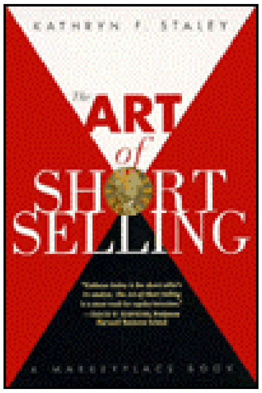

<u>The Art of Short Selling</u> (1997), Kathryn F. Staley.

With Price/Earnings ratios at historical highs (see my article on page 2 of our April 2005 Newsletter) it seems like a good time to look for what we can learn from short sellers.

Since the media didn't warn investors of scandals like Enron and Worldcom until after their stocks collapsed, we have decided to learn from these specialized managers who saw the issues with these and other stocks before their collapse and invested accordingly.

Since most investors have never hired a short only manager and have never shorted stocks themselves, please allow this brief explanation: The short seller buys low and sells high, but they sell before they buy. The short seller borrows shares of a stock or index from someone else with the promise to repay the given **shares**. He then sells the shares in the open market, waits for the stock to decline in price, re-buys the shares at a much lower price, and pays back the shares that he borrowed. For example, say you sold short 100 shares of XYZ Inc and the stock price went from say $100 to $50. You would then buy back the stock at $50 and give back the shares that you borrowed. Your profit would be the difference in share price multiplied by the number of shares.

So, which stocks would we want to short?

Bubble Stocks: "A perfect short-sale candidate is a stock with a large float to allow ease of borrowing and no buy-ins, high stock rice for maximum return, and no business or assets to keep the risk nominal. Shams are created by stockholders, brokerage houses, or corporate executives who relentlessly push the valuation higher without regard for the underlying financials, inflating the prices beyond expectation of future value." *Pg. 43*

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 phenomena. If you find five or six serious questions in financial statement s, you can be sure that there are many more that you cannot see. The corollary to the disclosure dilemma is that most analysts are afraid to admit that they do not understand account or accounting terminology." *Pg. 113*

The Patience of Ten Men: "Wall Street ices the inefficient cake with compulsive conformity. Everyone gets on the bandwagon and stays until the evidence is too compelling, then they all fall off with a jolt. Do not cover just because of price movements; wait until the resolution of the scenario. Short selling can be much like a cat waiting outside a mouse hole – the level of persistence, patience, and attentiveness is not for everyone, especially over sustained periods of time." *Pgs. 274 & 275*

Short selling at times of overvaluation in the markets can be very advantageous and profitable. In the meantime, waiting for the masses to return to reality is difficult to say the least. If it were as easy as we would like it to be, I suppose it would be far less profitable.

Doug Wakefield

Digitally signed by Doug Wakefield
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