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IS SHORT-SELLING RIGHT FOR YOUR PORTFOLIO?

- **Short-selling is a needed market function**
- **Short-selling has limited upside and unlimited downside**
- **Short-selling requires much more fundamental homework than the long investments**
- **Short-sellers are often early to the party, but usually right in the long-run**
- **Making money shorting is extremely difficult**
- **Lessons learned shorting should be applied to pick the best long investments**

Contrary to what most of the press will tell you, short-selling truly is a noble profession in our eyes. You do twice the work for at best half the profits of the longs. It just does not seem fair. Short-sellers are usually the ones that root out the fraud in corporate America (Enron, Tyco, Adelphia, etc.), making the market a better and safer place to invest – yet they are viewed as evil by most companies, most individual investors, and the media. For some reason, short-sellers work tirelessly year after year to try and beat a stacked deck. It may not be charity work, but it can certainly feel like it at times.

The long-term direction of the markets (and most stocks) is up and consequently, shorting is a tough business. This is coming from people who spent the several years their lives at one of the largest stock shorting funds in the country and one of the largest bond shorting hedge funds in existence during a bear market. It is simply so hard to make money shorting because irrational markets can inflict an unbelievable amount of pain before your short investment pays off.

For those not intimately familiar with short-selling, we will provide a quick primer. Analysts such as ourselves scan for companies just like traditional long-only fund managers, except we look for overvalued securities as well as undervalued ones. Upon finding an overvalued security with bad fundamentals, short-sellers can short a stock in the following manner: they call up a broker and ask to borrow the shares of the overvalued company from someone's account. Then, the short-seller turns around and sells the borrowed shares in the open market. The short-seller receives the sale proceeds immediately and can earn a little bit of interest on that cash. The hope is that before the owner of the borrowed shares demands his shares back, the short-seller can buy the shares back in the open market at a lower price and deliver it to the original owner. (For example, we borrow one of your XYZ shares at $10 a share, sell that share immediately and earn a little interest (at a reduced rate) off the money. Then 1 year later, the stock has dropped to $3, at which point we buy the share back at the $3 price and deliver it back into your account. We pocket the $7 difference plus a little interest for the time we held your cash minus commissions.) As a side note, you may be asking why anyone would allow their shares to be borrowed. The answer is simply that big mutual fund complexes like Fidelity own tons of shares in XYZ and by

lending it out, they can make some money off of the borrow along with the broker. The practice of short-selling has been going on since at least the 1920s, and there is nothing illegal or un-American about it, despite what you might hear on TV. In fact, it helps to make efficient markets because short-sellers are often the first to spot improprieties or overvaluation in certain securities. If the short-seller is wrong, he will be forced to buy back his short, thereby giving buying pressure and support to the stock price.

Short-sellers can see the future better than most analysts and portfolio managers because they do far more homework than your average long investor. Short-sellers read all the government filings by companies, talk to suppliers and customers, read about the products, read trade journals, talk to competitors, read the proxies, and do a whole host of other fundamental research that longs do not usually perform. Why? It is because they have to!

The flaw in short-selling is that your profit versus loss profile is the inverse of a long investor. For the long investor, if you buy a stock, you can theoretically make an infinite amount on your investment, because the stock can move higher and higher. When you buy a stock (not on margin), you can only lose the finite amount that you paid for it. Short-sellers are faced with just the opposite – unlimited loss and finite gain. Short-sellers have the constant fear in the back of their minds of losing everything because a stock shoots to the moon and never comes back. This is why they must do so much homework to find bad fundamentals coupled with an absurd stock price. There is no margin for error. Short sellers simply cannot afford to be wrong, hence the tireless work they perform.

This endeavor is made more difficult in that it is the market's natural inclination to give companies the benefit of the doubt and believe that all is right no matter what. Like we said before, most stocks go up, most investors are long only, and that combination yields a tough environment for a stock to crater. Hope springs eternal (i.e. every year since 2000, we have been hearing about this much fabled 2nd half recovery) for most investors who time and time again believe that stocks are going to go up whether or not the fundamentals support such a move. In the end, fundamentals always catch up with a stock. It may take years to make money shorting when you have an Internet bubble, and the pain of shorting a stock like Amazon and Yahoo when it runs may force you out first. In the end however, fundamentals force the market to adjust valuations to proper levels and shorts can be rewarded.

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