

## Who Would Believe?

by Doug Wakefield with Ben Hill

On January 2<sup>nd</sup> of 1900, the Dow Jones Industrial Average closed at 68. If you had told those living at that time that in one generation Americans would be driving automobiles and that the world would be looking back on a war in which the Allied Forces consumed 12,000 barrels of oil a day, who would have believed you? On September 3<sup>rd</sup> of 1929, the Dow closed at 381. If you had told those living at that time that on July 6<sup>th</sup> of 1932, the Dow would close at 44 – lower than its value on January 2<sup>nd</sup> of 1900 – who would have believed you?

After hitting 991 in January of 1966, thirteen years later, in August of 1979, the Dow closed at 885, and Business Week wrote a piece titled, “The Death of Equities.” If you had told those living at that time that the next generation would be surfing the web from their personal computers, who would have believed you? Who would have believed that median US home prices would go from \$64,000, in 1979, to \$257,000, in March of 2006?

On February 20<sup>th</sup>, 2007, the Dow closed at an all time high of 12,786. One week later, the Dow saw its worst one-day loss in 7 years (outside of 9/11). So, was February 27<sup>th</sup> a worldwide wakeup call for investors or just one more bump on the road to higher markets? While we wait to see what happens, we must contend with the fact that, collectively, we have a poor track record of foreseeing substantial changes in the future. Time and again, history shows the circumstances that have led to manias and the attendant aftermath of these episodes. In fact, the record is so replete, that we must consider how large of a role denial has played in financial history. The headlines and media coverage after Tuesday, February 27<sup>th</sup>, only serve to exemplify this trend.

In 2005, I dedicated five months to a topic that I think will be a historically significant in the near future and in generations to come. Though it has been around since the 1640s, little has been written on this topic. And, while many institutional players have had access to this tool through the hedge fund world, few people actually understand its value to investors. The topic? Short selling.

As recent events have caused some to consider the possibility that markets have a downside, I’ve decided to take this opportunity to revisit one of the managers that I interviewed for [Riders on the Storm: Short Selling in Contrary Winds](#). As attested to by the [Strunk Short Index](#), Robert B. Lang, Chairman and CEO of [Lang Asset Management](#), is one of seven dedicated short-only managers in the US at this time.

I recently had the opportunity to ask Mr. Lang the following three questions:

Doug – Bob, dedicated short-sellers are extremely rare in our financial markets. Can you share some of your background and perhaps some of the experiences that led you to establish a short-only strategy?

Bob – I started in the business in 1959, have managed portfolios since 1964, and started my own firm in 1980.

I remember when the markets were bottoming in the mid 70s... I remember calling prospects and telling them P/E (price-to-earnings) ratios were down to 7 or 8, dividend yields were better than 6 percent, and that the market had likely bottomed so I thought it was a good time to start buying. There was *absolutely no* interest. Most people responded with something to the effect of, “I don’t want to touch the stock market. All its good for is losing people money.” Well, times have certainly changed.

Though, I have historically operated on the long side of the markets, during the latter part of the 1990s, I could tell that the activities on Wall Street were becoming much more speculative. Security analysts were no longer performing their traditional roles as independent thinkers. They would just take the information given to them by the companies they covered and parrot it. Also, since they had been given a boatload of options, many corporate executives were primarily interested in hyping their stock by making overly-optimistic predictions. To boost performances, mutual funds acted in ways that were not in the best interest of their fundholders. In short, Wall Street lost its way in a bullish tsunami. Since I had experienced multiple investment cycles and had witnessed how investors swing from greed to fear, it became apparent that a significant opportunity was developing for contrarians. That is, it was time to move to the short side of the markets.

Of course, since we are all products of our experience, and since most participants have only experienced stocks going up, a bearish view was, and is, extremely unpopular. Only a handful of investors understand the bigger picture. Stocks are subject to cycles. That is why long-term cycles occur. That is, one generation grows up with the understanding that stocks always rise. Finally, the market declines and a lot of people get hurt and the next generation look at stocks with contempt. So unless an individual investor is made aware of this pattern, they are inclined to go along with the current prevailing opinion. After the fact, that is once a decline unfolds, that decline becomes obvious in hindsight. But until then, most find it extremely difficult to “fight the crowd.”

Doug – Since most investors have no experience with short selling, can you give us some basic lessons on how short selling works?

Bob – Most investors buy stocks hoping that the price will rise. But short sellers, like [Lang Asset Management, Inc](#), anticipate making a profit from declining prices. Expecting a drop in price, we sell the stock, and buy it back later at a lower price. The difference is our profit.

The natural question is: how can you sell a stock that you do not own? When you sell a stock short, the broker lends you the shares from a buyer, who previously approved such an arrangement. Later, when you buy the stock back (otherwise called covering), the broker returns the shares to the buyer, and all is settled. For example, you believe XYZ Corporation stock price is too high, so you instruct your broker to sell short 100 shares at

\$50. The broker borrows 100 shares from another account and “delivers” them to you, the short seller. As a short seller, you immediately sell the borrowed 100 shares at \$50 per share, and \$5,000, the proceeds from the sale, is credited to your account. If the stock were to fall to \$30 a share, you might then decide to buy the 100 shares you borrowed back for a total of \$3,000. You return the borrowed shares to the broker, and you make a \$2,000 profit.

Of course the stock may go up instead of down. Suppose it goes to \$60, and you decide to purchase in order to minimize your losses. You buy the shares back, and you have lost \$1,000 (\$5000-\$6000). The net result is not all that different from a situation where you had bought the stock at \$60 and watched it decline to \$50.

Unless the broker “calls” the stock back because he must return the borrowed shares to the owner for some reason, there is no limit on the amount of time you may remain short. But, having a stock called away is a highly unusual situation which usually only occurs with stocks that have a low level of liquidity. There are a few stocks that the broker cannot obtain, and in such cases, you may not short that particular stock.

There are only a very few pure short sellers, probably measured in the single digits, versus many thousands of mutual funds and hedge funds. In my opinion, this endeavor requires a special aptitude, which is not easily transferable from the long side (without considerable experience).

Doug – How does the client benefit?

Bob – The same way one benefits if a stock rises. Most investors buy stocks hoping they will increase. The short seller makes a profit when the stock declines. When an overvalued market turns down, by definition most stocks decline, and portfolios that are short, increase in value. So, not only does the client not lose money, but by implementing this “hedging” strategy, he or she actually profits. Typically, as a measure of diversification, short selling is only done with a portion of a client's total assets.

Doug – Bob, I’d just like to thank you for taking the time to share your experience and knowledge with us today.

Unfortunately, millions of investors will never heed the words of Bob Lang or an article like this one. They continue to see warnings in their everyday lives, but take comfort in the fact that their friends and advisors are all doing the same thing. They ignore reality and trust theories that have worked well (for the last 3 decades) in an ever-expanding sea of credit. So why do most individuals, maybe even those reading this article, never take steps to protect their capital from a bear market?

In answering this question, I turn to a professor of geology at UCLA. As an evolutionary biologist, biogeographer, and Pulitzer Prize winning author, Dr. Jared Diamond addresses the “it can’t break” mindset in a story about individuals who live below a dam.

According to Diamond, attitude pollsters ask people who live downstream from the dam how concerned they are about the possibility of the dam bursting. Naturally, those that live further away from the dam are less concerned about the dam breaking than those that live closer to it. But shockingly, from a few miles below the dam, where one would assume the fear would be the greatest, as we approach the dam, the concern about the dam breaking falls off to zero. Why? Diamond notes that those that live closest to the dam, who are sure to drown if the dam breaks, must believe that the dam couldn't break in order to preserve their own sanity. This ability to suppress or deny thoughts that cause us great pain is known as psychological denial. Diamond suggests that this behavior, common to individuals, could apply to groups as well.

The only way that investors will be able to take constructive financial steps before this credit cycle contracts, is to step outside of the powerful forces of the herd. From here, they can begin to address the unpleasant reality of that which is currently unfolding and how we got here. Denial will only lead to unnecessary losses and increased pain.

To read some of our other postings and learn about our [educational services](#), we encourage you to visit our [website](#). Our industry research paper on short selling, [Riders on the Storm: Short Selling in Contrary Winds](#), is available to those who subscribe to our monthly newsletter, [The Investors Mind: Anticipating Trends through the Lens of History](#)

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