

# **Riders on the Storm**

## **Short Selling in Contrary Winds**

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**with Ben Hill**

**January 2006**

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## 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.

## **Acknowledgements**

This work would not have been possible without the assistance of great minds and the wealth of knowledge that comes through experience.

I would like to personally thank those who were gracious enough to allow me to interview them, including Manuel Asensio, Stephen Blumenthal, Jim Chanos, Bob Lang, Julie Kirkpatrick, Kevin Duffy, Doug Gillespie, Harry Strunk, Alan Newman, Bill Laggner, David Tice, and Jim King. I would also like to thank all those who lent me their assistance, including Jason Goepfert, Charlie Minter, and Jon Sundt.

I would like to specifically thank Kathryn Staley, Dr. Frank Fabozzi, Maggie Maher, Roger Lowenstein, Frank Partnoy, Irving Pollack, and Dr. Bruce Jacobs for their efforts, which contributed significantly to various sections of this work.

Though I do not directly address different schools of economic thought, I would like to thank Dr. Murray Rothbard. He was a prolific writer and his works have profoundly impacted my thinking. I would also like to thank the brilliant professors who taught at the Mises University of the Ludwig Von Mises Institute in August of 2004. They are an ongoing source of great information and have often extended their help.

I would like to take this time to encourage the reader to expand your knowledge of risk through more fully exploring the many sources cited throughout this work.

I would also like to thank Ben Hill for his integral part in this work. His perception and verbal skills have allowed this paper to communicate lessons and ideas that would otherwise remain obscure. Though this may go unnoticed, his meticulousness in reworking and rearranging the voluminous amounts of material used in this work has allowed us to present a cogent, cohesive argument. In other words, if it weren't for Ben you wouldn't understand any of this.

Finally, the reader would do well to note something that I will expound upon more fully later. Namely, the great minds that have contributed to this work are fiercely independent. As such, they will often disagree on various issues. Therefore, the conclusions that I have come to are my own, and it should not be assumed that those who have contributed would agree with all of the conclusions and opinions presented herein.

## Introduction

Short sellers have often been “the man without a name.” This is true of those who were experts in the field of short selling throughout history. It is also true of those individuals who use short selling exclusively or as one of the main tools in their money management practices today.

While this is changing, the vast majority of investors have never been introduced to this part of our financial markets. Those who have are only vaguely familiar with short selling and its place in market history. Since short selling has often been looked upon negatively, this is understandable. In her book, The Art of Short Selling, Kathryn Staley states that in compiling material for her work, she discovered that the last book detailing the practice of short selling had been written in 1932. From my own research, Dr. Fabozzi’s book, Short Selling: Strategies, Risks, and Returns, looks to be the first work ever written that could be considered a textbook on short selling.

The first three sections of this paper and the section just prior to its conclusion, are various looks at what I call “the storm.” While the issues presented in these sections are ones that most of us have either suspected or observed in our day-to-day dealings with the world of finance, they are most often dismissed as just part of the noise. Since nobody else seems too alarmed, we figure we are safe as long as we stay the course.

However, this means that most investors do not understand the risk they face in capital markets. In some cases these risks are greatly underestimated.

We think of the financial world as very clean and hygienic, governed by those whose interests are closely aligned with our own. In truth, there are ethical and unethical leaders who run businesses, and there are ethical and unethical managers on both the long and short side of the markets. This is crucial for investors to understand.

There are also distortions in the data upon which we rely. Whether it’s a re-jiggering of the way statistics are compiled or accentuating some figures and downplaying others, most investors do not recognize that they are making critical investment decisions based on flawed information. With such distortions so prevalent, we still spend very little time as a culture examining the decisions and actions of our government, and its agencies, that have direct effects on the financial markets.

Sometimes we rely on extrapolated, average annual returns reflected in pretty pie charts. We take comfort in the fact that we are diversified and that our investment strategies are well aligned with impressive sounding math formulas.

Yet, as we age and look back on times in history, we see prolonged periods when market returns varied wildly. As we hear reports of financial duress, we are alarmed. We become more concerned as we ponder this nagging cognitive dissonance. Can we learn anything from looking back at history that would safeguard us into the future, or is it all truly just random chance?

We begin to realize that “average” seas contain both monsoons and calm. Sailors do not set sail on averages; they can be too misleading – too costly. I believe when we see red skies in the morning, we do well to prepare for a storm; when we see red skies at night, we relax in that the storm has past.

The “crew” comprises the bulk of the paper. This section looks at six essential character traits in selecting money managers. As I read and spoke with skillful managers, these qualities kept coming to the forefront and ultimately crystallized in my mind. While some of these behaviors can be found in every manager, those who possess all of these traits are very rare. Though these traits can be found in long managers, because of the difficulties involved in short selling, these strengths seem more pronounced in short managers.

Long-short managers have become much more common in the last several years. Yet, all too often many such managers are missing some of these crucial disciplines, usually skewing their biases to the long side of the markets. Thus, in a secular bear market, when these managers should be of greatest value, the risk of a breakdown in their strategies increases.

When the future seems vague, it often becomes clearer through the lens of history. As you read the historical record of issues short sellers faced after previous manias, you may gain an appreciation for how imprecise people can be as they dispense blame after sharp market declines. Since short sellers have comprised a relatively small part of the markets throughout history, they have made easy scapegoats for other groups of investors and managers. In 1935, these passions set the course for some of the regulations we have to

this day. Throughout the years the SEC has conducted repeated studies of short selling, usually after major market declines. From the many Pollack report references, the reader will see the hurdles that short sellers have had to surmount even in recent history.

In working on this paper, it became apparent that short selling, like the long side of the market, has its darker side. When short selling is employed in an ethical manner, it benefits the markets. It acts as a voice of dissent in maniacal periods and even provides support to the markets, by *buying* stocks-to-close, once a decline has occurred.

Unfortunately, with the advent of “naked short selling,” there is a new challenge for ethical short sellers. If this, like the unethical practices on the long side of the market, goes unchecked, it could bring undue damage to investors and hurt our capital markets.

Near the end of the paper, we look at seven major risks facing investors today and what some of the top financial names of our era have to say about our current juncture in market history. Look to be educated, not comforted.

Upon completion of the paper, I am confident that you will be much better equipped to begin or improve your due diligence process in selecting a short-only or long-short manager. For those who want to hurry up and get to the bottom line, this paper will prove frustrating. However, if you wish to find patterns that will help you avoid the pitfalls that so many investors fall into, you will be pleased that you have taken the time to learn about this area of the markets.

As you begin reading, let me encourage you to remember the words of Robert Rhea, from his 1934 book, The Dow Theory.

“Speculators who ‘go broke’ are usually those who fail to devote as much time to studying the subject of speculation as they devote to the risking of an equal sum or money in their own business. These individuals will seldom admit that their ignorance is responsible for their losses. They prefer to accuse ‘Wall Street’ and ‘bears’ of having cheated them out of their money in some mysterious fashion. They fail to realize that no profession requires more hard work, intelligence, patience, and mental discipline than successful speculation.”<sup>1</sup>



## **Section 1: Corporate and Wall Street Ethics**

In 2001, I was beginning to realize that the roaring 90's were over, and with the intensity of the correction, I felt compelled to search for reasons and causes. I began to question every aspect of the financial system. I had seen and heard of countless corporate accounting-fraud scandals; I had begun to ponder the inconsistency of government reported numbers; and, I had begun to question whether there was more at play in the markets than random chance.

The more I learned the more intrigued I became. I began to see the cause and effect relationships that I had dismissed with little thought in years prior. In pulling back these curtains, I was confronted with a less pleasant reality. Yet I found more comfort in discovering the truth than I had in relying on the trite teachings that are so common to the financial industry.

### **Accounting Fraud**

Convention holds that the best place to start a treatise is at a point of common agreement. With Enron, and Worldcom prior to that, making headline news in the not too distant past, accounting fraud is a common theme in most investors' thoughts. The commonality in these various accounting scandals is companies' focus on inflating corporate earnings.

While most of the fraudulent activity from the 2000 to 2002 was headlined as a problem relegated to telecommunications and technology industries, there were many companies in other industries who, in an attempt to boost their stock prices, used accounting gimmickery to embellish their earnings.

For example, Cendant, CUC until 1997, sold various types of club memberships to consumers. Prior to Enron, Cendant, with combined investor losses of over \$19 billion, was considered the biggest accounting fraud ever. In June of 2000, Cendant's former chief financial officer, Cosmo Corigliano, pled guilty to SEC charges. In his testimony he disclosed that *the fraud had been going on since 1983*, the year he joined the company and the same year it went public. In September 2000, the SEC announced the completion of its Cendant investigation, charging three individuals with fraud. <sup>1</sup>

Other blatant examples of fraudulent accounting activity were seen in Waste Management Inc., whom the SEC estimates to have exaggerated their pretax profits by \$1.43 billion from 1992 to 1996;(pg12-Schilit) Boston Chicken, who used one-time gains to offset future-period expenses; (pg 107- Schilit) and Sunbeam, who booked \$35 million in bill-and-hold transactions at one time, which allowed Al Dunlap to look like a “turnaround king,” and was later forced to rebook \$29 million of those transactions to the future quarters in which they should have been booked. <sup>2</sup>

At the ground level of our discussion is ethics. Since investors must be able to trust the institutions with which they place their money, this is one of the market’s most critical concerns. Yet, a study of the markets shows that stocks do not always go up solely from good strong growth; sometimes the “bottom line” is more important than “doing the right thing,”

A Business Week article in July 1998, recorded their findings at the magazine’s 7th annual forum for Chief Financial Officers (CFOs). Each CFO was asked to give his response to the following question:

“As CFO, I have fought other executives’ requests that I misrepresent corporate results.” Each CFO was allowed to choose from the following responses:

1. Yes, I fought them off.
2. I yielded to the requests.
3. Have never received such a request.

Their answers were as follows:

1. 55% – fought them off
2. 12% – were honest enough to admit that they yielded to the requests, but not honest enough not to yield to the requests in the first place
3. 33% – had never received such a request. <sup>3</sup>

Let me be the first to point out that 33 percent state that they never received such a request. While some would be skeptical of that number, my own personal experiences in

the business world have allowed me to work along side of, and serve, many individuals whom I consider to be of the highest ethical standards.

Yet, two-thirds of these CFOs freely admit that they had been asked to goose the numbers. Sixty-seven percent! That's a lot. When this many CFOs admit this is an issue they have had to address, I am forced to ask myself, "Is this just a 'few bad apples' or is there a larger reason for concern?"

As Maggie Mahar states in her book, Bull: A History of the Boom, "What was certain was that by 1998, financial chicanery had become commonplace throughout corporate America." With two-thirds of these CFOs freely admitting that their colleagues had suggested that they cook the books, commonplace is an apt word. <sup>4</sup>

News headlines always lead one-at-a-time with the biggest stories first, so it's easy to lose sight of the scope of these issues and dismiss headliners like World Com, Tyco, Enron, and the recent investigations into Freddie Mac and Fannie Mae, as rare occurrences. Yet, a quick review of the public record reveals accounting irregularities were discovered at AOL, Xerox, Cisco, Snapple Beverage, Oxford Health Plan, W.R. Grace, Rite Aid, Computer Associates, Health South, Global Crossing, McKesson, Marsh and McLennan, Quest Communications, ImClone Systems, Conseco, and Lucent.

Lessor known names such as Microstrategy, Medaphis, Solv-ex, Zonagen, Turbodyne Technologies, Crystallex, Home Owners Savings and Loan, Western Savings and Loan, Integrated Resources, Texas Air, and Crazy Eddie reveal the same problems for investors due to accounting irregularities. And the list could go on – ad infinitum, ad nauseam. <sup>5</sup>

My point in listing all these companies is that accounting fraud is not restricted to a few bad apples. Many companies have succumbed to the temptation to fudge the numbers. The accounting scandals of today are as numerous as those of the late nineties. In fact, in July 2001, Richard Walker, the SEC's enforcement chief said,

"If we had nothing else to do, the accounting investigations alone would keep us busy for the next five or ten years." <sup>6</sup>

So what factors contributed to this increase in fraudulent activity?

Regrettably, the truth is that companies' compensation of CEOs and senior management through stock options is so incredibly lucrative that it creates an enormous incentive to drive the companies' stock prices higher, regardless of the means involved. A few unfortunate changes to the laws and practices of pricing options all but paved the road for the rampant growth of unbridled greed. Since the markets were rising all was thought to be well, and investors and analysts alike became very lax in their due diligence processes.

### **Stock Option Compensation**

With the proliferation of stock options compensation, the definition of "well paid" changed during the 1990s. Though certainly used in compensating company officers in the tech and telecom industries, the use of stock options as compensation spanned the corporate landscape.

A case in point was Disney's CEO, Michael Eisner. From 1990 to 1997, Disney's stock climbed from \$8 ½ dollars to \$32 dollars a share. At that point Eisner cashed in a \$565 million dollar options package. This was believed to be an all time record. Though Eisner did well, Disney's shares suffered, ultimately falling to \$16 dollars a share, wiping out much of Disney shareholders' profits. All told, Eisner collected more than \$800 million at Disney, during which time his investors earned less than a Treasury-bond return. <sup>7</sup>

In a ten-year stretch across the 90s, Jack Welch, CEO of General Electric, made over \$400 million in salary bonuses and options. <sup>8</sup> Lawrence Coss, CEO of Green Tree Financial, took home \$102 million in 1996. <sup>9</sup> By 1997, the CEO of H.J. Heinz, Tony O'Reilly, cashed in options worth \$182 million, <sup>10</sup> and Stephen Holbert, CEO of Conesco, made \$170 million. <sup>11</sup>

Lest we be tempted to think that these were issues that were solely related to the roaring bull market of the 90s, consider the following table of CEOs' compensation in 2005, derived from Forbes magazine. <sup>12</sup>

<b>CEO</b>	<b>Company</b>	<b>Total Compensation (\$Millions)</b>	<b>Stock Options Compensation (\$Millions)</b>	<b>Stock Options Percentage of Compensation</b>
<b>Terry Semel</b>	<b>Yahoo</b>	<b>\$230</b>	<b>\$229</b>	<b>99.5%</b>
<b>Barry Diller</b>	<b>IAC/Interactive</b>	<b>\$156</b>	<b>\$151</b>	<b>96.8%</b>
<b>William McGuire</b>	<b>UnitedHealth Group</b>	<b>\$124</b>	<b>\$114</b>	<b>92.0%</b>
<b>Howard Solomon</b>	<b>Forest Labs</b>	<b>\$92</b>	<b>\$90</b>	<b>97.8%</b>
<b>George David</b>	<b>United Technologies</b>	<b>\$88</b>	<b>\$83</b>	<b>94.3%</b>
<b>Lew Frankfort</b>	<b>Coach</b>	<b>\$86</b>	<b>\$84</b>	<b>97.8%</b>
<b>Edwin Crawford</b>	<b>Caremark Rx</b>	<b>\$77</b>	<b>\$69</b>	<b>89.6%</b>
<b>Ray Irani</b>	<b>Occidental Petroleum</b>	<b>\$64</b>	<b>\$37</b>	<b>57.8%</b>
<b>Angelo Mozilo</b>	<b>Countrywide Financial</b>	<b>\$56</b>	<b>\$34</b>	<b>60.7%</b>
<b>Richard Fairbank</b>	<b>Capital One Financial</b>	<b>\$56.6</b>	<b>\$56.4</b>	<b>99.6%</b>

Though we could go on and list hundreds of CEOs and their remunerations, that would seem tedious. Yet, so that our conclusion does not seem to be made upon too small of a sampling, we will look at broader numbers on CEO compensation.

As the stock options elixir was poured out on CEOs, the distortion between their compensation and that of their workers widened. By 1997, CEOs in the U.S. were taking home 326 times what the average factory worker was making. This compared with a ratio of between 10 and 15 to 1 in Europe.<sup>13</sup>

In the early nineties, Carl Levin fought to change the accounting rules that allowed corporations to hide the cost of stock options compensation. A member of Senator Carl Levin's staff noted,

“In 2000, the Bureau of Labor Statistics looked at who actually received options in 1999, and found that, nationwide, only 1.7 percent of non-executive private sector employees received any stock options – and only 4.6 percent of executives received them.

In other words, in 1999 – which was a banner year for stock options – 98 percent of the U.S. workers did not receive a single stock option as part of their pay.”<sup>14</sup>

The same discrepancies in pay structure that were seen in 1997 can be seen today.

In May of 2005, The Dallas Morning News reported on CEO compensation for the area’s largest private companies. The article notes CEOs’ compensation soared 61.5 percent in 2004. This is compared to an average profit increase of 34.6 percent. CEOs’ realized a 68.8 percent increase in bonuses and a 53.8 percent increase in long-term incentive benefits, while their base salaries increased by 11.7 percent.<sup>15</sup> The article goes on to note,

“CEO pay was more than 300 times that of the average worker in 2003, up from 282 [times] in 2002, according to United for a Fair Economy, a non-profit group in Boston.

In a separate study, Business Week magazine said CEO raises and total pay in 2004 once again dwarfed those of the average worker, who saw [their] pay rise 2.9 percent.”<sup>16</sup>

Though one could question whether CEOs’ remuneration is commensurate with the value that they add, the issue at hand is not the level of overall CEO compensation. Rather, it is how that compensation is derived. If a company’s leaders are compensated based on stock price movement, then that company’s leaders have an enormous incentive to drive up the stock price. The share price of the company’s stock becomes foundational to all of the leaders’ decisions. If the accounting rules and tax laws are favorable, this agenda is well supported by adherence to “the letter of the law.” So while bull markets may be partly attributable to overly optimistic investors, changes in rules and laws can certainly add fuel to the fire.

### **Stock Option Pricing**

Academic endorsement of compensating CEOs with stock options and two landmark congressional activities acted as incendiaries, emblazing anew the bull market that had begun in 1982.

First, in 1990 stock options were given a boost by Harvard professor Michael Jensen when he published a piece in the *Harvard Business Review* calling for boards to revamp the way that CEOs were paid. While focusing on incentives to motivate leadership, he and his coauthor, Kevin Murphy, stated,

“It is not how much you pay, but how. On average, corporate America pays its most important leaders like bureaucrats. Is it any wonder, then, that so many CEOs act like bureaucrats?”<sup>17</sup>

The argument presented, is that granting options to company management acts to align their goals with those of the shareholders. Yet, this is not always the case.

While investors typically invest for longer timeframes, many company executives use their options to score short-term windfalls. Though executives do have a waiting period before they can exercise their options, they have no limit on how soon they can sell the shares they receive from exercising their options. Once the waiting period has past, company insiders have an incentive to do whatever they can to drive the stock price up over the short-term. Even if their actions set the stock’s price on a course that is not sustainable, and potentially harmful in the long-term, insiders can exercise their options and immediately sell the stock for a profit. So, though the theory of paying CEOs with stock options may have sounded like an improvement at the time, in practice, it has more often than not, proved detrimental to shareholders.<sup>18</sup>

Just as academic endorsement contributed to compensating key employees with stock options, so also did congressional legislation.

“In the early nineties, two events paved the way for Enron – and they both took place in Washington. First, in 1993, corporate lobbyists buried a proposal that would have forced companies to reveal the cost of the stock options that they were issuing to their top executives. Then, in 1995, Congress passed legislation that protected corporations – and their accountants – against being sued if they misled investors with overly optimistic projections. After that, the whole system could be gamed.”<sup>19</sup>

Jim Chanos, 2002

In 1992, excessive corporate executive pay was a hot campaign issue. As a result, in 1993, Congress prepared a bill that would ban tax deductions on salaries above a million dollars.<sup>20</sup> However, the million-dollar cap didn't apply to "performance based compensation." As a natural outflow of these conditions, companies began shifting executive compensation from salaries to stock options.<sup>21</sup>

Indeed, 1993 marked a major junction for stock options. In that same year corporate lobbyists defeated Senator Carl Levin's and the Financial Accounting Standards Board's (FASB) attempts to disclose the cost of executives' option compensation.<sup>22</sup> Until recently, options, unlike cash bonuses, did not have to be shown as an expense, and thus lower corporate profits. Consider the effect that expensing options might have had on corporate profits as you read these words from the Levy Forecasting Center:

"Under current [2001] accounting conventions, the granting of such an option to an employee is not considered an expense. This is the case even though the value of the grant can be readily calculated and even though the grant is in lieu of the payment of a like amount of wages or other traditional forms of compensation.

Because the granting of an option is not considered an expense, it does not lower the profits of the firm. Moreover, reported earnings are not reduced in the future when the option is exercised. The exercise of the option is looked on as a stock transaction and as such it does not effect the income statement."<sup>23</sup>

Though it is true that when an option is placed on the books, no cash has changed hands, it is equally true that those same options are deducted as a cost on the corporate balance sheet, when the corporation files its income tax statements with the IRS.

Noting this contradiction, Senator Levin stated,

"Stock options are the only kind of executive pay which a company can deduct from its taxes as an expense, but which it is not required [to include] in its books as an expense."<sup>24</sup>

Warren Buffet quipped,



“If options aren’t a form of compensation, what are they? If compensation isn’t an expense, what is it? And, if expenses shouldn’t go into the calculation of earnings, where in the world should they go?”<sup>25</sup>

In the same vein, Congress passed the Safe Harbor Act in 1995, which offered corporations and their accountants “safe harbor” from lawsuits if they accidentally misled shareholders about their earnings.<sup>26</sup> The idea was to defend companies, when they made predictions about future earnings and revenues, from the frivolous lawsuits of an increasingly litigious society. In essence, as long as corporations made some boiler plate disclaimers, this legislation made securities fraud suits much more difficult for plaintiffs to sustain.<sup>27</sup>

Again, Chanos pointed out in his Congressional testimony regarding Enron, that the Safe Harbor act,

“has emboldened dishonest managements to lie with impunity, by relieving them of concern that those to whom they lie will have legal recourse [and] also seems to shield underwriters and accountants from the consequences of lax performance.”<sup>28</sup>

The Levy Institute Forecasting Center issued a special report in September of 2001, titled “Two Decades of Overstated Corporate Earnings: The Surprisingly Large Exaggeration of Aggregate Profits.” Page four of this report reads:

“‘Just how widespread and serious is the overstatement of aggregate corporate profits?’

The answer is startling. The macroeconomic evidence indicates that corporate earnings for the Standard & Poors’ 500 have been significantly exaggerated for nearly two decades – by about 10 percent, or more, early in this period and by over 20 percent in recent years. These figures are conservative – the magnitude of the overstatement may be considerably larger.”<sup>29</sup>

In the end, the practice of corporations not expensing stock options was not changed until 2005. Shortly after the FASB statement to this effect went out, the Dow Jones Newswire commented,

“The nation's accounting rulemaker decided Thursday [December 16<sup>th</sup>, 2004] that companies will have to begin deducting the value of stock options from their profits next year, a move cheered by shareholder advocates but scorned by many companies who rely heavily on options to beef up compensation packages.

The Financial Accounting Standards Board's long-awaited decision means public companies will have to start expensing options beginning with their first annual reporting period after June 15, 2005.”<sup>30</sup>

What effect might this have on companies' earnings?

According to research by Credit Suisse First Boston, “had all companies in the S&P 500 expensed the cost of options, reported earnings would have been 20% lower in 2001, 19% lower in 2002 and 8% lower in 2003.”<sup>31</sup> In the same way, according to Bear Stearns, NASDAQ 100 companies' profits would have been 44 percent less in 2003.<sup>32</sup>

If you are like many you could be thinking, “Accounting problems may be more widespread than I first thought, but surely Wall Street analysts would warn us, their clients, ahead of time about potentially pending time bombs in our portfolios.”

### **Analysts' Conflict of Interest**

At the top of a bull market, any dissenting voices from the dull halls of research are sent packing, and those willing to write great promotional stories are brought to the forefront. Probably no story from the roaring Internet bubble makes this clearer than that of Henry Blodget.

In 1994 Henry Blodget began his career in the investment industry with Oppenheimer. Just one year prior, he had been earning \$11,000 a year as a freelance writer in Manhattan. Having graduated from Yale University with a degree in history six years prior, Blodget was searching for a more secure career.<sup>33</sup>

While at Oppenheimer, he was pursued by headhunters because of his writing abilities. Still a relatively inexperienced analyst, in late 1998, he made his famous prediction that Amazon shares, trading at \$200 at the time, would top \$400 per share. Within weeks the stock exceeded this one-year target catapulting his career into high gear.<sup>34</sup>

In February 1999, Merrill Lynch offered Blodget the chair of the firm's Internet research team.<sup>35</sup> As one of the most popular Internet analyst in the industry, he was guaranteed a compensation of \$12 million in 2001.<sup>36</sup>

Of course, the markets unraveled, and by 2002 Blodget was the ideal candidate as a scapegoat for the stock market bubble. In April of 2003, Blodget was fined \$4 million dollars and was barred from the securities industry for life. His crime? Blodget secretly harbored doubts about the companies he was recommending.<sup>37</sup>

What were the pressures that kept Blodget from expressing his doubts? Were these pressures unique to Blodget or were they symptomatic of a larger problem within the system?

In her book, Bull: A History of the Boom, Maggie Maher articulates well the analyst's predicament.

“As the market fell apart, Wall Street's analysts became the most logical targets. ‘Where was the research?’ the media asked. In fact, the financial press had been aware, for many years, that Wall Street research was tainted by the Street's interest in selling stocks, drumming up investment banking business, and remaining in the good graces of large institutional clients who owned those stocks.”<sup>38</sup>

Two professors at Dartmouth compiled one of the most important studies on analysts and conflicts of interest in February of 1999. Their research found that stocks with buy recommendations, that *were not* clients of a firm's investment banking unit, had higher long-term returns than stocks with buy recommendations that *were* clients of a firm's investment banking unit.<sup>39</sup> Plainly, investment banking pressures were interfering with analysts' stock recommendations. This was true for twelve of the fourteen brokerage firms within the study.<sup>40</sup>

Again, it is not the difference in the brokerage firm’s ability to analyze companies that drives the firm’s buy recommendations. Rather, there is a bias directly related to whether the company, recommended by the brokerage firm’s analysts, had an investment banking relationship with that brokerage firm. <sup>41</sup>

In April 2001, SEC Chairman Laura Unger expounds on this unfortunate reality.

“The natural incentive (as a result of the analyst working on the investment banking team), therefore, is to avoid releasing an unfavorable report that might alienate the company and impact its future investment banking business. In a recent survey of 300 CFOs, *one out of five CFOs acknowledged that they have withheld business from brokerage firms whose analysts issued unfavorable research on the company.*” <sup>42</sup>

For example, like most firms, Merrill Lynch had a stock rating system, which ranked stocks from one through five. One and two were positive ratings, three was neutral, and four and five were negative ratings. Yet, Merrill’s Internet group never gave a stock a four or five rating. If a stock merited a four or five rating, the analysts would discontinue covering that stock. <sup>43</sup>

Analysts’ biases are clearly revealed when we look at the numbers. The following table was taken from an article in *The Journal of Psychology and Financial Markets*. (2002, Volume 3 No. 4, pages 198-201)

<b>Year</b>	<b>Buy and Hold</b>	<b>Sell</b>	<b>Total Calls</b>
1996	96%	4%	29,734
1997	97%	3%	30,350
1998	98%	2%	35,445
1999	97%	3%	37,318
2000	98%	2%	32,633
<b>Average &amp; Total</b>	<b>97.2%</b>	<b>2.8%</b>	165,480

Again, former SEC Chairman Unger gives a poignant summation of the importance of this issue in April 2001.

“As the Supreme Court has stated analysts should play a crucial role by providing investors with *objective and independent analysis of a company’s prospects*. Our markets will remain strong and vibrant only as long as investors have confidence in them. Thus, it can only follow that the integrity of our markets relies fundamentally on the *integrity of market information available to investors*. To the extent that firms can ameliorate analysts’ conflicts and better ensure objectivity and independence, all of the investing community will be better served.” (Emphasis mine) <sup>44</sup>

We are not implying that all Wall Street analysts compromised. Those who did not bend to these pressures certainly deserve our respect, for on Wall Street voicing dissent has often proved costly.

Citigroup Smith Barney cites cost cutting as the reason for letting Louise Yamada and their entire technical research department go in February 2005. Still, one has to wonder if the groups’ bearish statements, like the one below, had some bearing on this decision.

“We still have no conclusive technical evidence that the structural bear market that began in 1999-2000 is completely behind us.” <sup>45</sup>

As we conclude this section, it seems appropriate to include the reflections of Henry Blodget from his interview with Maher in early 2002. When asked if he had ever read John Kenneth Galbraith’s book titled, *A Short History of Financial Euphoria*, Blodget responds,

“Well I hadn’t – until recently. I just finished it. It’s amazing how Galbraith spells it all out – what happens in every bubble, every time. If I had only read that book in the beginning of 2000, it would have been worth a million dollars to me then.”<sup>46</sup>

## Section 2: Government Inconsistency

As I became aware of the unethical practices on Wall Street and in corporate governance, in seeking to understand risk further, I began to sense the necessity of reviewing government numbers. Shocked at first by what I found, in looking back at the historical record, I began to realize, and better understand, the problems that are inherent to large bureaucratic organizations. Since the ramifications of questionable government numbers are so broad and far-reaching, due diligence requires any investor to search the actual government reports for themselves.

### Consumer Price Index

Let us start our look at the Consumer Price Index (CPI) with a summation from John Williams' Shadow Government Statistics. Williams has been a private consulting economist for 20 years, and his work with individuals and Fortune 500 companies necessitated that he become a specialist in government economic reporting. In order that the reader might come to his or her own conclusions, I strongly encourage review of Williams' material and the government reports from which he draws.

As an aside, I have intentionally omitted the timeframes (they are available in Williams' works) so as to avoid an over politicalization of issues that I believe to be beyond the presently debated agendas of the Republican and Democratic parties.

Originally CPI was calculated as follows: A fixed basket of goods was purchased on a periodic basis, and the change in the price of that basket represented inflation – a fairly simple and straightforward concept. Given its widespread usage and the number of contractual relationships that were anchored to it, the CPI was considered sacrosanct. It was one number that was **never** to be revised.

However, in an effort to calm down the rapidly rising CPI numbers, the substitution effect was introduced. The argument was that if steak got too expensive, the consumer would buy hamburger instead. Thus, the CPI began to measure changes in the cost of survival rather than changes in the cost of living. Then, geometric weighting was brought in, giving a lower weighting to components with rising prices and a higher weighting to those with dropping prices.<sup>1</sup>

## **Gasoline Pricing**

To see how inconsistent these numbers can be, consider that the seasonally adjusted gasoline portion of the CPI shows that gasoline prices declined 4.4 percent in May of 2005 and 1.2 percent in June of 2005, and that gas prices have only increased 6.9 percent since June of 2004.

Retail gasoline sales tell a different story. Retail gas sales show a decline of 0.5 percent in May of 2005 and an increase of 1.9 percent in June of 2005, and an increase of 16.2 percent since June of 2004. The government's own Energy Information Agency (EIA) more closely resembles the retail sales data since it shows that gas prices have increased 14.9 percent from June of 2004.<sup>2</sup>

Keep in mind that volume changes tend to be small so retail gasoline sales are mainly affected by changes in the price of gasoline. If anything, increasing gasoline prices should tend to reduce the amount of gas we consume, meaning that the price increase in gas could have been higher than the increases in the retail gasoline sales numbers.

## **Rental Equivalence**

Previously, changes in the costs of owner-occupied houses were measured in the CPI using the actual changes in the prices of houses. This was known as the asset price method, and it treated the purchase of an asset, such as a house, just like the purchase of any consumer good. However, because this method could lead to "inappropriate results" for goods that are purchased largely for investment reasons, a "rental equivalence approach" was introduced to the CPI to measure price changes for owner-occupied houses. Today, rents of primary residences (i.e., actual rents) and "owner's equivalent rents" (i.e., rental equivalences) are the two main components used in the CPI to measure increases in the cost of shelter.<sup>3</sup>

Now, based on the last few years, if you suppose that the change in the cost of renting is very different than the change in the cost of real estate, you would be correct. As evidence of this, look at the two charts below.

This chart shows the change in housing costs based on the rent formula of the Bureau of Labor Statistics.<sup>4</sup>

<b>Year</b>	12/2000	12/2001	12/2002	12/2003	12/2004
<b>Index</b>	171.9	176.9	181.4	185.1	190.7
<b>Annual change</b>	4.31%	2.91%	2.54%	2.04%	3.03%

The chart below shows the change in housing costs based on the price changes for new homes sold, as calculated by the U.S. Census Bureau.<sup>5</sup>

<b>Year</b>	12/2000	12/2001	12/2002	12/2003	12/2004
<b>Index</b>	117.9	120.8	128.1	135.2	146.6
<b>Annual change</b>	5.93%	2.46%	6.04%	5.54%	8.43%

Since 2000, the rental equivalent version shows a price increase of 15.72 percent, while the price of new homes sold version shows an increase of 31.72 percent. Or consider the report compiled by the National Association of Realtors showing the median sales price of existing homes grew by 8.43 percent in 2003 and 8.21 percent in 2004. This would mean that the median price of buying an existing home had inflated at 16.45 percent in the 24 months ending December of 2004. Statistical variance is to be expected, yet these variances are so wide that the number's usefulness must be called into question.<sup>6</sup>

### **Hedonic Pricing**

Hedonic pricing converts the “pleasure” we derive from quality improvements in the items we purchase into price reductions. This acts to lower the reported inflation rate and correspondingly increase reported national productivity. Since we have already touched on price reductions, we will briefly turn our attention to the question of overstated productivity.



Michael Hodges, of The Grandfather’s Economic Report, addresses this subject by looking at the most poignant point of the inconsistencies – namely computers.

Hedonic pricing is employed by government statisticians to measure computer output and investment. It is meant to capture the increase of computer power in terms of speed and memory and reflect the *hypothetical* benefits of this soaring computer power.

“Like corporations, which keep two sets of books, one for financial reporting and another for taxes, the government also keeps two sets of books. One set is the actual dollars spent on the output of goods and services and the other set incorporates ‘chained dollars,’ which are derived from hedonic calculations being applied to the actual numbers.”<sup>7</sup>

As this table shows, computer spending in actual dollars went from \$86.3 billion during the fourth quarter of 1998 to \$114.2 billion in the second quarter of 2000. This represented an increase of \$28 billion in actual dollars being spent during the last six quarters. However, after applying hedonic pricing, the actual increase of \$28 billion becomes \$127 billion for the same six quarters.<sup>8</sup>

**Investment in Computers & Peripheral Equipment**  
(Billions of Dollars)

Year	1998	1999				2000	
Quarter	4th Qtr	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	1st Qtr	2nd Qtr
<b>Actual Dollars</b>	86.3	88.1	92.8	97.6	98.9	104.3	114.2
<b>Chained Dollars</b>	171.3	186.1	208.5	230.9	243.9	264.1	298.5

Source: Department of Commerce: Survey of Current Business

So, how are we doing today?

In 2004, U.S. firms spent \$483.3 billion on new information technology, against \$467 billion in 2000. Within this total, computers accounted for \$101.4 billion in 2000 and

\$110.8 billion in 2004. In current dollars, business spending on computers *rose a trivial 9.4 percent* over these four years.<sup>9</sup>

However, according to the quantity index for productivity (GDP growth), using the hedonic pricing method, business investments in computers *soared more than 10 times as fast – by 113.4 percent.*<sup>10</sup>

Plainly, this statistical engineering magnifies modest sums of money spent in actual dollars into much larger sums of money in chain – weighted dollars.

Though we could expand this section far more, we will point to one more problem area of government reported numbers.

### **Unemployment & the Net Birth/Death Model**

To “*reduce a primary source of non-sampling error,*” in producing employment numbers the Bureau of Labor Statistics (BLS) relies on an adjustment known as the Net Birth/Death Model. In short, the household and payroll survey estimates, which comprise the basis of the BLS’s employment figures, are adjusted every month by this *statistical model* to help capture the lag that occurs between the time a business opens its doors and shows up on the survey databases for possible sampling. *The most current model began in April 2004.* The BLS states on their website that the even though “the birth [of new businesses] and death [of existing businesses] portions of total employment are generally significant, *the net contribution is relatively small and stable.*”<sup>11</sup> It is also worth noting that the BLS states the model *does not attempt to correct for any other potential error sources* in the estimates.

For reasons I trust the reader will soon understand, let’s pause and go over this again. This is *a model*, and not a survey of actual employers or employees. The intent of the model is to *reduce non-sampled errors* but it does not attempt to correct any *potential error sources* in the estimated data from the payroll and household surveys. All and all, the BLS notes that the net result should be *relatively small and stable.*

So, let’s take a look at the numbers below taken from the Bureau’s website in December of 2005 which shows the net adjustments in employment numbers since the most recent model was begun in April of 2004.

**2004 Net Birth/Death Adjustment (in thousands)**

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
<b>Total</b>				225	204	181	-80	123	44	55	9	66

**2005 Net Birth/Death Adjustment (in thousands)**

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
<b>Total</b>	-280	100	179	257	207	184	-76	132	54	37	18	

\*Source – Bureau of Labor Statistics, U.S. Department of Labor

From the table above, we can see that from April of 2004 through November of 2005 the Net Birth/Death Model has accounted for 1,639,000 of the 3,503,000 jobs that the Bureau of Labor Statistics reports to have been created.<sup>12</sup> Put another way, 47 percent of the jobs “created” in this recovery have no actual data proving their creation as a net result of hiring and firing by new businesses. When we consider the wild variance in the net birth/death component of reported jobs creation and the fact that this component comprises nearly half of all reported jobs created since April of 2004, one might think that describing the net birth/death model’s effect as “relatively small and stable” is a bit of an oversight.

However, what gives me deeper cause for concern is that the net birth/death model draws its assumptions on previous economic recoveries, and our current recovery looks very different from those prior. Consider the following comments from Dr. Kurt Richebacher who has been following economic issues for sixty years.

Here, Richebacher notes how the net birth/death model is derived.

“Net birth/death jobs do not accrue from the regular payroll surveys but from a statistical model – in other words, an estimate – bearing this name. It is *based on the assumption that in every recovery* a lot of people start their own businesses, involving extensive job creation that the regular job survey does not capture in time. The currently [October 2005] applied annual net birth/death factor of more than 800,000 per year has been derived from *the experience in past recoveries.*”<sup>13</sup>

Next, Richebacher notes how, when compared to all other post World-War II recoveries, the job gains in our current recovery are anemic and heavily dependent on the net birth/death model.

“[As of August of 2005] Reported private sector jobs are only 103,000 above their December 2000 peak. From the trough of the recession in 2001, private jobs have increased 2.2 million, compared with average gains of 7.2 million in previous postwar recoveries. But now consider that during this recovery the net birth/death model has so far accounted for 1.5 million [of the 2.2 million] new private jobs.”<sup>14</sup>

In December of 2005, Richebacher goes on to note how wide is the chasm between the current economic recovery and all of our previous recoveries.

“By far, the weakest component in the current economic recovery has plainly been job and labor income growth. Overall employment is just 1.3 % above its level in March 2001, the start of the recession. Private sector jobs are up only 0.8%, versus an average increase by 8.6% in all prior recoveries from recession. That is just **one-tenth of the average job growth** in prior post war recoveries.”<sup>15</sup>  
(Emphasis mine)

Even the BLS notes that “the most significant potential drawback to this or any model-based approach is that time series modeling *assumes a predictable continuation of historical patterns and relationships and therefore is likely to have some difficulty producing reliable estimates at turning points or during periods when there are sudden changes in trend.*”<sup>16</sup> (Emphasis mine)

With the noted differences between this and previous recoveries, how are we to depend on a model that blindly extrapolates conditions that do not look to exist?

Our national bureaucracy of number crunchers grows ever larger each year, and the numbers that they produce become more and more muddled as time goes on. If one can even get to the point of trusting the numbers, with such a wide variance between the reported figures from various departments, the usefulness of these statistics must certainly be drawn into question.

Imagine you’re sailing a ship across the Atlantic and your navigator tells you that true north on your compass changes from time to time. On top of that you’re looking at two weather reports for the same time and region – one predicting smooth seas and the other a hurricane. To top it all off, when you turn to your chief petty officer, he tells you that you

have somewhere between enough men to man your ship and enough to man one of the rowboats, and that it'll be quite a while before he knows which it more accurate.

While I know this sounds ludicrous, the reality is that we are talking about the health of a nation's economy, not a ship attempting to traverse the seas.

Next, we turn our focus to the "experts," whose knowledge from the hallowed halls of finance has affected investors and investment behavior for over a half a century.

### **Section 3: Market Inefficiencies**

With the corporate ethics problem and the government inconsistencies, it becomes increasingly obvious that things are not nearly as clean as we had previously believed. How is it that we pick up the paper and read about Enron, or Worldcom, or some politician who has shown favoritism in awarding business contracts, and yet ignore this information as we make our investment decisions?

The widest and most deeply held conviction in the investment world is that markets are efficient so the current price must be the right price. After all, given “rational” investors with the “same” relevant information, how could anyone be so arrogant as to think he or she could consistently beat the market over long timeframes?

So, we follow the crowd. We listen to the academic experts. If we should ever question any aspect of these theories (they are only theories), we draw comfort in the fact that peers and professionals alike endorse our beliefs and ridicule those that oppose them.

To drive this point home consider these words from the College for Financial Planning Investments Textbook 7th Edition:

*“Perhaps it is conceit that makes some individuals think they can use the dividend-growth model or P/E ratios or price-to-book ratios or any other technique to beat the market.”*<sup>1</sup> (Emphasis mine)

As we consider this subject, we will look at two well-known individuals from the world of investments. One beat the market for a few years, before the fund he was with collapsed. The other has handily beaten the markets for years and has debated those who hold to the Efficient Market Hypothesis (EMH). Then, we conclude our discussion of market inefficiencies with a word from one of the most influential mathematicians of the twentieth century.

#### **Myron Scholes – Developed the Black-Scholes Options Pricing Model**

In 1973, the same year that the Chicago Board Options Exchange opened for business, the Black-Scholes model, a major theory on how to price options, was unveiled to the

investment world. There are six assumptions in the Black-Scholes model, the 3rd of which is that “markets are efficient,” or, more directly, “that people cannot consistently predict the direction of the market or an individual stock.”<sup>2</sup>

So, did Scholes actually live out, in reality, this landmark theory he put forward?

Myron Scholes will go down in history, not only for the model that bears his name. He will also be remembered for his involvement in one of the biggest investment collapses of the 20th century. Consider this account of the beginnings of Long Term Capital Management, a hedge fund where Scholes was partner, from Roger Lowenstein’s work, When Genius Failed.

“At one point during the road show, a group including Scholes, Hawkins, and some Merrill people took a grueling trip to Indianapolis to visit Conseco, a big insurance company. They arrived exhausted. Scholes started to talk about how Long-Term could make bundles even in relatively efficient markets. Suddenly, Andrew Chow, a cheeky thirty-year-old derivatives trader, blurted out, ‘There aren’t that many opportunities; there is no way you can make that kind of money in Treasury markets.’ Chow, whose academic credentials consisted of merely a master’s in finance, seemed not at all awed by the famed Black-Scholes inventor. Furious, Scholes angled forward in his leather-backed chair and said, ‘You’re the reason – because of fools like you we can.’”<sup>3</sup>

Lowenstein’s recount of Long Term’s rise and fall is a warning to us all. There is a Proverb that states, “Pride goes before destruction,” and certainly it is right. As the partners’ wallets and egos grew to extremes, they eventually forgot about natural law.

In October 1997, Merton and Scholes received the prestigious Nobel Prize for Economic Sciences. At the same time Long-Term, where they were partners, was starting its descent.<sup>4</sup> At the end of 1997, the leverage was twenty-five to one. By the fall of 1998, it had grown to 150 to one.<sup>5</sup> By October 1998, their world clashed with the forces of nature and plain common sense. Through the end of April of 1998, investors had \$4.11 for every dollar they had invested. By the time of the bailout, only five months later, precisely 33 cents of that total remained.<sup>6</sup>

A thorough examination of the partners and the historical events that led to Long-Term's demise clarify a few excellent lessons on risk:

- Timing is important. Those who started investing in Long-Term in 1994 and pulled out in early 1998 quadrupled their money, whereas those who started investing in April of 1998 showed a 90 percent loss six months later.
- A substantial amount of leverage and trading in illiquid markets creates greater risks for investors and the market as a whole. When everyone wants out at the same time, liquidity disappears quickly. Models that do not address this are more vulnerable than their risk measures indicate.
- Markets are affected by nonrandom events. Large amounts of money moving around in the market have an equally large effect on the market.

The chart below shows the variance in the Dow in 1998, the year of Long-Term's demise. Was it coincidence that the markets declined sharply in August, at the same time that Long-Term suffered a \$1.9 billion loss leveraged to control \$125 billion in assets?<sup>7</sup> The Fed engineered a bailout by Wall Street banks, cut interest rates the day after the bailout and again two weeks later, on October 15th, signaling a willingness to keep cutting until liquidity was restored.<sup>8</sup> Was it chance that the markets bottomed shortly afterwards?





One final question: Are investors who try to avoid pitfalls like Long-Term “conceited,” or should that term be awarded to Myron Scholes and the partners of Long Term Capital Management?

### **Warren Buffet – the Icon of American Investing**

Ask any American whom he or she believes is one of the greatest investors in history, and you will likely hear the name Warren Buffet.

But rather than seeking to understand why he has been so successful and studying what he has done, many tend to assume that since they could never know all that he knows, it would not be worth their time to study him. After all, they reason, “we can buy Berkshire shares or buy the services or shares of other managers or just buy the index since so few manager have beaten it.” They look at the average annual returns on a colored pie chart and they *feel good*. Though they are not conscious of it, they enjoy the comfort and acceptance of staying in step with the crowd.

Yet, surely we can all learn something from this American investment icon. Here are four lessons we would do well to glean from him.

1. Markets can be Inefficient – Buffet stated in his 1988 Annual Report, “Observing correctly that the market was frequently efficient, they [Efficient Market Theory (EMT) proponents] went on to conclude incorrectly that it was always efficient. The difference between these propositions is night and day.” Buffet went on to say, “Berkshire illustrates just how foolish EMT is. Naturally the disservice done students and gullible investment professionals who have swallowed EMT has been an extraordinary service to us.”<sup>9</sup>
2. Passionately pursue Knowledge – “[The] impression was that ‘Buffet knew almost every balance sheet on the New York Stock Exchange.’ He had a most unusual appetite for research. He spent the day reading annual reports and business publications. Searching for ideas, he read the heavy purple-bound Moody’s manuals page for page with the zest of a small boy reading comics. He read ‘a couple thousand’ financial statements a year.”<sup>10</sup>
3. Avoid Herding Instincts – Teaching a night class at the University of Omaha, Buffet stated, “You try to be greedy when others are fearful and you try to be very

fearful when others are greedy.” However easy this may sound, I assure you it is not. Yet, at the height of the Go-Go market of the sixties, following his most successful year, Buffett closed the partnership, liquidated its assets, and sent the proceeds to his partners.<sup>11</sup>

4. Stay the Course – After losing \$12 million, or 23 percent, in 1973, Buffet continued to make purchases.<sup>12</sup> In 1974, Berkshire Hathaway took a 50 percent loss.<sup>13</sup> His optimistic outlook swayed not at all. In an interview Buffet did for the November 1, 1974 Forbes issue, when asked what his outlook was on the current market, Buffet stated, “There are plenty of bargains around. This is the time to start investing.” In the same interview, he commented on how the situation reminded him of the early Fifties, and his final words were, “Now is the time to invest and get rich.”<sup>14</sup>

### **Benoit Mandelbrot – Scientist, Mathematician, Discoverer of Fractal Geometry, 1993 Winner of the prestigious Wolf Prize for Physics**

Our last argument on the subject of inefficient markets comes from Dr. Mandelbrot’s book, The (Mis)Behavior of Markets. His arguments are based on the fact that the historical record does not jibe with the Efficient Market Hypothesis (EMH), and as such, *the efficient market position is untenable*.

To emphasize what I just wrote, let me add that if I say, “man can fly without the aid of a vehicle,” and the historical record shows that all such men who attempt this plummet to their death, then I am *wrong*. It is not just that I see it differently or that my ideas need some tweaking. There are absolutes. As surely as gravity exists and the past cannot be changed, the person who takes a position in opposition to the laws of nature and history puts himself in harms way.

Orthodox modern financial theory is built upon Fama’s Efficient Market Hypothesis, which traces its roots back to the Gaussian, Brownian distribution of numbers and upon which Bachelier constructed his “random walk” model. All of that to say that the Brownian, Gaussian, “bell curve,” normal distribution of numbers are considered synonymous for the point of this discussion.

Dr. Mandelbrot points to the fact that since EMH is built on the assumption that the bell curve governs market price movements, it is incorrect and leads investors to underestimate the amount of risk in the markets. Consider the following four examples that point out how unlikely it is that the bell curve governs market price movements.

For example, we wrote earlier of Long-Term's demise in August of 1998. Here is a play-by-play account of the Dow's price movement over that time:

“On August 4, the Dow Jones Industrial Average (Dow) fell 3.5 percent. Three weeks later, stocks fell again by 4.4 percent. And then again, on August 31, by 6.8 percent. Standard theories estimate the odds of the August 31 collapse at one in 20 million – an event that, if you traded daily for nearly 100,000 years, you would not expect to see even once. The odds of getting three such declines in the same month were even more minute: about one in 500 billion.”<sup>15</sup>

Of course, after the Fed's actions, the markets recovered, and that is related to our point. The decline in the Dow was not random. It was related to the activities of Long Term Capital Management. Likewise, the subsequent rise in the Dow was not random. It was the result of the Federal Reserve. And for those who take comfort in the “almighty Fed,” we will discuss their seeming omnipotence further in the section of this work that deals with the history of short selling.

Consider the unlikelihood of EMH governing the Dow over the last century:

“From 1916 to 2003, price changes on the Dow were far from following the bell curve. Theory suggests that over time there should be 58 days when the Dow moved over 3.4 percent; in fact, there were 1,001. Theory predicted six days of index swings beyond 4.5 percent; in fact, there were 366. And index swings of more than 7 percent should come once every 300,000 years; in fact, the twentieth century saw forty-eight such days. Truly, a calamitous era that insists on flaunting all predictions. Or, perhaps, our assumptions are wrong.”<sup>16</sup>

In 1962 Mandelbrot presented a paper after studying over a century of data on cotton prices. Based on his findings, consider the unlikelihood that the bell curve governs commodity prices:

“The results were clear and irrefutable. Far from being well-behaved and normal, as the standard theory predicted, cotton prices jumped around wildly.”<sup>17</sup>

This opened up the door for others to look at price patterns as well. Dr. Eugene Fama, Mandelbrot’s doctoral student, investigated the price movements of Dow stocks for his doctoral thesis.

“He [Fama] found this same disturbing pattern. Large changes, of more than five standard deviations from the average, happened thousands of times more often than expected. Under Gaussian rules, you should have encountered such drama only once every seven thousand years; in fact, the data showed that it happened about once every three or four years.”<sup>18</sup>

Theory holds that price changes are continuous; that is, “stock quotes or exchange rates do not jump up or down by several points at a time; they move smoothly from one value to the next.”<sup>19</sup> Mandelbrot notes the unlikelihood that this theory governs the currency markets:

“Clearly, prices do jump, both trivially and significantly. From 1986 to 2003, the dollar traced a long, bumpy descent against the Japanese yen. But nearly half that decline occurred on just ten out of those 4,695 trading days. Put another way, 46 percent of the damage to dollar investors happened on 0.21 percent of the days.”<sup>20</sup>

Dr. Bruce Jacobs reveals how quickly prices can change.

“During the week of October 5, the DJIA declined by 159 points, its biggest weekly point drop ever. This included a record one-day drop of 91 points on Tuesday, October 6, on heavy trading volume. The slide intensified during the week of October 12. On Wednesday the 14th, the DJIA dropped a record 95 points, or 3.8 percent; on Thursday, 57 points, or 2.4 percent; and on Friday, a new record 108 points, 4.6 percent. By the close on Friday, October 16, the Dow had fallen to 2246, down almost 500 points, or 17.5 percent, from its August 1987 peak.”<sup>21</sup>

And, all this was **before** Black Monday.

“On Monday, October 19, the market suffered its worst percentage decline in history. On this single day, the DJIA plummeted 508 points to close at 1738, off 22.6 percent.”<sup>22</sup>

“The probability of that happening, based on the standard financial theories, was less than one in 1050 (that is 1 in 10 to the fiftieth power) – odds so small they have no meaning. You could span the powers of ten from the smallest subatomic particle to the breadth of the measurable universe – and still never meet such a number.”<sup>23</sup>

The flaws in modern financial theories were not addressed after 1987. They were not addressed after 1998. They were not addressed after 2002. Indeed, these flaws have yet to be addressed.

### **The Irrational Investor**

The reason that we do not see a normal distribution of prices is that we are dealing with people, and people are not normal. By instinct, we are not rational; we are emotional, and as such, possess the ability, if not the tendency, to go to extremes.

*Theory* suggests that investors are rational, and that when they are presented with all relevant information about a security, individual investors will make the obvious rational choice that leads to the greatest possible wealth and happiness.

Reality is far harsher in that it suggests that investors are often irrational. In his book, Fooled by Randomness, Nassim Taleb notes, “We are not wired in a way to understand probability,” and that “mathematical truths make little sense to our mind.”<sup>24</sup>

Expounding on this point, Dr. Paul McLean, former head of the Laboratory for Brain Evolution at the National Institute of Mental Health, has developed a great deal of evidence that suggests we have a ‘triune’ brain, one that is divided into three basic parts.

The primitive part of the brain stem, called the basal ganglia, controls the impulses essential to survival. The limbic system controls emotions, and the neocortex, which is

significantly developed only in humans, is the seat of reason. Thus, we actually have three connected minds: primal, emotional, and rational.

The basal ganglia controls the brain functions that are instinctive, such as the desire for security, the reaction to fear, the desire to acquire, the desire for pleasure, being accepted in our social circles, and even choosing our leaders. More pertinently, this area of the brain controls behaviors such as flocking, schooling, and herding.

The limbic system is the seat of emotions and guides behavior required for self-preservation. It operates independent of our reasoning capabilities, and therefore, “has the capacity to generate out-of-context, affective feelings of conviction that we attach to our beliefs regardless of whether they are true or false.”<sup>25</sup>

These feelings are not isolated to the small, naïve investor, but affect the vast majority of professionals as well. Finance professor, Dr. Robert Olsen studied over 4000 corporate earnings estimates by company analyst and reached the conclusion that the greater the difficulty in forecasting earnings per share, which is a source of stress, the more analysts’ herding behavior increases. In other words, even the “brightest” on Wall Street are prone to follow the herd.<sup>26</sup>

And, what about the neocortex?

It is in a far inferior position. The neocortex is involved in processing ideas and using reason. However, it is trumped by the limbic system in that the limbic system is faster, controls the amplitude, or intensity, of emotions. Unfortunately, the limbic system has no concept of time nor does it learn from experience. Truly, for these reasons, we are not hard wired to make good investment decisions.<sup>27</sup>

Since herding is a natural instinct, and money decisions are one of the most emotional charged areas to handle, then it only makes sense that, without understanding the power of these instincts, investors are not even aware of their incapacity to take action to prepare for a sharply declining market.

Dr. Charles Kindleberger, economics professor at MIT for 33 years, states, “Mob psychology or hysteria is well established as an occasional deviation from rational behavior.” He notes some of the characteristics that are common to such times:

“People will change at different stages of a continuing process, starting rationally and gradually at first, then more quickly losing contact with reality; rationality will differ among different groups of traders, investors, or speculators, including those at the earlier stages and those at the later: all will succumb to the fallacy of composition, which asserts that from time to time the whole is other than the sum of its parts.”<sup>28</sup>

Even the brightest minds in history show us how hard it is to keep ones senses when enticed by rapidly changing prices and the lures of the crowd. Isaac Newton was certainly a great scientist and presumably of rational mind.

“In the spring of 1720 he stated: ‘I can calculate the motions of the heavenly bodies, but not the madness of people.’ On April 20, accordingly, he sold out his shares in the South Sea Company at a solid 100 percent profit of 7,000 pounds. Unhappily, a further impulse later seized him, an infection from the mania gripping the world that spring and summer. He reentered the market at the top for a larger amount and ended up losing 20,000 pounds. In the irrational habit of so many of us who experience disaster, he put it out of his mind and never, for the rest of his life, could he bear to hear the name South Sea.”<sup>29</sup>

We have established that the risks in the markets are much greater than we had previously believed. In fact, we are facing a great deal of risk. In the harsh light of reality that history shines forth, it is obvious that our economic models are broken. Markets are only as efficient as people, who trade in them, are rational. Given the extremes that people can go to and the emotions that trip us up at every turn, it is only logical to deduct that markets can suffer the same plight. Additionally, we see that, at best, we are receiving garbled information from our government. This misinformation can cause us to misinterpret the current economic and financial terrain. Doing so opens us all to greater risk. And finally, we see that corporate leaders have incentives to misinform us as to their companies’ financial soundness, and many have done just that. Wall Street analysts appear to have a conflict of interest or a very strong bias towards bullishness. So, in light of all this risk, what are we as investors to do?

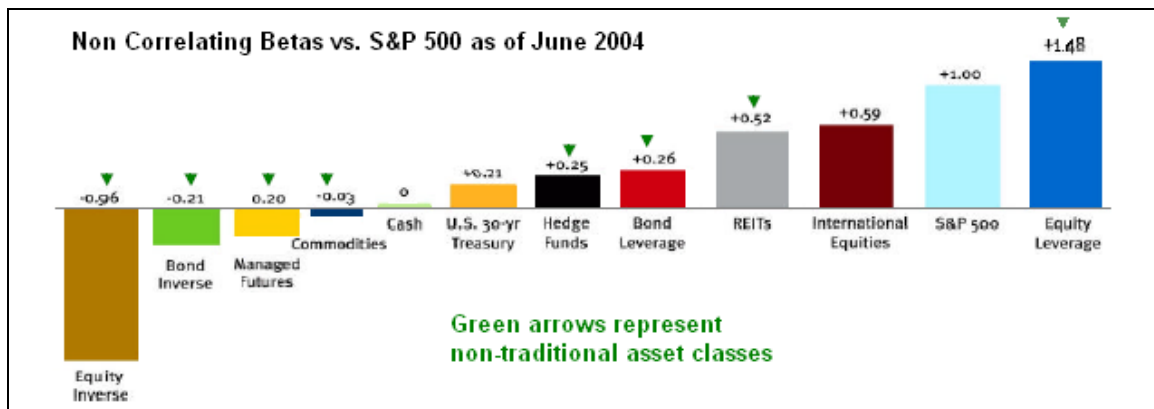
We must find a way to reduce the risks we face.

### 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 out of the 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, investors 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, 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>

## **Section 5: Traits of the System – to 1986**

### **History Prior to the SEC**

In the first portion of this work, we looked at the problems with corporate and Wall Street ethics, government reporting inconsistencies, and fallacies in our widely accepted financial theories. These three issues have major affects on our markets and make it clear, even if painful, that investors face a great deal of systemic risk in the markets today. Without an awareness that the risk level has changed, investors are lulled into a false sense of security, thinking that any and all risks can be mitigated away by appropriate asset allocation.

In light of this systemic risk, we discussed the traits that make these contrarians so different from most money managers and why contrarians are better suited to help investors. Clearly, John Templeton and Warren Buffett, and managers like them, cannot be categorized with mainstream managers.

In considering selling short, from a standpoint of due diligence, investors should understand current market risk, traits of skilled managers, and some of the challenges that short-sellers face. In addressing these challenges we will begin with distant history (prior to the SEC), move to recent history (from the creation of the SEC to 1987), and finish with the system as it is today. As you review this brief overview of short selling and short selling regulations, you will see the following patterns unfold:

1. Since it first began, short selling has been highly criticized. Any investor who would consider shorting should understand the long track record of society's negative views toward it.
2. History shows criticism of short selling is sharpest after major market declines, and is often blamed for the decline by those who have been most instrumental in causing it.
3. The up-tick rule, which was added in 1937 to protect investors, has not had the intended effect. Several SEC studies explain why this is the case. As an aside, the tick-rule has been temporarily suspended – a topic that we will discuss further in the section of this work that deals with the current traits of the system.

4. Throughout history, short selling has contributed to making markets more efficient and has guarded against those who seek to profit, by manipulating prices higher, at the expense of the general investing public.

So, as we begin our look at short selling, watch for these four patterns.

### **The Dutch East Indies**

Short sellers have been hated since the beginning.

“Short sellers became common in the earliest organized markets – the Amsterdam exchanges. Around 1610, joint stock companies were created to fund new ventures, such as the Dutch East India Company, for exploration in the New World. A speculative frenzy arose. As the bubble burst, the directors of the company launched attacks on short sellers for causing the decline. They wrote a memorandum to the government stating that ‘bear attacks, which generally assume the form of short selling, have caused and continue to cause immeasurable damage to innocent stockholders, among whom one will find many widows and orphans.

The agents of the Amsterdam Bourse responded, ‘The decline in the price of the corporation’s shares has been caused by unsatisfactory business conditions, and even prevailing levels appear too high, as a careful analysis will doubtless reveal. Furthermore, many highly reputable stockholders would gladly surrender their shares to the directors if they could be assured of a reasonable return on their investment. If speculation were prohibited, prices would be much lower.’ In February 1610, the Bourse passed a law prohibiting short selling, which was subsequently disregarded and later repealed.”<sup>1</sup>

### **The South Sea Bubble**

In the South Sea Bubble of 1720, shares of the South Sea Company surged from 325 to 1200 in less than a year. When the shares crashed to a value of 86 pounds sterling, a



political figure, Sir John Barnard, introduced a bill to void short sales. Even though this legislation was passed, it was largely ignored as harmful and unenforceable and was finally repealed in 1860. <sup>2</sup>

### **The Mississippi Scheme**

Across the channel, the Mississippi Scheme was developing in France.

“The finances of [France] were in a state of the utmost disorder. The national debt amounted to 3000 millions of livres, the revenue to 145 millions, and the expenses of government to 142 millions per annum; leaving only three millions to pay the interest upon 3000 millions.” <sup>3</sup>

Guided by the ideas of John Law, France would attempt to inflate its way out of the problem. So,

“For the first time in modern history, paper money was being introduced and officially sanctioned by a government. <sup>4</sup> By the end of 1719, the Banque Royale issued 1000 million new bank notes, effectively increasing the money supply by 16 times its previous amount. By all counts, it looked as if the French economy had recovered.” <sup>5</sup>

France’s stock market roared. Another of Law’s ventures, known as the Mississippi Company, promised shareholders a 40 percent return per annum. <sup>6</sup> Needless to say the shares jumped from 2,830 livres to 8,975 in four months. <sup>7</sup> Yet, all good things must come to an end.

“Early in 1720, Prince de Conti rounded up all the Banque Royale notes and presented them to the bank. He is reported to have said, ‘Your notes, which are “payable at sight.” Now you see them. Well then, hand over the coins.’ The bank complied, [but] a small fissure in the façade of confidence had opened. Before



long, mobs were trying to break down the doors of the Banque Royale, in an attempt to redeem their plunging banknotes and shares of Law's monopoly holding firm, the Mississippi Company.”<sup>8</sup>

So what happened to short sellers after this mania crashed?

“The readiest scapegoat, as usual, was ‘speculation’ and the ‘short seller.’” The politicians demanded regulation, and assuming that changing the rules of the market would provide economic stability. When the Paris Bourse was reestablished, it forbade short selling.”<sup>9</sup>

### **The 1900s**

If we fast-forward to the 20th century, we see this tendency continue. American financier, Bernard Baruch, made part of his fortune through short selling. In 1901, when Amalgamated Copper Company organizers attempted to corner the copper supply, the stock spiked upwards. Baruch shorted the stock and continued shorting it as rumors came out that insiders were selling.<sup>10</sup> He was attacked viciously for this short sell that attempted to “tear down a constructive enterprise.” In Baruch's autobiography he states:

“All of this was nonsense, of course. If Amalgamated had not overcapitalized and then blown the stock up, it never would have risen to such heights or descended to the depths it afterwards did. In the face of these attacks, I sat silent, knowing that if I was right, I would win.”<sup>11</sup>

In a congressional testimony, Baruch continued his recurrent sentiment that short selling evens out market prices and has more to do with the seller's thoughts on prices than an attempt to manipulate markets:

“The short seller is the greatest critic of the optimist, who continuously calls the attention of the man who is long on securities or the individual who might become long, of the defects of these securities, and you might in that way keep people from buying securities at extraordinary high prices.”<sup>12</sup>

## The Crash of '29

As we consider the effects of the Crash of 1929, let us briefly revisit the events of that led up to it. Who better to give a short synopsis than our own Fed governor, Alan Greenspan.

“The excess credit which the Fed pumped into the system, spilled over into the stock market, triggering a fantastic speculative boom. Belatedly, Federal Reserve officials attempted to sop up the excess reserves and finally succeeded in breaking the boom. But it was too late: by 1929 the speculative imbalances had become so overwhelming that the attempt precipitated a sharp retrenching and a consequent demoralizing of business confidence. As a result, the American economy collapsed.”<sup>13</sup>

From its peak of 386 in September of 1929, the Dow fell in excess of 89 percent to a low of 41 in June of 1932. President Hoover was incensed,

“During 1932, President Hoover greatly stepped up his one-man war on the stock market, particularly on short sellers, whom he naively and absurdly persisted in blaming for the fall in stock prices. Hoover forgot that bulls and bears always exist, and that for every bear bet there must be an offsetting bull, and also forgot that speculation smooths fluctuations and facilitates movement toward equilibrium. On February 16, Hoover called in the leaders of the New York Stock Exchange and threatened governmental coercion unless it took firm action against the ‘bears,’ the short-sellers.

The President used continual pressure to launch the investigation of what he termed ‘sinister’ ‘systematic bear raids,’ ‘vicious pools...pounding down’ security prices, ‘deliberately making a profit from the losses of other people.’ Besides such demagogic rhetoric, constitutional limitations seemed pale indeed.” “In answering the New York bankers, [who] protested against the investigation, Hoover used some unknown crystal ball to assert that present prices of securities did not represent ‘true values.’ The stock market viciously persisted in judging stocks according to their earnings, a useful criterion that Hoover seemed to find vaguely traitorous:

‘The pounding of prices by obvious manipulation of the market and propaganda that values should be based on earnings at the bottom of a depression is an injury to the country and to the investing public.’

The stock exchange was bullied into restricting short-selling, and Hoover went on to propose further controls of the stock market, in anticipation of the later Securities and Exchange Commission (SEC).”<sup>14</sup>

Though Hoover could not ban short selling, as he sought to in 1932, he wanted to restrict and obstruct it through the policies of the SEC. Yet, history is not without a sense of irony. Upon the SECs creation, President Franklin Roosevelt appointed Joseph Kennedy, who profited handsomely from his short positions in the Crash of '29, as the agencies first chairman.

These “further controls” that have acted to restrict short selling came about with the establishment of the SEC in 1933. Yet before we look at the SEC’s own studies on short selling, let us briefly deal with one haunting misconception that many economists cling to regarding the fallout of the 1920s.

### **Inflating – the Way Out of the Bust?**

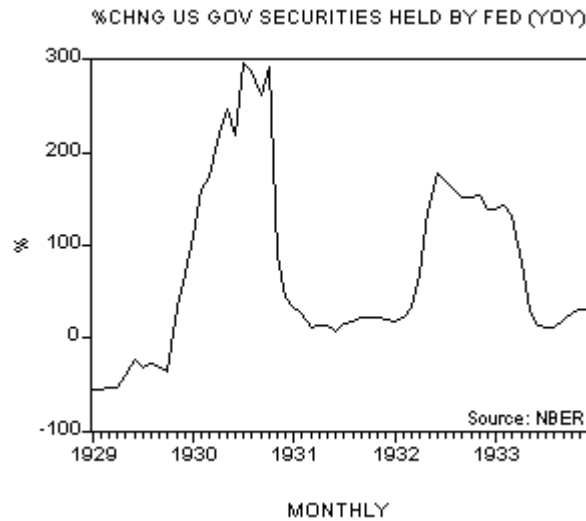
Keynesian and Monetarist views hold that if the Federal Reserve would have only expanded the money supply, the Great Depression would have been greatly mitigated if not avoided altogether. That the money supply did not expand is a fact of the historical record. However, another fact that often goes unnoticed is that the Federal Reserve did aggressively seek to expand it.

Since we were still on the gold standard in 1932, the primary means by which the fed attempted to expand the money supply was the purchase of US Treasuries. The historical records of the US Department of Debt show that from 1929 to 1932, our national debt grew from 16.9 billion to 19.4 billion dollars. In today’s monetary standards this may sound like a paltry amount. Yet if we remember that in 1932, any person could walk into a local bank and exchange twenty dollars for one ounce of gold, we begin to perceive how committed the Federal Reserve was to expanding the money supply.<sup>15</sup>

To further attest to this fact, we offer Dr. Frank Shostak’s research. This graph shows how dramatically Federal Reserves holdings of U.S. Government Securities changed during the early 1930’s.

“On January 1930 these holdings stood at \$485 million. By December 1933 they had jumped to \$2,432 million—an increase of 401%.

Moreover, the average yearly rate of monetary injections by the Fed during this period stood at 98%.”<sup>16</sup>



So, with this massive monetary stimulus, why didn’t the money supply increase? The growth of easy-credit over the prior decade proved unsustainable and thousands of banks failed. To be more specific, 1350 banks, with deposits of \$837 million, failed in 1930; 2293 banks, with deposits of \$1,690 million, failed in 1931; And, 1453 banks, with \$706 million in deposits, failed in 1932.<sup>17</sup>

If expanding the money supply could cure a country’s economic woes, then many Central and South American countries would be bastions of financial strength. Other examples throughout history bear witness to this fact as well. In fact, the failure rates of these attempts are so well documented this argument is basically untenable. Amazingly, many traditional economic schools of thought still hold to this as a viable solution.

### **Traits of the System – History with the SEC (1935 – 1986)**

In the fifteen years prior to 1982, the Dow Industrials had seen a 36 percent decline from February 1966 to May 1970, a 45 percent decline from January 1973 to December 1974, a 26 percent decline from September 1976 to March 1978, and a 24 percent decline from April 1981 to August 1982.

The recoveries that offset these declines and the fact that the Dow ended this time span seven percent from where it began has caused many to term the period the Big Yawn. Yet undoubtedly, these sharp declines followed by offsetting climbs, which made no further

progress, caused many investors to become disheartened and leave the markets. As earlier noted, by 1982 the markets had seen net redemptions, where more money goes out of the market than comes in, in eight of the previous ten years.

In the fall of 1985, as the markets were beginning to make headway, the National Association of Securities Dealers (NASD), retained Irving Pollack, a recognized expert in the field of securities regulation and surveillance,<sup>18</sup> to conduct a comprehensive study of short selling and its effects on the markets to see what additional regulations should be placed on short sellers.<sup>19</sup> The Pollack Report compiled and critiqued earlier reports, which included two Twentieth Century Fund studies covering the decline of the early 30s, two SEC studies – one covering the decline of 1937 and 1938 and the other, called the Special Study of Securities Markets, covering the decline of 1963, and an SEC staff working paper released in December 1976.<sup>20</sup> Pollack also conducted a detailed case study of 11 companies attested by media articles, the company's own complaints, or analysis of market trading data to be the target of manipulative short selling practices.<sup>21</sup> In reviewing his work, three patterns emerge:

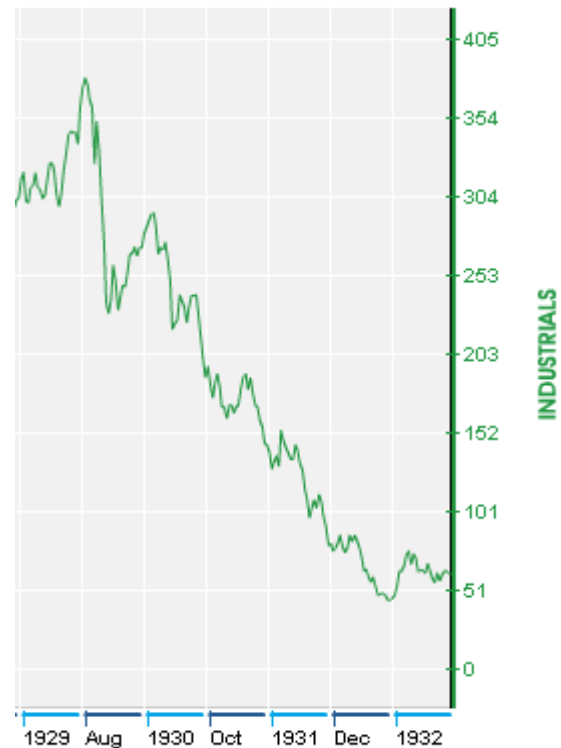
1. Rather than proactive attempts to understand short selling, these studies were often reactions to market declines, and later SEC studies questioned the validity of some of the earlier SEC studies.
2. The efficiency and effectiveness of the up-tick rule was often brought into question, and the SEC's suggestions to repeal the up-tick rule, were never acted upon.
3. Short sellers targeted companies that had inadequately disclosed their financial condition, experienced speculative price increases, or had misled the investing public.<sup>22</sup> Short sellers, benefiting from independent research, were also often correct.<sup>23</sup>

As it is a comprehensive and authoritative work, the Pollack Report is heavily cited in this portion of our paper.

## 1935 – The Beginnings of the Tick Rule

Regulations of short selling have often been enacted, strengthened, or examined following severe declines in the stock market. The Crash of '29 was no exception. As noted earlier, the Dow fell 89 percent, declining from 386 in September of 1929 to 41 in June of 1932. The SEC was created in 1933, and two years later we see the emergence of the tick-rule in its earliest form, when it was enforced by the exchanges.

“In 1935, the SEC requested all exchanges to regulate the practice of short selling. This resulted in the 16 exchanges then in operation adopting requirements that its members should not effect short sales that would demoralize the market, including sales on a downtick.”<sup>24</sup>



\*Source: [www.dowtheoryproject.com](http://www.dowtheoryproject.com)

That same year, the 1935 Twentieth Century Fund Study questioned the impact short selling had on markets and the validity of the plus tick rule of the exchanges.

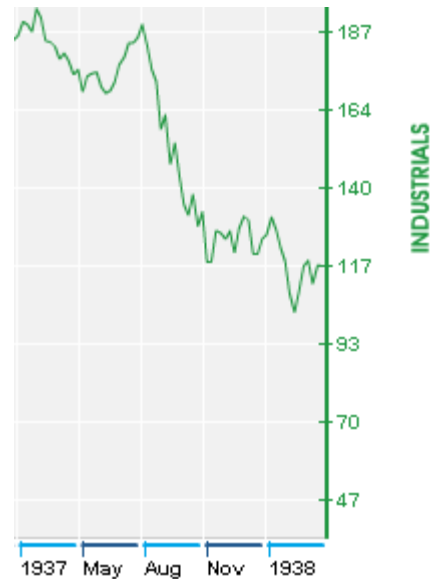
“The first major study of short sales analyzed the impact of short selling on prices utilizing data of NYSE members. The study found that short selling does not have any appreciable effect in limiting the extremes to which prices may rise. Its tendency is to accelerate the downward trend in prices during the early and middle phases of [price] movements. *However, considered in terms of long positions and total trading, short sales, ‘...have not been in sufficient volume to warrant the belief that their actual effect is at all material.’* The study concluded that there should be no general prohibition of short selling.”<sup>25</sup> (Emphasis mine)

The 1935 Twentieth Century Fund study further proposed that the rule prohibiting members from transaction that would upset the equilibrium of the markets “should also apply with equal force to purchases for long accounts.”<sup>26</sup> They reason, rapid buying, as

well as rapid selling, can cause markets to become unstable. As such, the same rule should apply.

### SEC Study of 1937

From February 1937 to March 1938, the Dow went from 187 to 99, a loss of 47 percent. This precipitated a SEC study of short selling in the latter part of 1937,<sup>27</sup> which concluded that the exchange rules had been ineffective.<sup>28</sup>



\*Source: [www.dowtheoryproject.com](http://www.dowtheoryproject.com)

“The Commission therefore adopted its own rule *prohibiting short sales on an exchange at or below the price at which the last sale was effected* on that particular exchange. Thus in 1938, federal tick-test regulation of short sales on exchanges began. The Commission’s [original] rule

precluded short sales at the last price regardless of prior price changes. It caused short interest and short selling to decline more than 50 percent. At the request of the exchanges, the Commission modified its rule shortly thereafter to permit short sales at the last price on a zero-plus tick.”<sup>29</sup>

### The SEC Tick-Test Rule

SEC Rule 10a-1, commonly called the “tick-test” rule stipulates:

“No person shall, for his own account or for the account of any other person, effect a short sale of any security...if trades in such security are reported... (i) below the price at which the last sale thereof was reported... or (ii) at such price unless such price is above the next proceeding [sic] different price at which a sale of such security was reported...”<sup>30</sup>

Or, if you prefer an easier explanation, you cannot short a stock if the current price is *below* the prior price (a downtick). And, you cannot short a stock if the current price is



the *same as* the prior price but lower than the (different) price before that (a zero-minus tick).

I realize this may seem laborious, but convention requires that I include an example even if that example is tedious and adds little by way of clarification. So, without further ado,

“This requirement of Rule 10a-1 is implemented by means of a ‘tick test’ which is best illustrated by the following examples:

- If the last sale was at 20 and the last different price was at 20 1/8, a short sale is not permitted below 20 1/8.
- If the last sale was at 21 1/2 and the previous different price was at 21 3/8, a short sale is not permitted at a price below 21 1/2.
- If the last sale was at 22 and the last different price was at 22 1/4, a short sale is not permitted at a price below 22 1/8.
- If the last sale was at 25 3/4 and the previous different price was at 25 1/2, a short sale is not permitted at a price below 25 3/4.”<sup>31</sup>

At the time the Pollack Report was written, stocks still traded in one-eighth increments. Though stocks now trade in increments of a penny, the same rules hold true to this day.

### **Opposition to SEC Study of 1937**

Around the same time that the 1937 SEC study was initiated, the NYSE requested that the Twentieth Century Fund do a second study.

“Although the second Twentieth Century Fund study was begun about the same time the 1937 SEC study began, this study was not published until 1951, over a decade later.”<sup>32</sup>

The 1951 Twentieth Century Fund Study stated:

“The study revealed no conclusive evidence that short selling materially affected the extent of a major decline or major advance in a market as a whole, [and] further concluded that short selling seldom, if ever, exerted a determining

influence on even the intermediate movement of stock prices during the period analyzed.”<sup>33</sup>

Again, since this study, initiated at the request of the NYSE, was not published until 1951, it was not factored into the establishment of the SEC short sale tick rule.<sup>34</sup>

In addition, the 1937 SEC study drew criticism from none other than a later SEC study. Sometime after the Crash of 1974, the SEC initiated a staff working paper that was an inclusive study on short selling, which was released in December of 1976.<sup>35</sup> This 1976 release re-assessed the SEC study of 1937,<sup>36</sup> analyzed short selling from 1960 to 1975, and re-evaluated the validity of the tick rule.<sup>37</sup>

The 1976 SEC review of the 1937 SEC study points out that,

“The study focused on *two weekly periods*, which were characterized by a large volume of trading, erratic price movements and ‘intensive’ liquidation<sup>38</sup> and pointed out that basic economic forces (a doubling of Fed reserve requirements and a decline of 67 percent in quarterly per share profits), were not taken into consideration as probable causes of the sharp market decline.”<sup>39</sup> (Italics mine)

As such, the 1976 re-assessment,

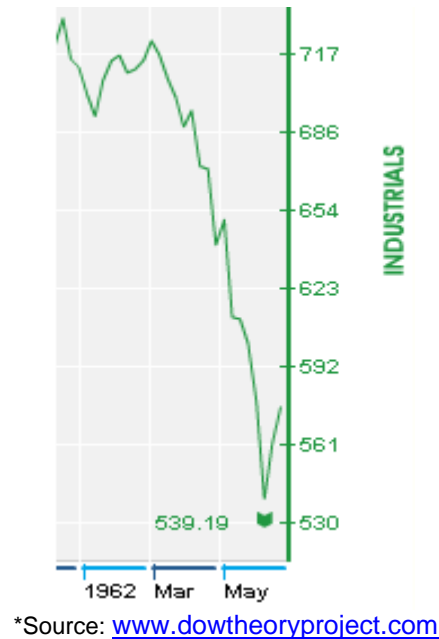
“‘argued that the [1937] Commission drew its conclusions from inadequate data and demonstrates trends which are inconclusive with respect to the general impact of short selling,’ [and] that the SEC short-sale rule was hastily adopted following a sharp bear market.”<sup>40</sup>

Plainly, the 1976 SEC release and the 1951 Twentieth Century Fund Study call into question the very origins of the short sell tick-rule.

## The 1963 SEC Special Study of Securities Markets

From January to June of 1962, the Dow dropped from 724 to 535, a decline of 26 percent, before recovering later that year. Again, short sellers would come under review. The SEC Special Study of Securities Markets According to the 1975 SEC Commission, the 1963 Special Study of Securities Markets found following:

“The ratio of short sales to total volume increased as the market declines primarily because of increased short selling by non-members. The study also found that short-sale rules, with their reliance on the tick test and because of the frequency of zero-plus ticks during sharply declining markets, were inadequate to prevent short sales from exerting downward pressure in declining markets.



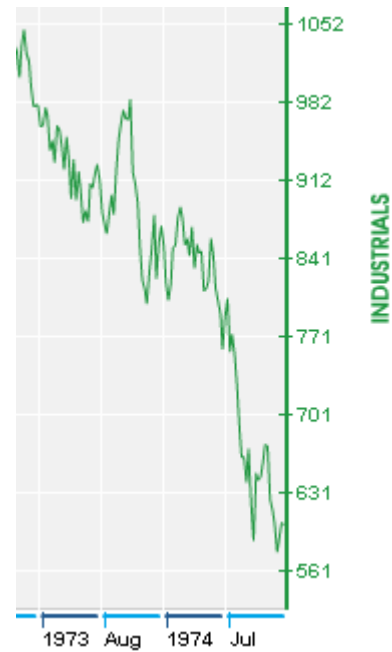
*In spite of a failure of the study to uncover ‘...any evidence of the use of short sales to spearhead a “bear raid”’, the Special Study concluded that a more stringent short-sale rule should be adopted which would more effectively limit short selling during price declines. However, the short-sale study’s recommendations were not implemented.”*<sup>41</sup> (Italics mine)

Again, we see a study that looks like a reaction to the decline in early 1962, that seeks to further restrict short selling in spite of a lack of evidence of the mythical “bear raid,” where short sellers are presumed to manipulate market prices lower.

## December 1976 SEC Release

After the Bear Market of '73-'74, when the Dow went from 1051 in January 1973 to 577 in December 1974, losing 45 percent, the SEC did a major review of short selling activities in a staff working paper that was released in December of 1976.<sup>42</sup> In regards to the decline, Pollack only notes that the SEC staff paper found that:

“In 1974, when the Dow Jones Industrial Average fell more than 30 percent, the margin longs were more than five times as active as the shorts. Aggregate margin long activity has consistently overwhelmed combined sales and covers of shorts.”<sup>43</sup>



\*Source: [www.dowtheoryproject.com](http://www.dowtheoryproject.com)

As evidenced earlier, the 1976 SEC Release focused more on reviewing past studies of short selling and the effectiveness of the short sale tick rule. The general assessment of these studies was as follows:

“Although several studies have been conducted during the past forty years with respect to short sale activities, those studies do not demonstrate conclusively the effects of short selling or the efficacy of short sale regulation.’ Statistical information concerning the incidence of short selling and the statistics necessary to evaluate the precise impact of short selling have never been adequate.”<sup>44</sup>  
(Emphasis mine)

In May of 1976, the SEC was considering whether short sale regulations continued to be necessary or appropriate.<sup>45</sup>

“The SEC staff working paper concluded that the tick test was costly and ineffective.”<sup>46</sup>

In addition to analyzing aggregated data, the SEC analyzed 30 Dow stocks during a 20-day period in the fall of 1976 when the Dow fell in excess of eight percent. They

concluded that the tick-test played a relatively weak role in deterring short sales.<sup>47</sup> After running further simulations using the same stocks and timeframe referred to above, they concluded, “that the tick test regulation is probably ineffective.”<sup>48</sup> The SEC went on to note,

“The widely held view among economists [is] that: ‘By preventing short sales on minus or zero minus ticks...investors and market professionals are prevented from translating negative perceptions concerning the value of individual stocks or the value of stocks generally into market action as rapidly as they wish, thereby impeding the market from expressing a valuation of securities on the basis of all available information (including all buying and selling interest) and creating inefficiencies in the pricing mechanism.’”<sup>49</sup>

In 1976,

“The Commission proposed a trial suspension of the tick provision of the short-sale rule, [but when] confronted with industry opposition, determined not to adopt the rule that would have suspended the tick test.”<sup>50</sup>

### **1986 – The Pollack Report**

The Pollack Report was commissioned to determine additional regulations to which short sellers should be subject. Pollack notes,

“Regulation of short selling was introduced in the 1930s because of a belief that short sales were used intentionally to force prices down, demoralizing investors and enabling short sellers to cover at prices substantially below their sales. This is commonly referred to as a ‘bear raid.’

However, the converse can also occur. Purchasers, particularly margin purchasers, can exert heavy buying pressures, forcing the price up rapidly to draw in substantial public interest, and then sell before the interest wanes.<sup>51</sup>

The amount of short sales is dwarfed by long sales. Historical data show that short sales in NYSE stocks in recent years have been equivalent to about 9 percent of [total] sales volume.”<sup>52</sup>

Pollack goes on to note that 80 to 85 percent of all short sales on NYSE stocks are made by NYSE members, presumably to facilitate markets and reduce risk.<sup>53</sup> The remaining 15 to 20 percent of short sales are made by the public and non-member broker-dealers.<sup>54</sup> With the fact that short sales made up less than 10 percent of the market transactions and that less than 20 percent of short selling is done by non-members, it is highly unlikely that “rogue” short sellers caused markets to decline at all.

Finally, in regard to the tick-test rule, the Pollack Report notes:

“Although the practice of restricting short sales was purportedly limited to activities that would demoralize the market in an abusive way, the SEC tick-test regulation had a far broader goal, i.e., attempting to moderate overall declines in stock prices.”<sup>55</sup>

To which, I will only add: from the preponderance of research conducted by various SEC studies, any attempt to manipulate markets by way of the tick-rule appears to have largely failed.

Let us briefly turn our attention to the Pollack study of the 11 securities that were supposedly the target of manipulative short selling activities. That the NASD was allowed to select the companies they thought were drawing fire from short sellers, shows this study was sincere in its intent. The Pollack study recognized the limitations of studying the effects of short selling from aggregate levels, so it was specific in its focus. For the companies that were selected, the study was also pervasive.

“The NASD staff developed a list of 11 securities, allegedly the target of professional short sellers, for purposes of the study from media articles, complaints of issuers and information concerning potentially manipulative trading patterns available through the normal market surveillance processes. For each of the 11 securities under study, the NASD staff selected specific time periods during which price declines appeared most significant. Detailed information was collected through questionnaires on trading from 80 brokerage firms found to have had transactions in those securities.”<sup>56</sup>

The character traits of excellent short sellers are reflected in the companies that they targeted. The two that stand out most prominently are short sellers' independence and preoccupation with research. Pollack notes:

“Information accuracy looms as the most important factor in short-selling situations. Those firms engaged extensively in short-selling professionally research companies whose securities they consider overpriced based on a variety of fundamental factors, including sales projections, products, reported earnings (losses) and book value. In one case, a highly speculative situation, the company's stock at one point traded at nearly 265 times its book value, despite increases in quarterly losses and no showing of success in its development project.<sup>57</sup>

In three other case-study companies, concentrated short selling was found to have been motivated by short-seller beliefs that the financial performances of the companies were substantially worse than the public perception. Each of these issuers became the subject of action by a federal agency or the courts based upon inadequate disclosures and/or improper accounting practices, supporting the short-selling fraternity's opinion that the financial condition of these companies was much worse than publicly disclosed.<sup>58</sup>

One company had no operating history and no income to support its operations. Also the subject of many rumors (both positive and negative) and numerous articles, the stock managed to continuously rise to relatively high levels despite a lack of material corporate developments, poor fundamentals, negative articles and rumors. In this case, investigations have been initiated by regulatory authorities.<sup>59</sup>

In all of the above cases, it appears that short sellers were reacting to imperfections in the disclosure process.”<sup>60</sup>

Pollack continues to comment regarding his findings.

“In certain case studies, substantial price increases occurred which were not based on fundamental financial results. Rather, buying and selling were based upon favorable publicity regarding unproven and untested products and speculation regarding the companies' potential success. The professional short sellers, through their research and investigative activities, arrived at the judgment that the

companies would eventually fail to meet investor expectations. As later discussion will show, their judgments were often correct. Indeed, a principal of one of these short-selling firms stated that his firm only shorts companies that it expects to fail completely.<sup>61</sup>

Of the 11 case studies, two did not have significant short selling. Nine experienced extensive short selling; and in six of these, subsequent corporate developments and resulting lower price levels demonstrated short sellers to be substantially correct in their assessment of the company. In the remaining three companies, the mastication of short sellers was clearly based on conflicting opinion and appraisals of future profit potential in a particular industry. Short sellers apparently misjudged the market for these companies.<sup>62</sup>

Therefore, their activities can be expected to contribute to the efficiency of the pricing process in the market. If management disclosures are overly optimistic or such that they permit investors to become overly optimistic, then the pessimistic appraisals of professional short sellers invariably help to reduce the extreme price rises that would otherwise occur and protect the market and investors from excessive optimism or defective or inadequate disclosure of both.<sup>63</sup>

So long as these sales are not accompanied by violations of delivery and settlement requirements or by fraudulent or manipulative conduct, they are not improper or abusive.<sup>64</sup> The economic motivation of short sellers is no different from that of any other investor or trader – ‘buying low and selling high.’ In the case of the short seller, the sequence of the transactions is simply reversed.”<sup>65</sup>

Throughout history, short sellers have often been vilified. Market crashes and sharp declines have often acted as catalysts, bringing harsher criticism and attempts to restrict, restrain, or outlaw short selling. The 1938 SEC tick-test rule, which has been questioned as to its legitimacy and its effectiveness by the SEC itself, is a prime example of this position. Throughout history, the effect of short selling on markets has been arguably negligible. If anything, it has contributed to making markets more efficient by guarding against speculative price increases and by providing support to markets when short sellers buy to close out their positions.



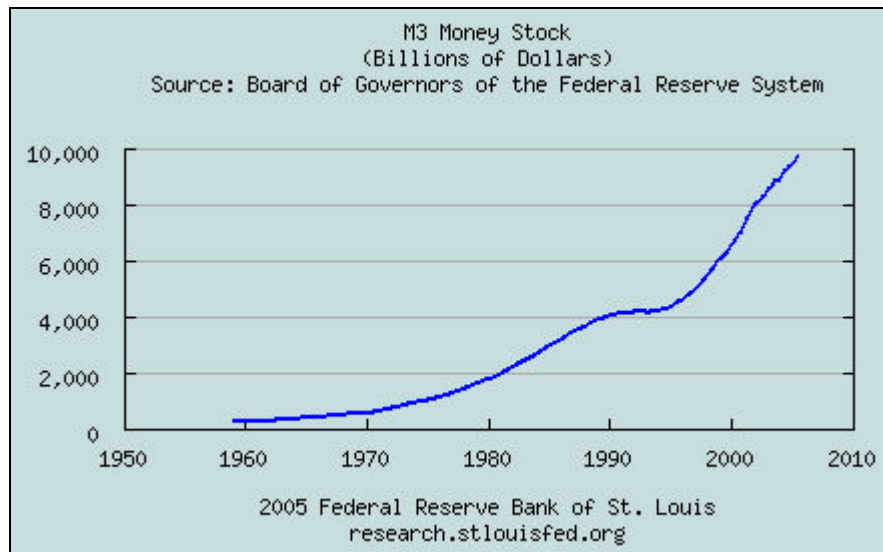
Next, we discuss the improvements and challenges that short selling faces in our current market environment.

### The 1970s – A Catalyst for Change

The 1970s laid the groundwork for the massive changes that helped launch the roaring bull markets of the 80s and 90s. We could discuss corporate America’s move from pension plans to 401ks, the introduction of the Individual Retirement Account (IRA) or any number of changes that took place in the 70s, which contributed to the bull market of the 80s and 90s. Yet without three specific changes, our financial markets would never have grown to the extent to which they have today. Changes in the gold standard, options usage, and technology have greatly affected our current markets.

First, in 1971, the US came off the last vestige of the gold standard. In 1933, the US began its departure from the gold standard by no longer allowing the public to exchange paper dollars for gold. In 1971, the US completed the process, by ceasing sales of gold to foreign central banks.<sup>66</sup> With every major country in the world now on fiat currencies, we were free to inflate.

In August 1971, when Nixon closed the gold exchange standard, the Federal Reserve’s records show that the money supply stood at \$744 billion. As of



October 2005, the Fed reports this figure is now \$10,007 billion. Though guarded when we saw inflation show up in consumer prices, when these additional dollars showed up in inflated asset prices, we were often pleased with the illusion of wealth that was created.

Second, in 1973, Fisher Black and Myron Scholes introduced their options pricing model. In the same year, the Chicago Board Options Exchange (CBOE) was founded as the first

US options exchange. These occurrences acted to greatly proliferate the use of options. Two years later the CBOE adopted the Black-Scholes model for pricing options and computerized price reporting began. A few years after that, put options and equity index options began trading.<sup>67</sup> These basic options were seminal in the development of the more complex derivatives markets of today and greatly enhanced and expanded the activity in the futures markets.

Last, technological advances changed the financial landscape forever. Personal computers provided investors the ability to calculate and engage in more complex investment strategies that would have previously been impossible. Calculation processes that were once impractical because of time constraints were now done in seconds. The eventual introduction and expansion of the Internet gave investors access to better information and the ability to access information more quickly. And, both computers and the Internet were instrumental in streamlining processes through the elimination of much of the paper handling of prior decades.

Thus, the financial landscape prior to the 1970s was quite different from that which came afterwards. Though we will not attempt to further address inflationary impacts of coming off the gold standard nor the systemic risks facing the derivatives markets, we thought it necessary to note that these issues have affected many aspects of today's financial markets.

## Section 6: Traits of the System (1986 to the Present) – The Good, the Bad, and the Ugly

### The Good

Short sellers, and the markets as a whole, have benefited from more readily accessible information brought about by advances in technology. In turn, the ability to compute and process this information has allowed for the creation of products that make it easier to sell short. Clearly, there appears to be less of a stigma in regard to short selling than there was at previous periods in history. Yet, these new products have affected the usual effects selling short has on markets.

Harry Strunk, who developed and publishes the Strunk Short Index, offers a brief example of how technology has improved the information available to investors.

“The short interest on individual stocks is more accurate now because the data is updated weekly, it’s reported by major news sources, and the Internet gives better access to research and investigative data.”<sup>1</sup>

Investors today are also aided from the availability of books on shorting, which were nonexistent even 10 years ago. In her book, The Art of Short Selling, Kathryn Staley comments, “When I first started selling short, only one book, written in 1932, detailed the practice.”<sup>2</sup> Dr. Fabozzi, the Fredrick Frank Adjunct Professor of Finance at Yale and Editor of the *Journal of Portfolio Management*, has even edited a textbook on the subject. His book, Short Selling: Strategies, Risks, and Rewards, contains the contributions of more than a dozen market experts from the investment and academic arenas.

Technology has certainly made it easier for short sellers and all investors to operate in today’s markets. John Breazeale, who began his career in the early 1970’s, was kind enough to share how things have changed.

“The 1970’s was a time when shorting was quite different than it is today. Stocks that were in a margin account still had to have the maintenance requirements calculated, by hand, every day. If you borrowed shares that the dealer didn’t have in inventory, you didn’t have a massive computer network to review inventory, you had to get on the phone and call around. Once you located the shares at another dealer on Wall Street, you’d have the courier, roll his metal box on

wheels over to the window [yes, they had bars like the old bank pictures] of the other dealer, and pick up the stock certificates that represented that short sale.”

And today,

“Today, when you short individual stocks, it is possible to borrow your shares from several players. Since ETFs [Exchange Traded Funds] can be shorted on a downtick, this is certainly an advantage that previous generations of investors did not have.

With technology, it happens almost instantly. Everything I do today is over the Internet – the trades, the signals, everything is over the Internet.”<sup>3</sup>

As Breazeale notes, technological advances have led to the development of ETFs. The benefit of ETFs is that, rather than making multiple transactions, investors can buy, sell, or sell short an entire index or sector in an instant. Unlike mutual funds, ETFs act like stocks, allowing investors the ability to trade them at current market value throughout the trading day. They can also be sold short. Unlike a stock however, ETFs are not subject to the SEC tick-rule requirement, so investors can short them at will.

One more benefit for investors today, which was not in existence twenty to thirty years ago, is that mutual fund companies have continued to develop inverse funds. This allows investors the opportunity to benefit from short selling. They can either directly purchase an individual fund or hire managers who often use long and short (inverse) index funds in their strategies.

Though long mutual funds have been around since the 1930s, it was not until 1994 that Rydex Investments introduced the first inverse index fund to the marketplace. If investors do not understand short selling, they understand inverse funds even less. As such, since Rydex developed the first inverse fund, we thought it would make sense for Jim King, a Rydex inverse fund portfolio manager, to elaborate on building and running an inverse mutual fund. In reading his comments, it becomes obvious that certain technologies had to be in place for these funds to function, as the day-to-day operation of an inverse fund is anything but simple.

King speaks of why stocks are less advantageous than derivatives to inverse funds.

“A big part of what we are doing today is dependent on derivatives, which just weren’t around in the late 70s. Prior to derivatives, you could create an inverse fund by selling [short] single stocks, but the problem is that there are all kinds of restrictions on short sales, even though some of them have been lifted lately. It’s also expensive, from a commission standpoint, to trade all the stocks in an index [individually]. Through derivatives, we can do things cheaper than would otherwise be possible. With daily rebalancing, this is very different than what most people think of when they rebalance a long [stock] portfolio on say a quarterly or annual basis. In fact, it would probably be impossible for us to run an inverse fund without the use of derivatives.”<sup>4</sup>

King goes on to explain why inverse funds use derivatives, rather than options, to approximate the opposite result of the market’s daily action.

“In order to keep the fund looking like the inverse of the markets, we have to rebalance our futures contracts daily. While put options could be used, options volatility, depending on whether they are in or out of the money, responds differently than futures contracts. Deep in the money options, which are less volatile, usually have high costs and thus require high capital outlays for their use. Put options that are way out of the money don’t have the heavy capital outlays, but are much more volatile than the daily movement of the index. As you can see, we have to use derivatives.”<sup>5</sup>

King speaks to investors’ concern that they might lose all their money in an inverse fund.

“One of the main things we get asked by our investors is ‘if the markets go up more than 100 percent, what would happen to our money?’ First, I don’t think it is likely that the markets would go up 100 percent in a day. In addition, since we have people coming in and out of the fund daily, and the market moves up or down, we have to rebalance every day in order to maintain a position as close to 100 percent short the index. The risk looks more like the analogy of taking steps toward a wall. If every step takes you 50 percent of the previous step’s distance to the wall, then you never get to the wall. In the same way, with daily rebalancing it is unlikely that one would lose all their money at once in inverse funds.”<sup>6</sup>

Because of the super leveraging effects of derivatives, inverse funds often have high cash levels on hand and therefore do not charge short-term trading fees. King speaks about this and other operational advantages derivatives afford inverse funds.

“When you tell a fund manager to sell on short notice, it forces the manager, if he does not have enough cash reserves, to sell in an inopportune time. Combine this with the fact that the fees from trading could eat up the fund, and you see the reason why a typical equity manager does not want a lot of trading. Another reason we don’t short individual securities is that there are so many restrictions on when I can sell short, that if a big sum comes in I can’t really get the portfolio invested that day.

Our funds can handle day-to-day trading, because our systems are built to handle this type of environment. All of our funds are built to handle speed; they’re built with liquidity in mind. We’re never in a position where the instruments in our funds are so illiquid that we’ll move the markets. Commissions on derivatives are miniscule compared to individual equities. We’re never in a position where a lot of money would come into and out of the fund, and we don’t already know how we would handle this situation. We know that this could happen at any moment.

With futures contracts, not only can we move a lot of money very quickly and without moving the market, we have a lot of restrictions on short sales, and the trading fees are very small.”<sup>7</sup>

In talking with King, it becomes apparent why only three mutual fund companies offer inverse index funds.

With better information, better technology, the ability to short ETFs, and inverse funds that cater to short sellers, it would seem that short selling has become more accepted in the mainstream.

Since he wrote his first research report on Baldwin United in 1982, Jim Chanos has seen a lot of changes in the industry. In stark contrast to the contempt for short sellers in the 1930s, Chanos was able to see the value of his firm’s research held in high esteem when he was called to Washington in 2002, to testify on Enron before Congress.

When I asked him if short selling had gotten any easier over the last twenty years, Chanos replied:

“In regards to shorting individual stocks, it has gotten easier over the last ten to twenty years. Prime brokerage operations at the big brokerage firms have become more sophisticated. The marketplace has gotten better at lending and borrowing stock through the rebate system. So, brokerage houses have made it easier for investors and speculators to go short.

I think there is less of a stigma today than there was in the past. More and more, individuals are shorting their own accounts. Now, we can question whether that’s efficacious for them or not, and I don’t think it is, but let me tell you, there are more that understand it today than twenty years ago.”<sup>8</sup>

As we wrap up the section, it is important to note how the benefits that short selling provides to the market have changed today. In prior times, when short sellers could only deal with individual stocks, short selling may have had a stabilizing effect of the markets. By borrowing stock shares and selling them when the market price is high, short sellers acted to limit the heights to which some shares would soar. Since the shares are borrowed, short sellers can only lock in gains by purchasing the stock back in order to repay the loaned shares. Thus, short sellers provided support for market bottoms.

Doug Gillespie, of Gillespie Research, comments on the benefits short covering provided to the market bottom in 2002.

“One of the virtues in a really nasty market environment where there’s a large volume of real shorting, not synthetic shorting but actual individual shares that are shorted, is that at some point there is built in support. At some point, short sellers will say, “That’s a nice profit,” and they will [buy to] cover their shorts.

For example, in the summer of 2002, there was a very large position of individual shares [that had been] sold short. Not derivatives, not index options, but the real stuff – the bellwether stocks and bellwether averages. And what that does is really obvious. At a certain point in the decline people wanted to cover their shorts, and to do so they had to buy the shares back. As far as the market is concerned, it has

the same effect as the outright buys. And that was very evident in cushioning the drop in the summer of 2002.”<sup>9</sup>

Yet Gillespie goes on to differentiate today’s short situation from that of prior markets.

“My gut instinct, and I can’t prove this right now, is that there’s no major [real] short position underpinning this market at all. I think there is a heavily synthetic short position. I think there are a lot of futures sold short, and I think that a lot of ETFs are being sold short. But that’s different. I think these are different [market] stresses than those we saw in 2002.”<sup>10</sup>

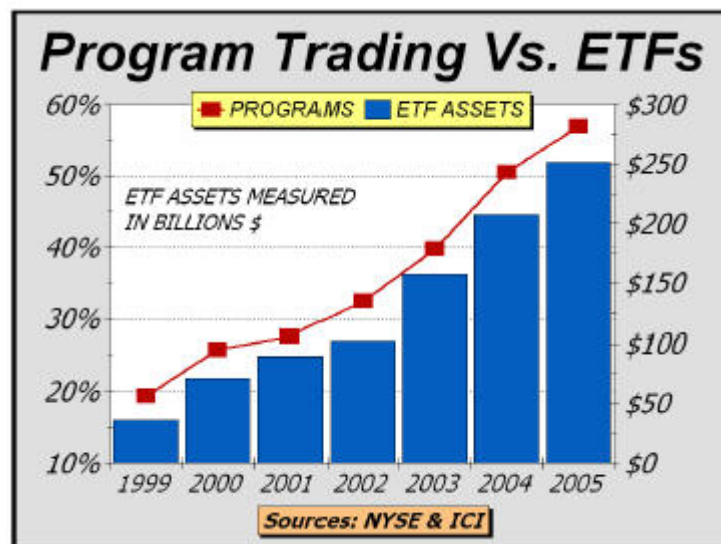
In the next section, as we look at the size of short interest in ETFs and other stresses our markets currently face, we will see that Gillespie’s intuitions are well founded.

### The Bad

Since their introduction to the marketplace in 1993, ETFs have experienced phenomenal growth, both in terms of the number of ETFs and the amount of dollars invested in them. As we consider their extraordinary growth, the amount of short interest in ETFs, and the easing of tick rule requirements, we must ponder the potential decline in our markets these issues portend.

This chart shows that program trading, shown as bars, has grown at an annual rate of 32 percent a year since 1999, while ETFs, shown as a line, have expanded at an annual rate of 29 percent over that same time frame.

This growth is reminiscent of the parabolic rate of growth we’ve seen in prior manias like the South Sea Bubble, the Mississippi Scheme or the NASDAQ in the late 1990s. Additionally,



Alan Newman, Crosscurrents, October 17, 2005



the program trading growth is disconcerting in that it calls to mind Levy's warnings of, "trend-following behavior, selling as the market falls and buying as it rises," contributing to the Crash of 1987.

As we dig a little deeper into the data, we find that the largest traded ETFs, the Spiders (SPY) and the Quad Q's (QQQQ) have revealed a rather large short interest in the last two years.

Gary Gastineau, Managing Director of ETF Consultants LLC, takes us back 3 years in his research. His work notes that in October 2002 the short interest percentage on S&P 500 Spiders (SPY) was 19.3 percent and that the short interest percentage on the NASDAQ 100 (QQQQ) was 24.1 percent. On January 2004 the short interest percentage was 29.9 percent on the Spiders and 52.8 percent on the NASDAQ 100.<sup>11</sup>

Since my source for Gastineau's research concluded with January 2004, Jason Goepfert, President and CEO of Sundial Capital Research,<sup>12</sup> was kind enough to provide more current data.

The following table combines the two information sources noted above to show the short interest percentages of the Spiders and the NASDAQ 100 through September 2005.

	Oct 2002	Jan 2004	July 2004	Jan 2005	July 2005	Sept 2005
SPY	19%	30%	19%	17%	30%	29%
QQQQ	24%	53%	44%	33%	40%	41%

This is important for three reasons. Short interest has remained elevated even past the markets' bottoms, short interest has predictive value as to the direction of the markets, and short interest tends to increase as markets decline.

Not to make too much of this, but it is worth noting that short interest has remained high even past the markets' bottoms. The S&P 500 bottomed at 776 and the NASDAQ 100 bottomed at 1114 in October 2002, while short interests in their proxies have remained elevated ever since. With the current levels of short interest 10 percent higher on the Spiders and 17 percent higher on the NASDAQ, we must conclude that somebody is expecting the markets to decline further.

Perhaps more importantly, short interest has been shown to have predictive value.

Douglas Diamond and Robert Verrecchia note this in their article in the *Journal of Financial Economics*.

“Large unexpected increases in short interest predict negative future returns because short sellers are better informed.”<sup>13</sup>

Paul Asquith and Lisa Meulbroek conclude similarly that,

“High short interest signals bearish sentiment about future returns [and] applies to the NASDAQ market as well as the NYSE and AMEX.”<sup>14</sup>

Pollack simply states,

“Professional short sellers, through their research and investigative activities, arrived at the judgment that the companies would eventually fail to meet investor expectations. As later discussion will show, their judgments were often correct.”<sup>15</sup>

Though it is true that some of these comments may have referred more to individual companies, it is equally true that markets portray the same characteristics, in this case overvaluation and ethics questions, as the individual companies which constitute them.

The ramification of various studies’ conclusions, that short interest increases as markets or stocks move lower, does not bode well for our current markets.

In his book, Stock Market Logic, Norman Fosback points out,

“That short selling tends to increase after sustained price declines, reflects the possibility of short sellers creating downward price pressure in which the last short sellers are more likely to be the least informed, especially if short interest was high to begin with.”<sup>16</sup>

Again, the 1963 SEC Special Study of Securities Markets, notes:

“The ratio of short sales to total volume increased as the market declines primarily because of increased short selling by non-members.”<sup>17</sup>

Therefore, the high short interest that remains in these two major ETFs combined with evidence that short interest increases as markets decline, portends the potential for a severe decline.

When we take into account the fact that ETFs have no tick rules to even possibly slow a decline, we see why I have chosen to call this section “the bad.”

If this were not enough, the SEC has finally agreed to remove the tick rule on certain stocks. Now, the SEC has discussed the removal of the up-tick rule for decades. Most studies have come to similar findings – that the tick-test rule is ineffective, costly, and should be removed. As noted earlier, the 1976 SEC paper remarked,

“that the [1937] Commission drew its conclusions from inadequate data and demonstrates trends which are inconclusive with respect to the general impact of short selling,’ that the SEC short-sale rule was hastily adopted following a sharp bear market,<sup>17</sup> [and] concluded that the tick test was costly and ineffective.”<sup>19</sup>

Pollack seems to believe that, “the SEC tick-test regulation had a far broader goal, i.e., attempting to moderate overall declines in stock prices.”<sup>20</sup>

So the removal of the tick-test would bring to a close years of questions concerning its legitimacy and efficacy, and, with less friction or interference on one side of the transaction, would likely make our markets more efficient. But why now? The removal of the tick-rule closer to what arguably looks like a market top, is cause for some concern. Perhaps, I am a bit too cynical.

Nevertheless, to meet the objective of “simplifying and modernizing short sale regulation, providing controls where most needed and temporarily removing restrictions where they may be unnecessary,”<sup>21</sup> the SHO regulations, issued by the SEC, went into practice in January 2005. One of the issues addressed was rule 10a-1, the tick test rule. As part of the pilot program (which is effective from May 2, 2005 to April 28, 2006) 1000 stocks of the Russell 3000 have been removed from the tick test requirement for a

designated period of time.<sup>22 & 23</sup> This means that what is commonly called the plus-tick rule will not apply to short sells on these stocks temporarily.

Though I may have some small misgivings about the timing, the removal of the tick-rule, even if only temporarily, has multiple benefits to the markets. And, with the proliferation of the use of products, like derivatives, options, and ETFs, which have no tick-test restrictions, this change would make stocks more competitive in the short selling arena.

Perhaps my concerns come from my study of history. Short sellers, specifically those who specialize in taking short positions in individual securities to profit from the decline of those shares, have often been the scapegoat for market declines at various points in history. Yet I am sure that if the markets were to decline sharply today, the populace would realize that short interest in derivatives and ETFs would far outweigh any impacts of a group of investors shorting individual companies.

So in titling this section of my work “bad,” the implication is not that short sellers have done anything wrong so much as the proverbial cards look to be stacked against the markets for what looks to be a substantial decline. And that would be bad.

In the next section, we will continue to explore the SHO regulations and the intentions of the SEC to bring illegal shorting to an end. For without understanding that there are both short sellers who are acting legally and those who are acting illegally, the public could naively assume that all short sellers act similarly, when in fact, nothing could be further from the truth.

### **The Ugly**

The illegal practice of short selling shares that have not been affirmatively determined to exist is known as “naked shorting.” Ordinarily, traders must borrow a stock, or determine that it can be borrowed, before they sell it short. However, some market participants have found a way to take advantage of loopholes in the rules for shorting stocks.<sup>24</sup> In the November 6, 2003 Federal Register, the SEC defined naked shorting as follows:

“Naked short selling is selling short without borrowing the necessary securities to make delivery, potentially resulting in a “fail to deliver” securities to the buyer.”<sup>25</sup>

In a "naked" short sale, the seller does not borrow, or arrange to borrow, the securities in time to make delivery to the buyer within the standard three-day settlement period of making a stock transaction. As a result, the seller fails to deliver securities to the buyer when delivery is due. This is known as a "failure to deliver" or "fail." <sup>26</sup>

As we explore this problem, let's start with some background information. The Pollack Report contained numerous references to addressing the failure to deliver issues accompanying short selling. For example, here the report recommends,

“A borrowing requirement for delivery in broker-dealer proprietary transactions should be adopted, [and] a mandatory requirement should be adopted for guaranteed delivery buy-in after a reasonable period.” <sup>27</sup>

Pollack is suggesting that if the shares are not delivered within a set number of days, then the short position should be closed out with a buy transaction.

Yet, things are never so simple. Not all failures to deliver (FTDs) result from naked shorting. The SEC notes:

“Failures to deliver may result from either a short or a long sale. There may be legitimate reasons for a failure to deliver. For example, human or mechanical errors or processing delays can result from transferring securities in physical certificate rather than book-entry form, thus causing a failure to deliver on a long sale within the normal three-day settlement period.” <sup>28</sup>

And, not all naked shorting is illegal. The SEC continues:

“Naked short selling is not necessarily a violation of the federal securities laws or the Commission's rules. Indeed, in certain circumstances, naked short selling contributes to market liquidity. For example, market makers who sell short thinly traded, illiquid stock in response to customer demand may encounter difficulty in obtaining securities when the time for delivery arrives. Because it may take a market maker considerable time to purchase or arrange to borrow the security, a market maker engaged in bona fide market making, particularly in a fast-moving market, may need to sell the security short without having arranged to borrow shares. This is especially true for market makers in thinly traded, illiquid stocks

such as securities quoted on the OTC Bulletin Board, as there may be few shares available to purchase or borrow at a given time.”<sup>29</sup>

So, market makers are generally excluded from illegal naked short selling. The problem arises when certain market participants abuse the loopholes in the current regulatory requirements. According to the rules proposal in the Federal Register,

“The SROs (Self-Regulating Organizations) have adopted rules generally requiring that, prior to effecting short sales, members must ‘locate’ stock available for borrowing. An NYSE interpretation to the rule further states that no orders to sell short should be accepted or entered unless prior arrangements to borrow the stock have been made *or other acceptable assurances that delivery can be made on settlement date* [sic].”<sup>30</sup>

The Federal Register continues,

“The comparable NASD Rule 3370 generally provides that no member shall effect a short sale for a customer or for its own account unless the member makes an ‘affirmative determination’ that the member can borrow the securities or otherwise provide for delivery of the securities by settlement date. The affirmative determination must be annotated in writing [so there’s a paper trail], evidencing that the member firm will receive delivery of the security from the customer or, if the member firm locates the stock, the identity of the individual and firm contacted who offered assurance that the shares would be delivered or were available for borrowing.”<sup>31</sup>

Again, just like the NYSE members, the NASD members must follow rules that require them to have shares, or be able to acquire them, before they loan shares to short.

In that the legislation allows a transaction to occur, and all moneys to be paid, before delivery occurs, it has been constructed in a rather porous way. Naked short sellers have simply taken advantage of the structural deficiencies within the system.<sup>32</sup> So, the real question is, where is the enforcement if these laws break down?

In seeking to answer this question, I wanted to check in with a few dedicated short sellers and see if the environment in which they operate would allow the leeway necessary for

naked shorting. Julie Kirkpatrick, president of Lang Asset Management, discusses their process for selling a stock short.

“Since we are trading large liquid stocks, when we place a short sell, the online trading system will usually confirm our trade almost instantly. The broker who takes the trade has to get approval from their stock loan department on all the shares we trade. Because of the speed of the computer networks and online trading, most of the approvals come via the Internet on a secured computer network.

However if we were to trade in small stocks, which we do not, then the trade might take longer to approve. If the broker didn’t have the stock in inventory, theoretically they would notify us that the trade is rejected. I say theoretically because this hasn’t happened to us so far.”<sup>33</sup>

Bob Lang, chairman and CEO of Lang Asset Management, discusses the incentive to those who loan stocks.

“Since institutions or individuals are compensated for loaning their stock through lending fees, they have an incentive to loan out their stock. Remember though, before institutions are allowed to loan their stock, they must give prior approval to their broker dealer permitting the broker dealer to lend out their stock.

Lang continues with a comment on the broker dealer’s supervision of the short selling process from his firm’s point of view.

Occasionally, we will get a call from a brokerage firm asking if we had been given authorization to short a particular stock. These calls lead us to believe that loaning shares for the purposes of short selling is a highly supervised process.”<sup>34</sup>

Jim Chanos expounds on Lang’s assessment of the supervision of shares loaned for the purpose of short selling. Here, Chanos speaks of the checks and balances that exist in legitimate short selling operations. He then goes on to give a few suggestions on how to investigate trades that involve naked short selling.

“The most obvious observation is that there is a paper trail.

If you remember from September 11th, there was a general charge of suspicious short selling going on in various stocks, like insurance and airlines, right before September 11th – basically indicating a pattern of pre-knowledge. It was in the papers every day. People were convinced.

Yet, because short selling has more of a paper trail than any other securities transaction, it is easy to prove who was short and when they went short. You have to mark your tickets when you are selling short to show that you borrowed the shares. And the trader has to call you to verify that you borrowed the shares and that you borrowed them correctly. These steps show that the naked short seller has to fill out the paperwork incorrectly, and lie to his counterparty, which in and of itself, is against the law.

With the required paper trail, it's easy to trace who borrowed the shares in question, why the fail [to deliver] has occurred, and to get the prime brokers to clear these tickets up. All we have to do is follow the paper. Its not rocket science; it's not ever great criminal detective work; it just takes some time.

As for all these allegations of naked shorting going on, in our opinion it most likely has to do with broker dealers abusing the market maker exemptions for short selling. According to the NASDAQ, broker dealers, as market makers in a security, do not necessarily have to deliver shares if the shares in question were not delivered in conjunction with legitimate market making activities. Logically, that's where I would start looking. Because those who short, like us, are scrutinized so carefully, it seems unlikely that they would not be detected.”<sup>35</sup>

Chanos' comments on the controls within the system show how difficult it would be for market participants to take a “naked short” position.

Yet, just as there are rules in place to protect investors from fraudulent accounting schemes, and firms continue to harm investors by fraudulent conduct, so also, when it comes to short selling, there are those in the system who have found a way to circumvent the rules. Next, as it pertains to our discussion of naked shorting, we will zero in on one event that has just occurred in our financial markets. There were a lot of reasons to short Refco, yet there is also evidence of illegal shorting. This looks like a story of the sharks eating the sharks. It gets pretty ugly.



## **Refco**

The recent events leading to the demise of Refco point to the dangers present in our markets today. Those who participated in the initial public offering (IPO) or bought shares shortly thereafter saw their money disappear in an instant. The only safeguards against such market wiles are managers who are exceedingly focused on research, attention to details, and continuous monitoring of companies and markets.

For all intents and purposes, Refco was a prime candidate for short sale consideration. And yet, the record of its last days shows the telltale signs of naked shorting. This should never happen.

In speaking of his concerns about the increasing number of allegations of concerted efforts to manipulate down the price of companies via naked shorting, Alan Newman notes,

“The practice of targeting micro-caps on the NASDAQ Bulletin Board has gone on for years and has been so successful that the logical next step in the strategy has expanded to include billion dollar companies.”<sup>36</sup>

As we consider the recent bankruptcy filings for Refco, it is hard to find sympathy for the companies' leaders.

## **Refco Issues**

Even before it went public in August 2005, Refco had all the markings of a company that would have given legitimate short sellers ample motivation to target it. One needn't look very far to find reasons why the stock had high odds of declining in value.

As evidenced in various public and government documents, consider the relationship Refco had with the SEC before even going public. Matthew Goldstein, senior writer for TheStreet.com, outlines the problem.

“A wide-ranging investigation into stock manipulation in the private-placement market has tripped up Refco, a brokerage that last month filed plans for an initial public offering. The New York firm disclosed late Monday that the SEC is

considering filing civil charges against it over short sales in shares of Sedona, a tiny Pennsylvania software company.

The looming action against Refco stems from a 2003 SEC enforcement action against Rhino Advisors, a defunct investment firm that regulators charged with manipulating shares of Sedona in 2001. Regulators charged that Rhino illegally shorted [Sedona's] stock on behalf of one of its clients, Swiss-based Amro International. Federal prosecutors in New York subsequently charged the principals of Rhino...with conspiracy to commit securities fraud.

Refco, which filed for a \$575 million IPO last month, disclosed in the offering document that *the SEC has been investigating its involvement with Sedona* since June 2001. In October 2003, the brokerage received subpoenas from the U.S. attorney in New York. But the firm, which specializes in the futures and derivatives markets, said it 'has been advised orally that it is not currently the subject of the U.S. attorney's investigation.'" (Emphasis mine)<sup>37</sup>

Though we may not be able to see all that is going on with Refco, Goldstein's article points to potential problems. For a short seller, this would be enough to merit a closer look.

An S-1 is a document that a company who is looking to make a stock offering prepares for the SEC. As many of these tend to be in excess of 100 pages, most investors do not read them. In the absence of a 10-K, the S-1 serves as a useful compendium of information about a company. On page ninety of their S-1, Refco acknowledges the SEC's investigation.

"In 2002 and 2003, we received subpoenas from the SEC and a request for a written statement. Generally, the subpoenas and the request required the production of documents, tapes and information regarding two of our former brokers who handled the account of Amro International, S.A., *one of our former customers that engaged through its account with us in short sales of Sedona stock and whose financial advisor settled SEC charges with respect to such short sales* in February 2003; our relationship with Amro and its two principals; other securities traded by Amro; and our record keeping, supervisory and short sale policies and restrictions.

In October 2003, we received a subpoena from the U.S. Attorney's Office for the Southern District of New York, which called for the production of documents we had produced to the SEC. On May 16, 2005, we announced that our subsidiary, Refco Securities, LLC, received a 'Wells Notice' from the SEC arising out of the investigation." (Emphasis mine)<sup>38</sup>

As an aside, Investopedia defines a Well's Notice as a notification issued by regulators to inform individuals and companies of completed investigations where infractions *have been discovered*.<sup>39</sup>

So far, the S-1 has expounded on Refco's legal problems. Yet a closer look at Refco's financials, on pages 110 and 111 of their S-1, would give investors further cause for concern and short sellers stronger reasons to target this stock. In the section on debt, after describing its various banking and financing relationships, we read:

"The senior credit facilities provide for aggregate borrowings of up to \$875.0 million, including:

- a revolving credit facility of up to \$75.0 million in revolving credit loans and letters of credit, none of which has been drawn, and
- a term loan facility of \$800.0 million, all of which was drawn in connection with the THL Transactions, with an option to increase the aggregate amount of term loans up to \$200.0 million without the consent of any person other than the institutions agreeing to provide all or any portion of such increase and subject to certain closing conditions."

Later, we read:

"The term loan facility is subject to amortization in equal quarterly installments of principal as set forth in the table below."<sup>40</sup>

Year	Term Loan Facility
1	\$ 8.0 million
2	\$ 8.0 million
3	\$ 8.0 million
4	\$ 8.0 million
5	\$ 8.0 million
6	\$ 8.0 million
7	\$ 752.0 million

At this stage, we have to ask ourselves, “What’s wrong with this picture?” If we don’t mind investing in a company with a questionable past, which the SEC is investigating, a company that is taking on \$800 million in debt, which has a huge balloon payment in year seven, a company that can easily take on an additional \$275 million in debt, and a company that is looking to amass another \$575 million in capital through its IPO, then nothing. Though a short seller would do far more research, from our standpoint this looks like a serious candidate for shorting.

### Refco’s Demise

Change comes about quickly, but a detailed account of trades on Refco from October 10th to October 18th of 2005, leaves us questioning the validity of all of the transactions of this stock. David Patch, an investor advocate, has constructed a daily description of Refco’s demise:

October 10th – Refco announces accounting problems associated with a \$430 million payment made by CEO Phillip Bennett back to the company to cover ‘bad debt’ that appeared on the ledger. Just prior to that announcement, Refco is trading at nearly \$29.00/share with a total of 127,500,000 shares outstanding, giving it a \$4 billion market capitalization. However, according to SEC documents, **only 26,500,000 of those shares are in the float, or publicly owned and free for trading.** The rest of the shares are restricted, or locked up and unavailable for trading.

On the day of the announcement, with an opening price at \$20.00/share, *Refco trades over 24 million shares*, closing at \$15.60, and never sees the light of day thereafter.

October 13th –  
 In the following  
 days, prior to the  
 NYSE halting  
 trading of its  
 shares on the  
 morning of  
 October 13th,  
*Refco trades yet  
 another 55  
 million shares,*  
 closing at \$7.90.



At this point, with a 26 million share public float, Refco has traded 79 million shares in a little over 3 days. Refco’s Form 4 filings with the SEC, shows only one insider, Credit Suisse First Boston, had sold 85,000 shares. However, that transaction occurred back on August 16th at \$20.00 a share.

October 18th – The day after it files for bankruptcy, Refco resumes trading. That day 10 million shares are sold, bringing the stock from an opening price of \$1.50/share to a closing price of \$0.65. The next day, another 11 million shares trade, and Refco closes at \$0.85.<sup>41</sup>

Patch questions how this is possible.

“By my calculations, Refco has traded the entire public float a minimum of 4 times in 5 trading days and has traded down more than 97% in market capitalization. Will all these trades settle within the 3-business days as required by law? I doubt it.”<sup>42</sup>

Based on the numbers shown in Refco’s trading record, Patch’s question merits consideration. How can a company’s shares trade four times the public float in five days, much less while it loses 97 percent of its share value? To Patch’s query, I add my own.

The short sellers I interviewed had to get permission from their broker-dealers before effecting a short sell. As Chanos points out, there is a paper trail. As such, who were the

broker-dealers who took these trades and on which firms' behalf were the trades received?

While Refco may have justly drawn the attention of short sellers, the volume of shares that were traded seems awry. Yet, I am not naïve enough to think that these questions will be answered. At the root of the problem lies a law that, in its current form, is difficult to enforce.

### **Hindrances to FTD Enforcement**

The problem of enforcing fails to deliver (FTDs) is that the system is constructed in such a way that does not lend itself to close regulation of FTDs and that the SHO regulations are written in such a way that they are easily circumvented. Though this discussion may seem an attempt to belabor the obscure, history has shown that after market declines short sellers are often scapegoated. In the previous section, we see that as it concerns short sellers, there is chaff amongst the wheat. In this section we explore the question of why the chaff has not been separated yet.

### **Clearing and Settlement Systems**

First, let us get a basic understanding of how the clearing system between market participants works. The financial industry handles securities clearing and settlement, the matching of all buy and sell orders in the market, in one of two ways – either within or outside of the Continuous Net Settlement (CNS) system. This begs the question, what is the CNS?

The CNS is an automated centralized settlement service, offered by the National Securities Clearing Corporation (NSCC), where securities are recorded in electronic entries (called books) instead of paper certificates. Since we refer to it later, it is worth noting that the NSCC is a subsidiary of the Depository Trust & Clearing Corporation (DTCC). The CNS allows parties to make transfers to the clearing corporation, rather than to each individual party with whom they transact. So, for all intents and purposes, the CNS acts as a middleman, keeping the markets moving. Through the Stock Borrow Program, another service offering of NSCC to its members, the CNS system also accommodates temporary FTDs.<sup>43</sup>

Yet, “temporary” is a rather ambiguous term, and when we address the shortfalls of the SHO regulations, we will see that temporary can be a long time.

The other way to clear and settle securities is through the non-CNS, or ex-clearing, system. Here, the NSCC handles the cash transfers between brokers and pays everyone, but leaves the delivery portion of the transaction outside of the system, between the two brokers, on the honor system.<sup>44</sup>

Now that we have a cursory understanding of how the system works, our next logical question is how big of a problem are FTDs?

If we consider what happens within the system, the FTD problem appears to be small. DTCC First Deputy General Counsel Larry Thompson to discuss these issues.

“While naked short selling occurs, the extent to which it occurs is in dispute. Currently, fails to deliver are running about 24,000 transactions daily, and that includes both new and aged fails, out of an average of 23 million new transactions processed daily by NSCC, or about one-tenth of one percent. In dollar terms, fails to deliver and receive amounts to about \$6 billion daily, again including both new fails and aged fails, out of just under \$400 billion in trades processed daily by NSCC, or about 1.5% of the dollar volume. The Stock Borrow program is able to resolve about \$1.1 billion of the “fails to receive,” or about 20% of the total fail obligation.”<sup>45</sup>

So, if 20 percent of FTDs are resolved within the Stock Borrow Program, what happens to the other 80 percent that are not resolved? To muddy the waters further, Bob O’Brien, of the National Coalition Against Naked Shorting (NCANS), an investor advocacy group, points out,

“It is unclear whether that [number] includes the ex-clearing [system] transactions or not – the language used is ambiguous and allows for different interpretations. Many have asked [the DTCC] for clarification, and none has been offered.”<sup>46</sup>

So, O’Brien’s question is 80 percent of what? As we learned earlier, shares can be cleared through the system or ex the system. Is the 80 percent that is not resolved through the system or *through and ex* the system?

Though we may not know the size and the scope of the problem, we do know it is large enough that the SEC felt it necessary to investigate the issue and enact the SHO regulations to attempt to curtail these activities. In November of 2003, the Federal Register notes:

“Naked short selling can have a number of negative effects on the market, particularly when the fails to deliver persist for an extended period of time and result in a significantly large unfulfilled delivery obligation at the clearing agency where trades are settled.”<sup>47</sup>

### **SHO Regulations**

The main thrust of the SHO regulations is to “update short sale regulations in light of numerous market developments since short sale regulations were first adopted in 1938. Some of the goals of Regulation SHO include:

- Establishing uniform "locate" and "close-out" requirements in order to address problems associated with failures to deliver, including potentially abusive ‘naked’ short selling.
- Temporarily suspending Commission and SRO short sale price tests in a group of securities to evaluate the overall effectiveness and necessity of such restrictions.
- Creating uniform order marking requirements for sales of all equity securities. This means that orders you place with your broker-dealer must be marked ‘long,’ ‘short,’ or ‘short exempt.’”<sup>48</sup>

Our discussion of the SHO regulations will limit itself to the closeout provisions as they are aimed at limiting the size and scope of FTDs. Here, the SEC outlines its action plan for the closeout provisions.

“‘Close-out’ Requirement: Regulation SHO imposes additional delivery requirements on broker-dealers for securities in which there are a relatively substantial number of extended delivery failures at a registered clearing agency (‘threshold securities’). For instance, with limited exception, Regulation SHO requires brokers and dealers that are participants of a registered clearing agency to



take action to ‘close-out’ failure-to-deliver positions (‘open fails’) in threshold securities that have persisted for 13 consecutive settlement days. Closing out requires the broker or dealer to purchase securities of like kind and quantity. Until the position is closed out, the broker or dealer and any broker or dealer for which it clears transactions (for example, an introducing broker) may not effect further short sales in that threshold security without borrowing or entering into a bona fide agreement to borrow the security (known as the ‘pre-borrowing’ requirement).”<sup>49</sup>

As we can see from this SEC outline, brokers and dealers with substantial numbers of FTDs that are older than 13 *consecutive* settlement days are required to purchase the security in order to close out the position to clean up the failed position from the books. The SEC clarifies this further by stating,

“Regulation SHO requires broker-dealers to close-out all failures to deliver that exist in threshold securities for thirteen consecutive settlement days by purchasing securities of like kind and quantity ("close-out").

Until the position is closed out, the broker or dealer and any broker or dealer for which it clears transactions (for example, an introducing broker), may not effect further short sales in that threshold security without borrowing or entering into a bona fide agreement to borrow the security (known as a "pre-borrowing" requirement).”<sup>50</sup>

To be perfectly clear, the law stipulates that brokers and dealers have 13 days to clear up these FTDs. If they do not, they are required to buy the security in question back or they will not be able to transact additional short sells in that security unless they borrow, or agree to borrow, the shares of that security. This should act to motivate those with FTDs to clean up their books quickly.

However, based on observations since the beginning of 2005, there are many market participants who continue to circumvent these rules. Alan Newman August 25th commentary addresses this issue,

“The SEC’s Regulation SHO places companies on a ‘Threshold’ list when failures-to-deliver shorted stock reach at least 0.5% of the outstanding

capitalization. These failures are supposed to be resolved within 13 days. However, it seems clear that in many instances, *old failures are continually replaced by new failures so that some companies remain on the list indefinitely*. An even dozen companies have been on the Threshold list every one of the 156 days since the official list first appeared.”<sup>51</sup>

Pollack corroborates that FTDs are an issue in his work in 1986. He states,

“This situation [the buy-in procedure] arose because there is no automatic discipline in the settlement process on the delivery of stocks sold by firms. Under the Continuous Net Settlement of the NSCC it appears that a broker can effectively be in a short position to the clearing corporation ‘in perpetuity’ as long as he is financially able to meet the NSCC ‘mark-to-market’ procedures. While these procedures generally protect the clearing corporation, they permit short-selling brokers to assume much larger positions than they might otherwise be able to undertake if they were prevented from continually rolling over short positions without borrowing securities for delivery.”<sup>52</sup>

To clarify a somewhat muddled issue, we thought it necessary to present a *possibility* of how this could occur. *Hypothetically*, a broker desires to short 10 thousand shares of a stock. Though he cannot locate the shares to short, the broker “makes an ‘affirmative determination’ that [he] can borrow the securities or otherwise provide for delivery of the securities by settlement date.” As a result, the broker effects a short sell of 10,000 shares of the stock, and a “temporary” FTD is created. The broker in this hypothetical example intends to stay short 10 thousand shares of this stock. To that end, at some point prior to 13 days later, the broker shorts another 10,000 shares of the same stock. Thus, at this point, the broker is net short 20 thousand shares of the stock. The broker is notified that the first FTD transaction must be closed, as the 10,000 shares were unable to be located for the first short sell. The broker complies and buys (in or to close) the stock to close the first position. The broker is now short 10 thousand shares of stock. The *possibility* exists that this could be repeated. To be fair, this could also happen with a market participant and two different brokers, a market participant and the same broker, or between two or more brokers. Again, this is one *possibility* that is presented to try to explain how a FTD could continue beyond 13 consecutive settlement days. For the record, we are certainly not experts in the actual mechanics of how this could occur.

What we do know is that not all FTDs were forced to be covered. In fact, as the new SHO regulations went into effect in the beginning of 2005, provisions were made which grandfathered past FTDs. The SEC states,

“The requirement to close-out fail to deliver positions in threshold securities that remain for 13 consecutive settlement days does not apply to positions that were established prior to the security becoming a threshold security. This is known as ‘grandfathering.’ For example, open fail positions in securities that existed prior to the effective date of Regulation SHO on January 3, 2005 are not required to be closed out under Regulation SHO.”<sup>53</sup>

The SEC’s reason for this is that they did not want to create a short squeeze. Again, the SEC states,

“The grandfathering provisions of Regulation SHO were adopted because the Commission was concerned about creating volatility where there were large pre-existing open positions.”<sup>54</sup>

To be fair, this is not a carte blanche for those under the grandfather provisions. The SEC continues,

“The Commission will continue to monitor whether grandfathered open fail positions are being cleaned up under existing delivery and settlement guidelines or whether further action is warranted. It is important to note that the “grandfathering” clause of the Regulation does not affect the Commission’s ability to prosecute violations of law that may involve such securities or violations that may have occurred before the adoption of Regulation SHO or that occurred before the security became a threshold security.”<sup>55</sup>

This begs the question, what action has the SEC taken with those who were grandfathered, since these regulations came into effect earlier in 2005. Again, we turn to Alan Newman to expound upon this issue. He states,

“Although failures were “grandfathered” for those on the list when the Regulation took effect, it is inconceivable that six months can pass with failures still in place! Ironically, the rationale for the “grandfather” clause was to prevent upside

manipulations (read short squeeze). However, the result of this policy is that downside manipulations have been enabled.”<sup>56</sup>

O’Brien’s views of the grandfather provisions could be considered inflammatory. He states,

“Why would the SEC grandfather all prior fails, and knowingly violate their Congressional mandate? It is akin to allowing bank robbers to keep the proceeds of all prior bank robberies.”<sup>57</sup>

O’Brien’s is a question with which we must reckon. The Securities Exchange Act of 1934, Section 17(a)(1)(A) states,

“a. Congressional findings; facilitating establishment of system

The Congress finds that –

The prompt and accurate clearance and settlement of securities transactions, including the transfer of record ownership and the safeguarding of securities and funds related thereto, *are necessary for the protection of investors and persons facilitating transactions* by and acting on behalf of investors.”<sup>58</sup> (Emphasis mine)

That this was the first finding in section 17, which is on establishing a “National System for Clearance and Settlement of Securities Transactions,” evidences the importance of this rule. In the same vein, Pollack notes,

“If a customer intentionally deceives a broker by stating that he holds the security when he does not and fails to deliver the security, he has committed a fraud upon the broker and may be subject to prosecution under the anti-fraud provisions of the federal securities laws.”<sup>59</sup>

In the conclusion of his book, *Infectious Greed*, Frank Partnoy comments on the likelihood of punishment as a deterrent to fraudulent behavior. While his comments are aimed at the “long” side of the markets, they could just as easily apply to those who participate in illegal short sells.

“In general people are not deterred from criminal activity unless they view it as morally wrong, or perceive that its expected costs – including the possibility of jail time and fines – outweigh the benefits. In the financial markets, the question of whether an action is morally wrong is typically irrelevant; the relevant consideration is profit, with reputation as a secondary restraint on behavior. In other words, participants in the financial markets are rational economic actors: they violate legal rules not because they are evil people, but because it makes economic sense for them to do so. If the gain from cooking the books is substantial, and the probability of punishment is zero, the rational strategy is to cook, cook, cook. Unless the probability of punishment increases, additional penalties won’t do much to deter. Not surprisingly, in 2002, when Congress doubled the maximum prison term for financial fraud to twenty years, it barely registered in the financial markets. Legislators might as well have added the death penalty, given the low probability of conviction for complex financial fraud.”<sup>60</sup>

If illegal short selling is to be curtailed, it must be enforced.

My intention in this section is not to attack the SEC. With their oversight of markets that are valued today into the tens of trillions of dollars, and an annual budget in 2004 of less than \$1 billion dollars, to say that their job is difficult, would be a gross understatement.

However, as the SEC is the branch of the United States government that we depend on to keep our markets fair and equitable, to punish wrongdoers, and to protect investors, we must turn to them to answer the issues that we have heretofore discussed. We are thankful for our freedom of speech, which allows us to do so.

Rather, my intention is as follows. Due to the perception that the problem is “small” in comparison to the size of our overall markets, a discussion of naked short selling may seem esoteric. However, with the very real possibility of a substantial decline in the markets, this issue may move to the forefront in years to come. There are ethical and unethical participants on the long side of the market. In the same way, we can see that there are ethical and unethical participants on the short side of the markets. Since history has repeatedly shown that after periods of market declines short sellers are often scapegoated, should there come a period of great demagoguery against short sellers, our desire, for the record, is to make it apparent that there are differences between ethical and unethical short sellers.

To show that our discussion of short selling is not merely academic in nature, we turn now to seven real problems that our markets currently face that point to a potentially substantial decline.

## Section 7: Now, About that Bubble

At this point, it should be painfully obvious that things are not always what they seem to be. As we are deluged day in and day out with bullish and bearish rhetoric, it is easy to lose sight of the big picture and the issues that undergird our financial markets. Only a few things are really important, and somehow in the daily newsreels, we have missed them.

Jeremy Grantham speaks to bull/bear debate in his quarterly letter. This section of his letter is titled, “The Greatest Sucker Rally in History?”

“But, you may answer, this bear market rally is bigger...than any previous bear market rally and certainly longer: no other bear market rally after the three great bubbles broke in 1929, 1965, and Japan in 1980 came close to this performance. And this is true! But it is also true that more stimulus and moral hazard has been offered to this rally than any previous one, by a wide margin. It is reasonable, therefore, to expect a big response and we are certainly getting it.

But Ben Inker, more cold blooded than I and less interested in semantics says, “Who cares what you call it, it’s going to end badly eventually because it’s overpriced.” (Emphasis his.)<sup>1</sup>

John Mauldin reveals why this bull/bear debate is much more than frustrated academics sparring with one another.

“In secular bull markets, strategies that emphasize relative returns work well. They are a disaster in secular bear markets. In secular bear markets, you want your investment portfolio to be positioned in investment programs that emphasize absolute returns and have sound risk control policies.”<sup>2</sup>

Though we could discuss the deterioration of the markets in any number of ways, we will limit our discussion to fundamentals. We do this for two reasons: One, we are still deluded enough to believe that fundamentals ultimately drive markets. There is certainly some lag time between a breakdown in macro or micro fundamentals and the reflection of this in the markets. Yet, the historical record shows that markets eventually come into line with fundamental trends. Secondly, fundamentals, especially macroeconomic ones,

are generally easier to understand as most investors have a commonsense understanding of how economies work.

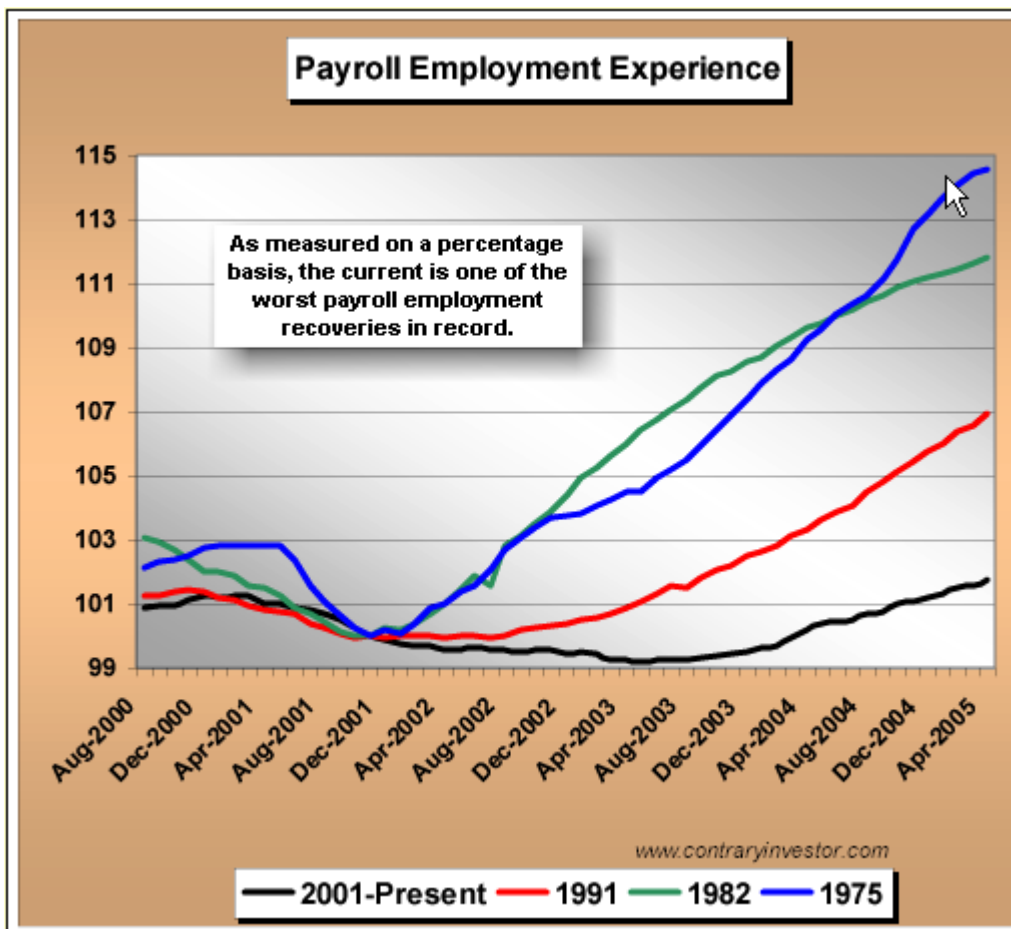
Lastly, we will limit our discussion to market and economic experts.

## Seven Risks Facing US Financial Markets

### 1. The Jobless Recovery

As Managing Director, Chief Economist, and Director of Global Economic Analysis of Morgan Stanley, it should go without saying that Stephen Roach is widely recognized as one of Wall Street's most influential economist. Roach gets to the root cause of many of the issues facing the US economy.

“The evidence is overwhelming that the current economic recovery is unlike anything America has ever experienced in the modern-day, post-World War II era. Job growth remains decidedly subpar: The May [2005] employment report





was only the latest in a long string of disappointments on the US hiring front; by our reckoning, *private nonfarm payrolls are more than 10 million jobs below the cyclical profile of the past five economic recoveries in the US.*”<sup>3</sup> (Emphasis mine)

Roach continues,

“*Consumption has boomed even in the face of subpar labor income growth. Can this anomaly persist?*”

The simple answer, in my view, is not for long. America’s income-short, consumer-led recovery is the aberration – not the norm – in this Brave New World. It is all about *ever-declining personal saving rates, ever-widening current account deficits, mounting debt burdens, and increasingly wealth [asset] dependent consumers*. It personifies what I believe is one of the most precarious macro models that has ever existed for a major economic power. In my view, income-short growth models are not sustainable – the only question pertains to the circumstances of their demise.

The endgame is not in doubt, in my view. The American consumer will ultimately cave. It is the only means by which the US will ever “fix” its *twin saving and current account problems*. It is the timing and circumstances of that fix that we endlessly debate. Excess consumption is on a collision course with subpar labor income growth. Courtesy of an unrelenting global labor arbitrage, the “big squeeze” is getting tighter and tighter on the world’s only real consumer.”<sup>4</sup>

## **2. Mountains of Debt**

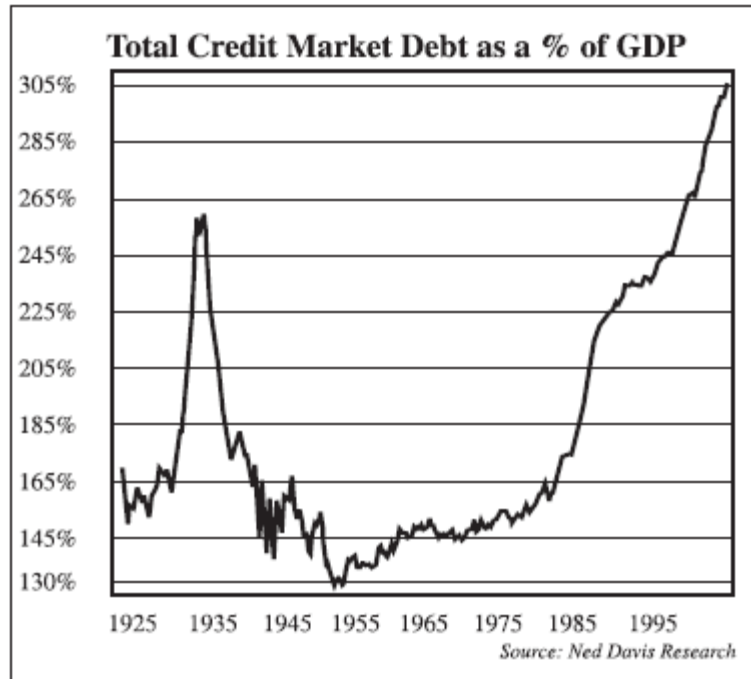
Former Fed Chairman Paul Volcker once said, “Sometimes I think the job of central bankers is to prove Kurt Richebacher wrong.” Having followed the world currency and credit markets for over 60 years, Kurt Richebacher is a trusted voice in economics. In July of 2005, Richebacher notes,

“The Federal Reserve’s Flow-of funds statistics for the first quarter are just out. Evidently, credit creation has been completely taken over by the printing press. In

the quarter, overall credit skyrocketed by \$2,976.1 billion, close to \$3 trillion, at an annualized rate.

Nonfinancial credit was up \$2,411.5 billion. This compares with an increase of \$1.943.2 billion in the fourth quarter of 2004 and \$836.2 billion in 2000.

*Over those four years, credit growth in the nonfinancial sector has literally tripled. To us, this looks more like monetary lunacy than monetary policy.”*<sup>5</sup> (Emphasis Mine)

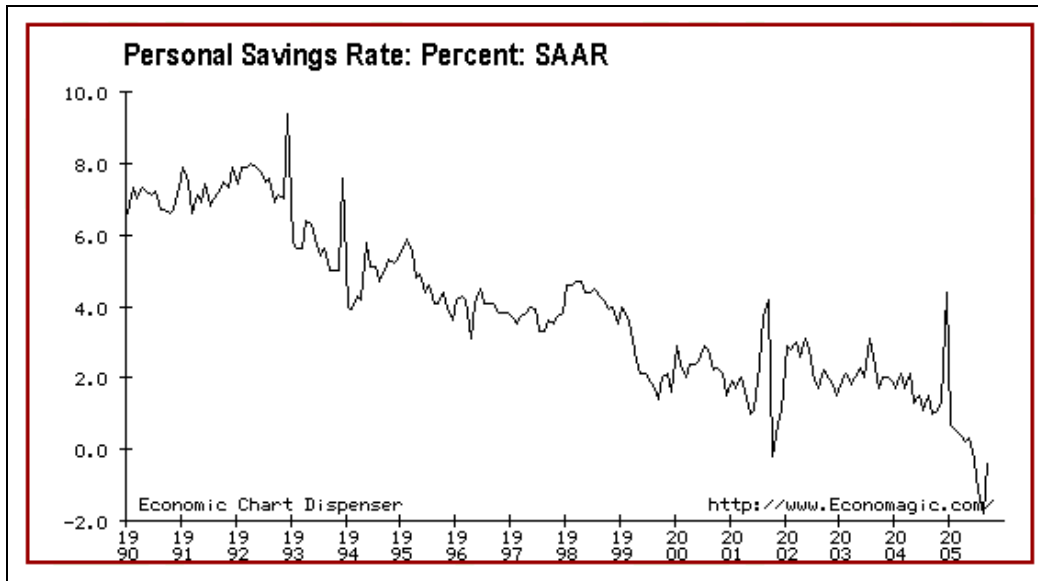


### 3. Personal Savings Plummetts

Paul Volcker was Fed Chairman from 1979 to 1987. In February 2005, Volcker notes the litany of problems he sees with the current US economy and expresses bewilderment at the lack of personal savings.

“Yet, under the placid surface, there are disturbing trends: huge imbalances, disequilibria, risks – call them what you will. Altogether the circumstances seem to me as dangerous and intractable as any I can remember, and I can remember quite a lot. What really concerns me is that there seems to be so little willingness or capacity to do much about it.

We sit here absorbed in a debate about how to maintain Social Security -- and, more important, Medicare – when the baby boomers retire. But right now, those same boomers are spending like there's no tomorrow. *If we can believe the numbers, personal savings in the United States have practically disappeared.*



*We are buying a lot of housing at rising prices, but home ownership has become a vehicle for borrowing as much as a source of financial security. As a nation we are consuming and investing about 6 percent more than we are producing.*

The difficulty is that this seemingly comfortable pattern can't go on indefinitely. I don't know of any country that has managed to consume and invest 6 percent more than it produces for long. The United States is absorbing about 80 percent of the net flow of international capital. And at some point, both central banks and private institutions will have their fill of dollars.” (Emphasis Mine)<sup>6</sup>

In looking at the US personal savings rate over the last fifteen years, it is easy to see why Volcker is concerned.

#### 4. Home Equity Extraction and Household Debt

We speak of home equity extraction as opposed to an overall housing bubble, because the real danger is not the rise in value of houses. Rather it is the extraction of equity and the resulting assumption of debt that makes housing bubbles more baneful than other economic distortions. Richebacher notes this, when he says,

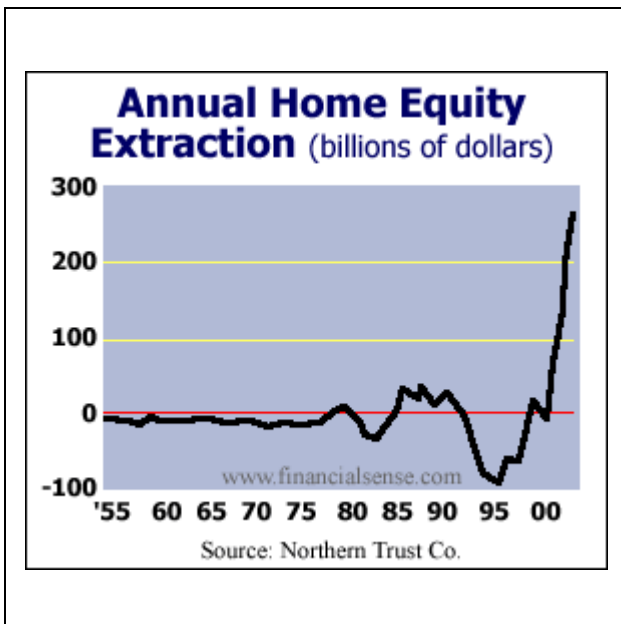
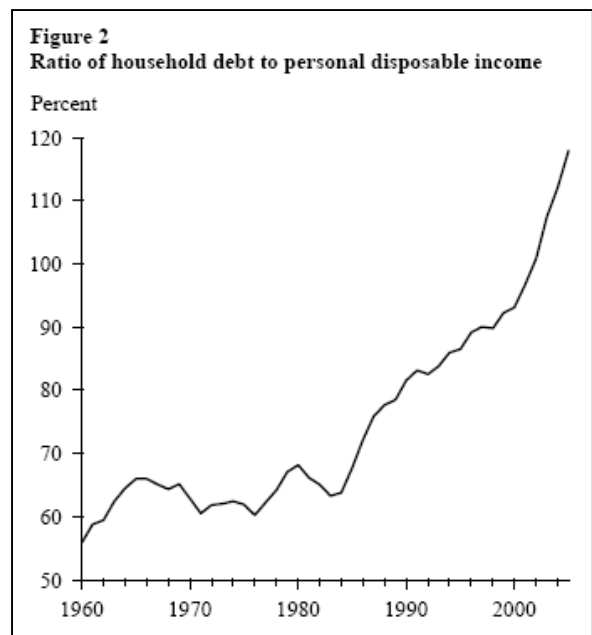
“Equity withdrawal – that is, extraction of housing equity through borrowing against rising housing prices as collateral – is the crucial factor.

*Frankly speaking, we see a general gross illusion among people behind this ballyhoo...about the inherent prodigious wealth creation through rising house prices. But as for the policymakers and leading economists who are publicly trumpeting this stupid message, we presume deliberate, systematic delusion of the public in a desperate attempt to drive up consumer spending in the face of falling real incomes. (Emphasis his)*<sup>7</sup>

House price inflation has delivered the collateral for unprecedented consumer borrowing through mortgage equity withdrawal.”<sup>8</sup>

Yet, in an August 2005 Los Angeles Times article, we read: David Lereah, Chief Economist of the National Association of Realtors, says,

“If you paid your mortgage off, it means you probably did not manage your funds efficiently over the years. It's as if you had 500,000 dollar bills stuffed in your mattress – very unsophisticated.”<sup>9</sup>



In the same vein, Anthony Hsieh, Chief Executive of LendingTree Loans, an Internet-based mortgage company, used more disparaging terms.

“If you own your own home free and clear, people will often refer to you as a fool. All that money sitting there, doing nothing.”<sup>10</sup>

Conversely, Paul Kasriel, Director of Economic Research at Northern Trust, notes that the “wealth effect” of rising home prices is an illusion.

“The rise in household net worth in recent years has largely resulted from inflating prices of corporate equities in the late 1990s, and residential real estate in the past four years. But this rise in household wealth is illusory. The true measure of an increase in the wealth of a nation is the growth in its capital stock. In recent years, growth in our capital has slowed and the composition of the slower growth has moved in favor of McMansions and SUVs, which do little to increase the productive capacity of our economy.”<sup>11</sup>

Kasriel expounds on the possible domino effects of unwinding this illusion.

“What might happen if a severe decline in the housing market caused real estate values to fall for the first time since the Great Depression?

- Household wealth would decline, putting a crimp in consumer spending
- The ripple effect of weaker consumer spending would increase unemployment
- Increased unemployment would lead to mortgage defaults
- Mortgage defaults would lead to further downward pressure on real estate values
- Mortgage lenders, including banks, could suffer significant losses”<sup>12</sup>

Because of the debt assumption associated with housing bubbles, their unwinding often involves more trouble, turmoil, and angst amongst the populace.

## 5. Trade Deficit

The reason this cannot go on forever is because the US is increasingly dependent upon the kindness of strangers.



In

February 2005, Nouriel Roubini, Professor of Economics and International Business at New York University's Stern School of Business, states:

“If the US does not take policy steps to reduce its need for external financing before it exhausts the world’s central banks willingness to keep adding to their dollar reserves – and if the east of the world does not take steps to reduce its dependence on an unsustainable expansion in US domestic demand to support its own growth – the risk of a hard landing for the US and global economy will grow. The basis outlines of a hard landing are easy to envision: **a sharp fall in the value of the US dollar, a rapid increase in US long-term interest rates and a sharp fall in the price of a range of risk assets including equities and housing.** The asset price adjustment would lead to a severe slowdown in the US, and the fall in US imports associated with the US slowdown and the dollar’s fall would lead to a global severe economic slowdown, if not an outright recession.”<sup>13</sup> (Emphasis mine)

## 6. Stock Valuations

Sir John Templeton recently notes,

“I do think it’s interesting that in all my 92 years, I’ve never seen a time when it was so hard to find a bargain. I aided wealthy families by helping them find stocks that were selling at a small fraction of what the company was worth. But now, it’s very difficult to find companies where you can buy the stock at a fraction of its value.

In all my experience, I don’t remember a time where you had to search so diligently to find anything that was a bargain.”<sup>14</sup>

S&P 500 Price/Earnings								
	1929	1937	1968	1973	1987	Average	2000	9/2005
<b>Peak</b>	21	18	19	19	23	20	32	17.6
<b>Trough</b>	8.5	9	13.5	7	12	10	29	?
S&P 500 Price/Book								
	1929	1937	1968	1973	1987	Average	2000	9/2005
<b>Peak</b>	2.8	2.1	2.3	2.2	2.5	2.4	7	2.9
<b>Trough</b>	0.4	1.2	1.6	1.2	1.7	1.22	2.5	?

\*Courtesy of Comstock Partners, Inc.

The chart above evidences Templeton’s observation in regard to a lack of values in today’s markets. Price-to-earnings (P/Es) and price-to-book (P/Bs) ratios are used to compare stock prices.

Charlie Minter, Director and co-portfolio manager of Comstock Partners, notes:

“With a P/E of 29 and a price-to-book of 2.5, the 2002 valuations were way too high to believe that 2002 was really a trough. We are convinced that the trough will come later.”<sup>15</sup>

Minter commented that the September 2005 P/E number is lower than it would otherwise be because it includes operating earnings, whereas all the other P/Es listed used only reported earnings. Minter explained, “Operating earnings are reported earnings with the exclusion of ‘write offs,’”<sup>16</sup> which are large, company expenses.

In October 2004, Jeremy Grantham expounded on this point.

“In theory, operating income and net income should be the same, with unusual debits in the long run being offset by unusual credits. In real life there is a bias to unusual debits because of systemic overstatement of earnings. In the last 10 years, there has been an average of 14% net write-downs.”<sup>17</sup>

Valuations are still closer to prior market tops than prior market bottoms.

## 7. Government Debt

Electing a Republican or Democrat to the Presidency or Congress will not, in and of itself, solve our country’s fiscal problems. History is replete with a lack of fiscal restraint on both sides of the aisle. Yet U.S. fiscal problems continue to grow at an alarming rate.

	2004			2003			\$ Change
	Balance Sheet	Additional Responsibilities	Combined Amounts	Balance Sheet	Additional Responsibilities	Combined Amounts	
<b>Overall Perspective</b> (in billions of dollars)							
<b>ASSETS</b>							
Inventory, cash	\$ 359	\$ -	\$ 359	\$ 372	\$ -	\$ 372	\$ (14)
Property, plant & equipment	653	-	653	658	-	658	(6)
Loans receivable	221	-	221	221	-	221	(0)
Other	165	-	165	154	-	154	11
<b>Total Assets</b>	<b>\$ 1,397</b>	<b>\$ -</b>	<b>\$ 1,397</b>	<b>\$ 1,405</b>	<b>\$ -</b>	<b>\$ 1,405</b>	<b>\$ (8)</b>
<b>LIABILITIES &amp; NET RESPONSIBILITIES</b>							
<b>Social Insurance</b>							
Medicare (Parts A, B, & D) <sup>1</sup>	-	(24,615)	(24,615)	-	(15,006)	(15,006)	(9,609)
Social Security (OASDI)	-	(12,552)	(12,552)	-	(11,742)	(11,742)	(810)
Other (Railroad Retirement)	-	(112)	(112)	-	(110)	(110)	(2)
Subtotal, Social Insurance	-	(37,279)	(37,279)	-	(26,858)	(26,858)	(10,421)
Fed. empl. & veterans pensions/benefits	(4,062)	-	(4,062)	(3,880)	-	(3,880)	(182)
Federal debt held by the public	(4,329)	-	(4,329)	(3,945)	-	(3,945)	(385)
Other liabilities	(716)	-	(716)	(675)	-	(675)	(41)
Other responsibilities	-	(903)	(903)	-	(862)	(862)	(41)
<b>Total Liabilities &amp; Net Responsibilities</b>	<b>\$ (9,107)</b>	<b>\$ (38,182)</b>	<b>\$ (47,289)</b>	<b>\$ (8,500)</b>	<b>\$ (27,720)</b>	<b>\$ (36,220)</b>	<b>\$ (11,070)</b>
<b>BALANCE (Total Assets minus Total Liabilities &amp; Net Responsibilities)</b>	<b>(\$7,710)</b>	<b>(\$38,182)</b>	<b>(\$45,892)</b>	<b>(\$7,094)</b>	<b>(\$27,720)</b>	<b>(\$34,814)</b>	<b>(\$11,078)</b>
<small><sup>1</sup> Part D's Medicare Prescription Drug &amp; Transitional Assistance Accounts not included in 2003 because both established after fiscal year 2003. Note: Details may not add to totals due to rounding.</small>							

The chart above comes from page 16 of the 2004 Financial Report of the United States Government.<sup>18</sup> It shows the US government’s debts in 2004, according the Generally Accepted Accounting Procedures (GAAP), were just shy of \$46 trillion dollars. Perhaps this is why the Comptroller General of the United States, David Walker, is so concerned. A November 14th 2005 USA Today interview with him states,



*“The comptroller general of the United States is explaining over eggs how the nation’s finances are going to hell.*

*‘We face a demographic tsunami’ that ‘will never recede,’ David Walker tells a group of reporters. He runs through a long list of fiscal challenges, led by the imminent retirement of the baby boomers, whose promised Medicare and Social Security benefits will swamp the federal budget in coming decades.*

*To hear Walker, the nation’s top auditor, tell it, the United States can be likened to Rome before the fall of the empire. Its financial condition is ‘worse than advertised,’ he says. It has a ‘broken business model.’ It faces deficits in its budget, its balance of payments, its savings – and its leadership.”*<sup>19</sup> (Emphasis mine)

## **Experts Conclusions**

Roach has written extensively on the macroeconomic imbalances our country now faces. Here he bemoans our current financial environment.

*“In the end, denial is usually the only thing left. Imbalances on the real side of the global economy have moved to once unfathomable extremes. *Perceptions of a Teflon-like US economy underpin this denial.* A personal saving rate that has plunged to zero is widely dismissed as irrelevant. Related to that, record levels of household indebtedness are now viewed as just fine. The budget deficit is depicted as ‘normal.’ And why worry about a world record current-account deficit?*

This sure-thing syndrome all hangs together under an unusually tantalizing financing climate – in this case, underwritten by the extraordinary monetary accommodation of America’s Federal Reserve. Courtesy of its post equity bubble containment strategy, the Fed has taken the [accommodation] to an unprecedented extreme, with one bubble begetting another. Systemic risks in financial markets (and their real economic underpinnings) have only mounted. The longer the central bank waits to deal with a serious imbalance, the greater the imbalance becomes and the more pervasive the concomitant perils of systemic risk.

There is a strong temptation to believe that this relatively benign climate can persist indefinitely. But what the Fed giveth it can now taketh. As I see it, the carry trade is about to meet its demise. Investors banking on the sure-thing syndrome are in for a rude awakening.”<sup>20</sup>

John Mauldin, President of Millennium Wave Advisors, writes on the Fed's ability to rescue flailing US stock markets.

“I wrote a series of articles on the Fed versus History. If you thought the Fed could keep us out of recession, you would be a bull. If you thought History would prevail, you should stay out of the market. I bet on History. Time has shown that History won that fight. History is a tough opponent. Betting against History is usually a losing proposition.”<sup>21</sup>

Mauldin continues,

“Faith is required to invest in this market. You have to ignore high valuations, accounting issues, and all the myriad issues surrounding a secular bear market. You have to believe that two centuries of trends are suddenly of no value. You have to believe that we are in a new economic era. You have to have Faith that this time, things really are different.”<sup>22</sup>

We close this section, with a word of warning from Jeremy Grantham.

“We have in fact searched through all the data that we can find on currencies, commodities, and stock markets and have found 27 bubbles. Unlike Chairman Greenspan, we have no problem in defining a bubble: we arbitrarily use a two standard deviation event, the kind that would occur randomly every 40 years. Predictably (at least for believers of regression to the mean), *all 27 bubbles broke and went all the way back to the preexisting trend! To be equally predictable, the current bubble, which at its maximum inflation in March 2000 was the biggest bubble in American history, will have to pass through its trend of 720 on the S&P 500, currently at just over 1100* [1250 in November 2005]. If it does not do this, it will be the first failure to do so in modern times.”<sup>23</sup>

In light of the preponderance of evidence that suggest an imminent financial decline, what should we as investors do?

## **Conclusion**

To say that this paper has been somewhat discouraging, would be putting it mildly. Speaking about its contents has certainly not won me any popularity contests. But as I discussed in the introduction, the trial by fire that unfolded from 2000 to 2002, painful as it was, forced me out of my comfort zone and into the fray in search of answers. As I learned, at times I wanted to deny the gravity, the seriousness, and the scope of these problems. Yet after a gut check, I began formulating plans, for those I serve and my family, to weather the storm.

The more I learned, the more I felt compelled to write for the benefit of those who will listen, that the truth may be told, and because I realize that we are living through historically significant times. As it became clearer to me that we were in the throes of a mania, I began to look at similar periods throughout history. What were the solutions for investors? What tools and strategies had investors used to secure their futures? While I could have chosen a wide range of topics, there was a dearth of information and a gross misunderstanding in the area of short selling. That is why I chose this topic.

Since the charts and comments from the last section could tend to leave one shell-shocked, I want to shift our focus to the steps every investor should take to prepare for the storm that lies ahead.

## **The Storm**

*We must read* non-traditional sources if we are to get truly useful information. There is a great deal of misinformation given out everyday. Much of it is touted as research or conventional wisdom. In order to understand what is happening in the markets, we must step outside the cacophony of noise to which we have so often turned.

In my humble opinion, the Dow Jones Industrial Average both reflects and is a reflection of the collective social mood of investors. While there are periods of divergence, like the current voluminous amount of negative events accompanied by a four-and-a-half year high, in the long run they move in tandem. Yet we are all aware that the level of the markets has a definitive effect on our future business plans and spending habits.

The significance of the level of the Dow to our national economy cannot be underestimated. Years ago John Maynard Keynes, whose writings have impacted economic thought more than any other economist of the twentieth century, wrote,

“With a ‘stock-minded’ public, as in the United States to-day, a rising stock-market may be an almost essential condition of a satisfactory propensity to consume...”<sup>24</sup>

We must understand that investing is not a gentlemen’s sport played out on a level field. In this comedy of errors that borders on a Greek tragedy we see: corporate leaders elevated to the status of demigods for their ability to get a piece of paper to move higher; political leaders with legions of statistical wizards, who concoct numbers to placate the desires of their various constituencies; and those academicians whose works suit Wall Street’s selling interests, have their theories, which defy the historic record and natural law, moved to the forefront in the financial world and held to as sacred writ. But as long as the markets stay up and my little world continues to provide the comforts I desire, then I assume that all these have the *big* picture under control.

There is no way to completely safeguard oneself against such a sea of troubles. However, if we are cynical enough to understand the existence and elevation of this risk, if we are diligent enough to read and grapple with various resources, and if we are steadfast enough not to be swayed by the sirens of emotion, we might successfully navigate the storm that is to come.

### **The Crew**

We must understand that we are ill equipped to weather the elements alone. Though our common sense *might* be able to cause us to heed a warning, our complexity as humans is both friend and foe. When the current is with us, we laud our gains and deny our losses. When it is against us, we demean our gains and become overly focused on our losses. We tend to be bullish at the top and bearish at the bottom. We rely on conventional wisdom, which fails at market turning points. These, and reasons like them, will always be why the majority of investors who go it alone, do not fare well.

We must understand that only a few individuals are hardwired to go against the crowd. Only a few have the fortitude to continue down a path under constant criticism from the masses. Only a few have the drive to constantly ask the question, “How could my system

be improved?” Only a few have the poise to dismiss the market media, proclaiming brilliance to the most recent frontrunners. Only a few have the tenacity to read the thoughts of dead men (and gain perspective) in a culture that believes if it happened prior to the 1970s, it’s irrelevant.

If we are not hardwired like this group above, then when we must employ a crew that is unlike ourselves before the monsoon strikes. Like any preparedness effort, this takes forethought and time, and requires the logic to prepare before the intensity of the tempest arrives.

### **Charting a Course**

There is nothing new under the sun. This is an old story that is not isolated to any one era, but is repeated over and over again. The characters change, the types of ships may be different, but ultimately it is the same ocean of human behavior.

We must understand that through 400 years, the historical record shows that once a bust ensues, and anger mounts, those who were often responsible for the excesses that created the bubble, seek to villanize those who are not. In 1610, 1734, and 1867 laws were passed to prohibit short selling, only to be repealed later. In 1935, short selling was regulated. Short sellers, who have acted ethically, should be vindicated.

Should history once again repeat itself, it will be important not to get caught up in the emotional rhetoric that is sure to ensue. It will be imperative that the record be made straight for those who acted ethically and those who did not.

We must understand labels are often misnomers. There is no substitute for critical thinking and independent evaluation. Schools of thought that appear to be the Holy Grail, often become artifacts that delineate the same period.

We must understand that governments’ actions affect the markets. While government officials make and change rules that govern our financial markets, they cannot be expected to establish and regulate ethics.

We must understand that markets are not near as random as we have been taught. Markets are affected by the actions of men, both good and bad: Men who lead corporations, men who lead governments and men who postulate theories.

## **Change Course**

In the end, I am trying to get you to change course. Though this may not be the first time you've heard this story, I trust you will see its symbolism.

How often do we make assumptions without knowing the facts? Where are we, and where are we going? Is this real?

“One night at sea, a ship’s captain saw what looked like the lights of another ship heading toward him. He had his signalman blink to the other ship: “We are on a collision course, advise you change course 10 degrees south.” The reply came back: “Divert your course 10 degrees north to avoid collision.” The ship’s captain answered: “I am a captain, change your course 10 degrees south!” The answer: “I am a seaman second class, recommend you change course 10 degrees north.” The captain was furious. He had the signalman reply: “Dammit, I am a battleship! Change your course 10 degrees south!” To which the reply came back, “I am a lighthouse. Your call.”

## Notes

### **Introduction**

1. The Dow Theory(1932) Robert Rhea, page 104

### **Section 1: Corporate and Wall Stree Ethics**

1. Financial Shenanigans: How Tp Detect Accounting Gimmicks & Fraud in Financial Reports, Edition (2002) Howard Schilit, page 3 & 7
2. Ibid, pages 71-72
3. Bull: A History of the Boom (2003) Maggie Mahar, page 270
4. Ibid, pages 269-270
5. Sources used to compile the list of companies were
  - a. [http://en.wikipedia.org/wiki/Accounting\\_scandals](http://en.wikipedia.org/wiki/Accounting_scandals)
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