clarity to our current circumstances. History is either randomly and chaotically moving forward or it is somehow demonstrably repeating derivations of past patterns. While studying the past does not guarantee an outcome, it does give one a much better understanding of the likelihood of risk.

### **The Crash of 1987**

In focusing on history and patterns that led to substantial market declines, we would be remiss to exclude Dr. Bruce Jacobs. Dr. Jacobs is co-founder and principal of Jacobs

Levy Equity Management, which is recognized as one of the world's leading institutional equity money management firms, and he is an expert on the events that led up to and occurred during the Crash of 1987.

In his book, Capital Ideas and Market Realities, Dr. Jacobs details the account of an investment tool known as portfolio insurance and its contribution to the Crash of '87. Much like indexing and diversifying and program trading today, portfolio insurance promised a way to allow investors to participate in market rises and at the same time reduce the risk associated with market downturns. Dr. Jacobs describes the foundation upon which portfolio insurance was built.

“The portfolio insurance strategy was born from the tenets of market efficiency, drew milk from the ideas of traditional insurance, and was given substance by Black-Scholes option pricing theory.”<sup>61</sup>

Next, Dr. Jacobs describes how portfolio insurance sought to protect investors.

“An actual put on an underlying stock portfolio protects the portfolio from stock price declines below a certain level while leaving the portfolio open to stock price advances. [Using] computerized rules and *program trading* [again, like today]... portfolio insurance aimed to replicate the behavior of a put option by selling short stock index futures.”<sup>62</sup> (Emphasis mine)

Yet, there were differences. Unlike a put option, where loss is limited to the amount invested, a synthetic options replication system (like portfolio insurance) requires the use of futures contracts, which do not have the same loss parameters. Each trade represents an obligation, and if a trade keeps moving against the investor, losses continue to mount and can exceed the original investment.

Additionally, like program trading and indexing today,

“Option replication requires trend-following behavior – selling as the market falls and buying as it rises. Thus, (in a classic fallacy of composition) when substantial numbers of investors are replicating options, their trading alone can exaggerate market trends.”<sup>63</sup> (Parenthesis mine)

In the market environment of the early eighties, risk reduction with continued participation was as desirable as ever. The Dow had started 1965 at 874. Seventeen years later, at the end of 1981, it closed at 875.<sup>64</sup> Consider these comments from a 1979 Business Week article titled, “The Death of Equities,”

“The U.S. should regard the death of equities as a near-permanent condition. Even if the economic climate could be made right again for equity investment, it would take another massive promotional campaign to bring people back into the market. The range of investment opportunities is so much wider now than in the 1950s that it is unlikely that the experience of two decades ago, when the number of equity investors increased by 250% in 15 years, could be repeated. Nor is it likely that Wall Street would ever again launch such a promotional campaign.”<sup>65</sup>

The markets experienced a brief reprieve in 1980, but again collapsed.

In 1980, the Dow scratched its way back up to 950. The price of oil had been spiraling [upwards], and as a result, by 1980, oil or oil-related stocks accounted for nearly one-fifth the S&P 500. When they toppled, so did the index, falling 27 percent.”<sup>66</sup> (brackets mine)

Doug Gillespie, of Gillespie Research, comments that, “In 1982, the mutual fund industry had seen net redemptions in eight of the last ten years.”<sup>67</sup> Needless to say, this was not a time where individuals or institutions were excited about the markets. However, Wall Street introduced portfolio insurance, and as money began to pour in, the great bull market came snorting out of its pen.

“Portfolio insurance appealed to the self-preservation instincts of investment managers and fund officers ‘who nearly lost their jobs maintaining static positions in the 1973-4 period.’”<sup>68</sup>

The similarities between Long Term Capital Management (LTCM) and Leland O’Brien Rubinstein Associates (LOR) were uncanny. Fisher Black and Myron Scholes, who created the option-pricing model that bears their names, were partners of LTCM and gave strong endorsement of their hedge fund. In much the same way Hayne Leland and Mark Rubinstein, from University of California, Berkeley, were at the helm of the discussion and implementation of portfolio insurance and were principals of the firm, which bears

their name. LOR, who with its licensees is conservatively estimated to have accounted for seventy-five percent of all insured portfolio assets, was the primary marketer and vendor of portfolio insurance. In both cases, the credibility of scholastic genius gave way to implicit trust that was largely unmerited.

Both LTCM and LOR, and program trading today, built their models on the premise of increasing returns and limiting risk, based on the assumption of efficient markets. In fact Leland and Rubinstein contended that,

“Long term returns can actually be raised, with downside risks controlled, when insurance programs are applied to more aggressive active assets. Pension, endowments, and educational funds can actually enhance their expected returns by increasing their commitment to equities and other high return sectors, while fulfilling their fiduciary responsibilities by insuring this more aggressive portfolio.”<sup>69</sup>

Like LTCM, the flaws of LOR’s posit were not apparent at first, and both experienced short-term success.

Yet, as John Breazeale, in a statement resonant of Yogi Berra, comments, “If your trading strategy is fundamentally flawed, *eventually* you’ll lose a lot of money.” Breazeale ought to know. He has been managing money since the early ‘70s and currently manages a long-short portfolio.<sup>70</sup>

In a fallacy of composition similar to LTCM, as other players entered the market and employed similar program trading models, portfolio insurance (dynamic hedging today) actually exacerbated the volatility in markets – the very thing it was designed to protect against. As the markets rose, so did the amount of money in portfolio protection products. In 1986,

“The November issue of [the] *Institutional Investor* had indicated that ‘76.5 percent of investors that selected insurance did so primarily to protect the gains...made since the onset of the bull market in 1982.’”<sup>71</sup>

As investors began to buy, the markets moved higher. As the markets climbed, the portfolio insurance models assumed that the markets were safer and the black boxes (automatic trades built on various models) took increased exposure to the markets.

However, as Gilbert and Sullivan note in the H.M.S. Pinafore,

Things are seldom what they seem, skim-milk masquerades as cream;  
Black sheep dwell in every fold; all that glitters is not gold.

### **Black Monday**

By the close of trading the Friday prior to Black Monday, from its August 1987 peak, the Dow had lost 17.5 percent. Somehow this little piece of history is overlooked. Yet the recurrence of this “decline-before-the-decline” pattern can be seen in other crashes as well.

“Portfolio insurers sold futures equivalent to \$530 million, \$965 million, and \$2.1 billion in stocks on the Wednesday, Thursday, and Friday preceding the crash (SEC 1988: 2.6, 3.9). The market fell 10 percent in this same period. A typical portfolio insurance strategy would have called for the sale of 20 percent of the equities in response to a 10 percent decline.”<sup>72</sup>

In what could be interpreted as a false sense of security, the total equities sold that week were only about a third of that volume. This muted selling created a huge overhang of selling pressure that would wreak havoc on the markets the next week.

On Monday morning, the fallacy of composition that Dr. Jacobs had debated with his colleagues was now to take place. No more marketing. No more debating, just the hard cold reality of the markets.

“From 9:30-9:40 a.m., program selling constituted 61 percent of NYSE volume. Between 11:40 a.m. and 2:00 p.m., portfolio insurers sold about \$1.3 billion in futures, representing about 41 percent of public futures volume (Brady Comm. 1988:36). In addition, portfolio insurers sold approximately \$900 million in NYSE stocks. In stocks and futures combined, portfolio insurers had contributed over \$3.7 billion in selling pressure by early afternoon.

From 1:10 – 1:20 p.m., program selling constituted 63.4 percent of NYSE volume and over 60 percent in two intervals from 1:30 to 2:00 p.m. In the last hour and a half of trading, insurer sold \$660 million in futures. The DJIA sank almost 300 points in the last hour and a quarter of trading.”<sup>73</sup>

Again, this was a loss of more than 13 percent in the last hour and a quarter of trading.

### **Lessons from 1987**

Dr. Jacob’s work on the intricacies of the patterns and probable causes of the 1987 crash makes a few points painfully clear:

1. Markets are given to the irrational herding instincts of the masses, and are therefore inefficient. The extremes of the black pessimism of the early eighties and the manic behavior that led to Black Monday lend evidence to this truth.
2. Fallacies of composition eventually lead to liquidity crises, where everyone wants to sell, and as Jim Chanos pointed out, “Short sellers always benefit in a liquidity crisis.” As well, program trading and indexing foster trend following behaviors, which often lead to fallacies of composition.
3. There are patterns that are evident before market crashes. This is true of 1929, 2000, and events leading up to Black Monday in 1987. Managers who study history and who are given to independent research can often identify these patterns and, in anticipation of decline, exit the markets ahead of other investors.

As a point of clarification, Chanos says, “Short sellers always benefit in a liquidity crisis,” for the following reason.<sup>74</sup> Short sellers borrow stock and sell it immediately. In a liquidity crisis everyone wants out, so stock prices fall, which benefits the short seller. Still, to capture a gain, short-sellers must buy (to close out their position) and repay the borrowed shares. Since short sellers buy in oversold conditions, short selling can stem losses and thus, benefit the market.

Kevin Duffy and Bill Laggner, of Bearing Asset Management – a Registered Investment Advisor in Houston, are another example of investment managers who see current circumstances through the lens of history.

“We both subscribe to the Bill Bonner view of history: When it comes to science and technology, man learns. When it comes to love, war, and finance, he makes the same mistakes over and over again. We also find it important to view history through the proper macroeconomic lens, our choice being Austrian economics – led by greats like Mises, Hayek, and Rothbard. Fortunately, the vast majority does not follow the same playbook and is thus prone to severe bouts of folly, moving from feelings of inferiority to superiority. The trick is exploiting the crowd's folly, not participating in it.

For example, during the late 1980s the Japanese suffered from delusions of grandeur while Americans caught an inferiority complex. At its height in 1989, Japan's total stock market capitalization exceeded that of the U.S., despite being supported by an economy less than half the size. Many, including economists, academics, management gurus, and politicians, were convinced the Japanese had developed a superior form of capitalism in which government and business cooperated. Enlightened ministers supposedly directed economic activity for the benefit of all.

Any Austrian worth his salt knew this was absurd. He also knew enough to look skeptically at the mix of low inflation and rapidly rising asset values, practically a carbon copy of the U.S. run-up during the Roaring Twenties. These were classic hallmarks of an asset bubble fomented by central bank-engineered credit expansion. The Austrian knows a bust follows an artificial boom, but can't possibly know the timing with precision. He sees the bust as a healthy cleansing process of the boom's past sins, and fully expects the authorities to interfere, prolonging and deepening the crisis. Of course, this was, in fact, Japan's post-bubble experience.

Today's financial markets are best summed up as "same play, different actors." The shoe of hubris is on America's foot while the Japanese are shoeless. Pax Americana has replaced Pax Nipponica. The U.S. "New Economy" illusion of 2000 ended in bust, but unfortunately the Fed has tried to alleviate the pain by administering a massive credit drug. The consequence is our current predicament, euphemistically referred to by the powers-that-be as the "Ownership Society." Debt is fashionable, saving passé, real estate on fire, and ever-rising home prices the latest elixir. We've seen this movie before, and it ends in tears.”<sup>75</sup>

## What – The Question of Appropriate Action

While understanding crowd behavior and wanting to be the first out the door is a given in hindsight, we know from our own experience that reading about a time in history and living through it are two very different things.

If we suspect something is coming, what do we do? If we ignore the warnings and proceed, we may be severely punished by the markets. If we opt to change, we are certain to face obstacles and opposition from within and without. As we continuously make our daily decisions, we know that there is difficulty in each direction. Consider the difficulty these investment managers faced as they acted on probability.

“In May 1969, Business Week proclaimed that Fred Carr ‘may just be the best portfolio manager in the U.S.’” That same month, the man from Omaha made up his mind. Weary of jeremiads and wary of jeopardizing past profits, Buffet did a *remarkable* thing. He quit. He *stunned* his partners with the news that he was liquidating Buffett Partnership. And now, *at the height of a bull market, he was getting out.*”<sup>76</sup> (Emphasis mine)

Some will argue that Buffett got out too early, that he should have waited until December of 1972. Yet, this only serves to reinforce the point that Buffett did not know what would happen. You see, we have the benefit of looking back to critique an early departure. What is more astounding to me is that a successful money manager would step away from the table before the onslaught.

Like Buffett in 1969, the late 1990’s forced Kevin Duffy to make some major decisions. Hundreds of small events from that period, as interpreted through his understanding of history, led him to make significant operational changes and to leave a business he had built to focus on what some considered a less desirable investment platform. This could not have been a quick decision as it certainly involved significant financial cost. Plainly, his historical perspective forged the business that he runs today.

“Lighthouse Capital Management began employing put/short strategies as early as the 1995 bubble in memory chips, with Micron Technology as poster-child. Bill and I cut our teeth during the late 1990s tech/Internet madness. More accurately,

we got our teeth smashed in. I still believed tech and Internet stocks were in a massive mania. I sold my share in Lighthouse in 1999 largely because the put/short part of the firm's strategy became unpalatable to our clients and leaving gave me the chance to at least take advantage of the opportunity on my own. My partner at the time was willing to focus on the other part of the strategy – small and mid-cap value investing. As it turns out, both strategies worked out.”

“So, Bill and I had developed considerable short selling experience before starting Bearing Asset in 2002, and our experience of the late ‘90s gave us a healthy dose of timidity and humility when designing risk controls for the Bearing Fund.”<sup>77</sup>

Bob Lang was managing money when Duffy and I were in kindergarten. If it is true that the longer we do something the more we get set in our ways, then this change from the long to the short side of the market must have been extremely difficult.

“My thinking changed after the Crash of 1987. As this big rally of the 90’s unfolded, I realized that the fundamentals of the markets had changed. One of the biggest changes was the growing amount of debt: government debt, corporate debt, and individual debt. Also, the sentiment indicators showed that people were wildly bullish. And, I couldn’t get past the [stock] valuation levels. Normally, price-to-sales ratios average was 0.8. In 1999, they were in the 2 to 3 range. Now, they’re about 1.5 to 1.6.

Around the mid 1990s, I started questioning, ‘what should I do? Should I continue to do what I have always done, with all of these negatives?’

Then I started looking at shorting. I read [about shorting] extensively; I remember going up to North Carolina to spend a day with an individual who had a great deal of experience selling short. Then, I tried it with paper money to see how it works. That was a real tough learning process. I continued to test it for several years before I went live in 2000.”<sup>78</sup>

These guys realized what was going on, and they changed course. If we pause from our hectic schedules long enough to ponder our current circumstances, we are apt to realize that we are living in historically significant times. And since numerous historical references, combined with knowledge of the present, lend evidence to our current

juncture, we would do well to consider a change. Like Buffet in 1969 or Duffy and Lang in 1999, the world of financial opportunities and debacles never stops. For this reason, another trait present in great managers is a desire to constantly improve their processes and skills.

### **Pattern 6 – Constantly in the Lab**

At this point the frank question is, “If these excellent managers are so smart, and have such a grasp of history, and understand our current markets so well, why the need for change any aspect of their trading platforms? If it ain’t broke, don’t fix it.” Whatever their reasons, most people just don’t like change.

A few see the need for change as times progress. Like re-allocating a portfolio, they realize the necessity of shaving off a little over here and putting it over there. The main structure stays intact, but it is periodically rebalanced.

Very few managers realize a need for radical change. Those that do, realize that the financial terrain is constantly changing. Risk is not only constant; it is also constantly changing. They recognize the need to depart from the status quo. As they change their processes and search for answers, they may even experience some confusion.

In his book, Mass Psychology, Jim Dines talks about the positive benefits of confusion.

“Confusion is a high state [where crucial discoveries are made], believe it or not, since confusion is looked down on in our civilization. In fact, confusion simply means that one has not yet found the truth; it is a state of being unattached *and therefore open*. When the stock market is confusing, simply withdraw to calmly and patiently observe until a truth arrives that is so strong it wrenches reason to recognize its reality. Yogi Berra said, ‘you can observe a lot by just watching.’”<sup>79</sup>  
(Brackets mine)

A passion for research and study and an aspiration to improve are character traits common to excellent managers. They look to understand and implement solutions based on that understanding. Their independence provides the latitude needed to do this.

John Breazeale runs a long-short trading platform, seeking to benefit from both the upside and downside of broad market moves. While long-short platforms are common, his passion to improve his process is unique. Breazeale conveys his thoughts,

“I sometimes spend fourteen to eighteen hours fiddling with my program. You could say it’s a passion that meets some need. But, let me start from the beginning. I believe that God laid down the universe in His way. Since He is incompressible, as are His doings, we can’t begin to understand from our perspective. But, we do our best.

In our best efforts to figure things out, we have explored mathematics, as math seems to be the closest representation of everything that goes on. It doesn’t tell us everything; it just proves to us that something very big is taking place. There are certain patterns in mathematics that scream creative design at us. For example, phi is a number that, even with our massive computer programs, we have yet to figure out.

Or consider the Fibonacci sequence. Fibonacci shows us that there are patterns in the universe that can be totally reduced to mathematics. Whether we are discussing stock markets, radio signals, sunflowers, bees, or the shape of the Milky Way, we see this Fibonacci pattern. Clearly, something is going on. As I study, I see patterns and through that I begin to discover solutions. So, every time I sit down, I get closer to the ultimate solution of these patterns. It jumps from mathematics to a quest. I can go for hours.

What makes me sit down is the desire to take care of my clients. I believe I can always improve my system. I study to see if I can make it better. Sometimes, I can make a small change, and if not, I can leave the system the way it is. I am a black box guy. None of this is required of me. I just have this drive to make it better for my clients, which gets me into my experiment seat, which ultimately makes me drive toward a better solution.”<sup>80</sup>

Clearly, Breazeale has a passion for research. Though his appetite for research is certainly uncommon to most people, and is even uncommon to the majority of money managers, when we group him with other excellent contrarian managers, he is closer to the mean.

In prior bear markets in high-yield bonds, Stephen Blumenthal had to be content with strategies built to preserve his clients' capital. With the market's introduction of new products, he has been diligent to build a strategy that could profit from price declines in the high-yield (junk) bond market and grow his clients' capital. As you read his explanation, rather than try to grasp all the details, seek more to understand the general idea.

“We trade a credit-default-swap basket composed of 125 of the larger, more liquid high-yield bonds. Similar to a regular bond, this derivative trades with a spread between the bid and the ask. Additionally, we buy put options on the (DJ CDX) index, which has only been in existence for the last three years. There were various, fragmented credit-default index like products that were similar to exchange traded funds. Thankfully, in July of 2004, eleven major dealers came together to support one common index, the DJ CDX, and since then, volume has picked up extensively.

Execution and liquidity are the most important aspects of our strategy. Spreads between bids and asks have narrowed from three-quarters of a point, or more, to as low as five cents. As we've learned more and worked hard to develop our trading relationships, our execution has improved considerably. And, liquidity has grown from approximately \$25 million (notional) a day to over \$2 billion (notional) a day. As a matter of fact, the average daily volume on the (DJ CDX) index exceeds the total daily volume in the entire high-yield bond (cash) market. Of course, there's been a learning curve for us, and for the entire industry, to get our hands around the (DJ CDX) index. And the learning continues.

The (DJ CDX) index has been widely embraced and serves as a tool for professionals to reduce risk. For the most part, the correlation to the high-yield bond market has proved to be very good and the ability to profit in down trends is attractive, especially when markets are priced at the extremes we see today.”<sup>81</sup>

Due to enhancements in this part of the markets, Blumenthal has seen liquidity improve over the last 2 to 3 years. However, he and the other managers in our study are keenly aware of how changes in overall liquidity impact markets. As evidenced by Dr. Jacob's work on 1987, managers must understand what has historically happened when liquidity dries up, especially in derivatives markets.

“After the crash [of 1987], however, the SEC (1988: 3.22) concluded: ‘Low margins...contribute to the *illusion of almost unlimited liquidity* in the futures market. During a market break, however, that liquidity disappears at a rate geometrically larger than liquidity in the lower leveraged stock market.’”<sup>82</sup>  
(Emphasis mine)

Asensio concentrated short positions made the timing of his trades very important. As such, he constantly monitored the effects market stimuli had on his investments. He explains,

“We don’t use technicals for technicals sake. We don’t analyze volume and price movements on a graph or chart to make our decisions. That’s just not our way. Our processes include an analysis of how the price action of a company has historically responded to either a company or external stimulus. Not a big event like a merger, or a re-financing, or a large order that most businessmen would consider. The stimulus might be a press release, an article, a presentation at a conference, or a filing, or something else. That’s what we call stimulus. Then we analyze the effect.

If we look at the way a stock reacts on the day the stimulus occurs and on the days and weeks after, we begin to get a sense of the level or stage of maturity in which a transaction finds itself. Since shorting is already costly and stressful, it makes no sense for us to be early. We don’t want to be too early and use our resources in a way that places us in opposition to the way the stock reacts to that stimulus. In both staff and research dollars, it’s too costly. And of course, if we get in early, we miss the opportunity to make more money on the shares we sell. We are very sensitive to price action and the reaction to stimulus. This is a detailed process that involves close attention to price action and volume data.”<sup>83</sup>

As we wrap up this section on the character traits of excellent contrarian and short managers, Buffet’s words come to mind,

“It’s only when the tide goes out that you learn whose been swimming naked.”<sup>84</sup>

As the level of risk continues to increase, investment managers’ skills will become increasingly important. As Buffet notes, circumstances can cause some to look brilliant

when in reality they have benefited from luck. Nassim Taleb discussed this very idea in his book, Foiled by Randomness. In the following excerpt, Taleb presents his thesis from the standpoint of the Greek Philosopher, Solon:

“Solon was wise enough to get the following point; that which came with the help of luck could be taken away by luck (and often rapidly and unexpectedly at that). The flipside, which deserves to be considered as well (in fact it is even more of our concern), is that things that come with little help from luck are more resistant to randomness. Solon even understood another linked problem, which I call the skewness issue: it does not matter how frequently something succeeds if failure is too costly to bear.”<sup>85</sup>

## Notes

### **Section 4: Traits of Excellent Managers**

1. Harry Strunk, interview with the author
2. [http://www.ici.org/stats/mf/trends\\_07\\_05.html#TopOfPage](http://www.ici.org/stats/mf/trends_07_05.html#TopOfPage)
3. Manuel Asensio, interview with the author
4. Value Investor Insight, (July 29, 2005) “Smarter than the Average Bear”, page 2
5. Ibid, page 1-3
6. Ibid, page 3
7. Ibid
8. James Chanos, interview with the author
9. <http://www.slate.com/id/1003832/#ContinueArticle>
10. Ibid
11. Ibid
12. Ibid
13. [http://www.businessweek.com/2001/01\\_02/b3714009.htm](http://www.businessweek.com/2001/01_02/b3714009.htm)
14. Litigation Release No. 17722 (September 12, 2002), United States Securities and Exchange Commission
15. New York Times (Tuesday, October 4, 2005) “Bail Denied To Two Tyco Executives”, Section C, page 2
16. The Wall Street Journal, (June 16, 1988) “Loaded for Bear”
17. Sold Short, Manuel Asensio, page 92
18. GMO, Letters to the Investment Committee I (October 2004), page 2
19. Manuel Asensio, interview with the author
20. The Art of Short Selling (1997) Kathryn F. Staley, page 229
21. Short Selling, Frank Fabozzi, page 191
22. Sold Short, Manuel Asensio, page 102
23. Manuel Asensio, interview with the author
24. Julie Kirkpatrick, interview with the author
25. James Chanos, interview with the author
26. Ibid

27. Bob Lang, interview with the author
28. Julie Kirkpatrick, interview with the author
29. David Tice, interview with the author
30. Ibid
31. Ibid
32. Ibid
33. Short Selling, Frank Fabozzi, page 191
34. Sold Short, Manuel Asensio, page 75
35. Ibid, page 76
36. Ibid
37. Ibid, pages 75-77
38. Ibid, page 78
39. Ibid
40. Ibid, pages 80-81
41. <http://www.fool.com/features/1996/interview961018.htm>
42. Ibid
43. Short Selling, Manuel Asensio, page 85
44. <http://www.fool.com/features/1996/interview961018.htm>
45. Short Selling, Manuel Asensio, page 92
46. Ibid, page 97
47. Ibid, 94
48. Ibid, 100
49. Ibid, 100-101
50. Ibid, 102
51. Testimony of James S. Chanos concerning Enron Corporation before the Committee on Energy and Commerce, United States House of Representatives (February 6, 2002), page 3
52. The Art of Short Selling, Kathryn Staley, page 113
53. Financial Shenanigans, Howard Schilit, page 261
54. Testimony of James Chanos, Enron, page 4
55. Infectious Greed, Frank Partnoy, page 332
56. Financial Shenanigans, Howard Schilit, page 165

57. Testimony of David Tice, “Analyzing the Analysts”, page 11
58. Bull, Maggie Mahar, page 179
59. Ibid, page 178
60. Origins of the Crash, Roger Lowenstein, page 61
61. Capital Ideas and Market Realities, Bruce Jacobs, page 4
62. Ibid
63. Ibid
64. Unexpected Returns: Understanding Secular Stock Market Cycles (2005) Ed Easterling, page 34
65. Bull, Maggie Mahar, page 46
66. Ibid
67. Doug Gillespie, interview with the author
68. Capital Ideas and Market Realities, Bruce Jacobs, page 45
69. Ibid, page 40
70. John Breazeale, interview with the author
71. Capital Ideas and Market Realities, Bruce Jacobs, page 42
72. Ibid, page 148
73. Ibid, pages 152-153
74. James Chanos, interview with the author
75. Kevin Duffy and William Laggner, interview with the author
76. Buffet, Roger Lowenstein, page 114
77. Kevin Duffy and William Laggner, interview with the author
78. Bob Lang, interview with the author
79. How Investors Can Make Money by Using Mass Psychology (1996) James Dines, page 15
80. John Breazeale, interview with the author
81. Stephen Blumenthal, interview with the author
82. Capital Ideas and Market Realities, Bruce Jacobs, page 144
83. Manuel Asensio, interview with the author
84. <http://chatna.com/author/buffet.htm>
85. Fooled by Randomness, Nassim Taleb, page 10