STREETSMART GUIDE TO

Short Selling

Techniques the Pros Use to Profit in Any Market

Learn the Techniques of Wall Street's Top Money Managers

Tom Taulli

The Streetsmart Guide to

Short Selling

Techniques the Pros Use to Profit in Any Market

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Foreword

"Buy low, sell high."

Most stock market participants recognize the challenge as well as the humor embedded in that simple adage, but many do not realize that they can change the order. "Sell high, buy low" is an often profitable alternative for those willing to learn the techniques and the pitfalls of short selling.

Short selling is not complicated. First, you sell a security you don't own. How is this possible? Working through your broker, you borrow shares and deliver them to the buyer. In the future, you will have to settle this position by buying shares on the open market and using them to repay those you borrowed. If you can buy those replacement shares at a lower price than your original sale, you make a profit. During the period prior to settlement, you are "short." If the price of the stock rises, then your short position loses value. If the price of the underlying security falls, your short position gains in value.

Investors take short positions for two basic reasons, the first of which is obvious. An investor who believes that the price of a security (or even a broad market index) is going down, can "go short" to profit if his or her hunch proves correct. In the less obvious case, an investor holds both long and short positions in the same portfolio, so that one goes up when the other goes down in value. In other words, the short position is a hedge, and is used to reduce portfolio risk.

As director of portfolio management for a family of mutual funds that include short funds—funds that move in the opposite direction of the general market—I am often asked whether short positions aren't in some way harmful to the securities markets. Particularly after the 2001 terrorist attacks, many journalists expressed discomfort that some investors actually profited from those calamitous events. Isn't it admirable, on the other hand, that our markets offer a means to protect those who are unable to withstand the financial consequences of such a calamity? In the best of market conditions, short selling adds liquidity and flexibility to our already dynamic securities markets. During difficult times, we should remember that those who bought flood insurance did not cause the flood. They are entitled to their claims.

As Tom Taulli makes clear on the pages that follow, short selling is a powerful tool. Short selling can expose investors to unlimited risk, but this same technique can be used to virtually eliminate portfolio risk. In other words, the tool itself is not inherently risky, as long as it is in the hands of a prudent and knowledgeable user.

As we move through the third year of a ferocious bear market, more investors are learning the range of choices available as they approach the role of buyer or seller in a securities trade. Those who take time to understand these choices can unlock a whole new world of investment opportunities.

Charles J. Tennes
Director of Portfolio Management
Rydex Global Advisors
July 5, 2002

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CHAPTER 1

History of Short Selling

Short selling is not a new phenomenon. Its history stretches back centuries to the establishment of stock markets in the Dutch Republic in the late 1500s, when investors realized that they could not only buy a stock long but could also short a stock.

Like many great economic powers, the Dutch Republic had the advantage of access to the seas—making trading easier. To finance the growth of trade, the Dutch Republic had created a stock exchange. One of the hottest companies was the East Indies Company, which was founded in 1602.

Besides short selling, Dutch investors created other newfangled financial instruments, such as options, unit trusts, and debt/equity swaps. One of the most flamboyant short sellers was Isaac le Maire, who basically invented the "bear raid." That is, he would target a company that was faltering and short as many shares as possible, driving the stock price down. After this, he would buy the depressed stock and create rumors to boost the stock value.

The Dutch Republic underwent a tremendous boom. But, like any capitalist wave, it ended—not with a thud, but a thunder. The markets crashed in 1610. Investors wanted someone to blame. Why not short sellers? Don't they profit when stocks fall? Didn't they put selling pressure on the markets?

As has occurred throughout history, the Dutch stock market consequently prohibited short selling. But, as has also been the case through history, the ban did not last long. Investors found ways around it.

For example, in the 1720s, the French market collapsed and short sellers were blamed. Short selling was outlawed. Interestingly enough, Napoleon considered short selling to be treason, because it was more difficult for him to finance his wars when the markets were shaky. The ban was not lifted in France until the late 1880s. Yet during the time of the ban, there was certainly a good amount of short selling.

The Robber Barons

The history of short selling in the United States is similar to that of the Dutch Republic. That is, it did not take long for the United States to outlaw the practice.

Keep in mind that until the 1850s, the United States was essentially a Third World nation. The economic system was quite unstable, as the country underwent extreme boom–bust cycles. To try to mute the speculation, the New York legislature banned short selling in 1812. However, the ban was not very significant. After all, the New York Stock Exchange was small. For example, on March 16, 1830, there was volume of a mere 31 shares. Such low volume days were not at all uncommon.

By the late 1850s, the short selling ban was lifted in the United States, which was good news for the many speculators of the time. Even though the U.S. economy was showing strong growth, the stock market was still small. Thus, it was not difficult for a speculator to move markets.

In fact, new technology was making it easier to trade. The invention of the telegraph in the 1840s made it possible to trade on a national basis. Then in the 1860s, a telegraph cable was laid across the Atlantic Ocean, making it easier for European investors to access U.S. markets. It was also during this time that the ticker tape was invented. As the name implied, this was a machine that streamed current stock quotes from the New York Stock Exchange.

A critical element in the economic growth of the U.S. economy, and in the boom of the stock market, was the rise of railroads. But building railroads required huge amounts of capital. Thus, savvy financiers had to find ways for these railroads to get the much-needed investment dollars.

For the most part, these financiers were fiercely competitive. They would do just about anything to make money. And the top financiers would make fortunes. They were known as robber barons.

One of the first robber barons was Daniel Drew. Although illiterate, he was an expert at short selling. One favorite technique was "the corner." Simply put, it means an investor captures most of the market of available stock. Once this was done, the speculator could dictate the price.

For example, Drew would manipulate a stock, driving up the stock price. It would achieve a very high valuation. Short sellers would see this as a chance to make money from the collapse of the stock. But Drew would control most of the stock; he had cornered it. Thus, when short sellers tried to cover their shorts, there was no stock to do it. It could be ruinous for them. One of Drew's favorite sayings was: "He who sells what isn't his must buy it back or go to prison." This was definitely the Darwinist view of the era.

In 1854, Drew loaned the Erie Railroad $1.5 million and eventually took control of the company. The railroad was poorly managed and its stock price crashed several times. Interestingly enough, he shorted the company's stock, making huge sums of money.

Drew met Jay Gould and Jim Fisk, both of whom also wanted to make a fortune buying and shorting stocks. Gould was a fervid entrepreneur. His first business was a tannery, which quickly became profitable. He parlayed the money from this business into investments in hide futures. By 1818, at the age of 21, he was a multimillionaire.

As for Jim Fisk, before making his splash on Wall Street, he had such disparate jobs as a waiter and a ticket agent for a circus. In fact, he eventually earned the nickname of "Barnum of Wall Street."

When Drew died in 1867, Gould and Fisk took control of the Erie Railroad. For them, the company was a personal piggy bank. Gould and Fisk used the Erie treasury to finance their extravagant tastes.

These so-called robber barons also had strong political connections. For example, Gould was close with Boss Tweed and the Tammany Hall Group that ran New York City. Bribes became an ongoing cost of business. Gould even bought the *New York World* newspaper. It was an ingenious way to hype his business interests.

Besides running a railroad, Gould was a speculator. At one point, he attempted to corner the gold market and made about $10 million.

As a result, several major investment banks went bust. Because of the incident, a New York crowd attacked Gould. It was no surprise that, after this, Gould would always have a bodyguard. By 1872, he had been removed from the railroad. It was also during this year that Fisk died, after being shot by the lover of a former mistress.

No doubt, the eighteenth century was a financial free-for-all. There seemed to be no boundaries. Take, for example, John Gates, who was the president of the American Steel and Wire Company. He announced that business was soft, so he laid off workers and closed down plants. He also shorted the company's stock, which went from the $60s to the $30s. He covered his short and then announced that business was better. He hired back the employees and opened the plants. Of course, he bought the stock in the $30s, making a tidy profit when the stock rose again.

Livermore

By the twentieth century, the stock markets were getting much bigger and, as a result, more difficult for individuals to manipulate prices. Besides, there were more regulations, such as the ban on cornering a stock.

Despite this, there were legendary traders who made fortunes from short selling. One was Jesse Livermore, who was born in Massachusetts in 1877. At age 14, he left home and got a job at Paine Webber. It was not an exciting job; basically, he would post stock prices on a chalkboard. But it turned out to be a great education. He closely watched how stock prices moved and wondered how he could make money from the volatility.

In Livermore's era, there was little information available about stocks. Rather, investors would act mostly on rumors (or, in many cases, create the rumors). The atmosphere was wild.

But Livermore did not believe in rumors. He thought he could use stock movements as a way to make money from the market. He had a photographic memory and incredible math skills. He could remember all the historical price movements of the stocks he followed. From this, he was able to determine profitable trading patterns. Essentially, Livermore was practicing technical analysis (which is explained in detail in Chapter 11).

Livermore had no preference between buying long or shorting a stock. Rather, he would do whatever would make him the most money. Some of his most memorable trades were short sales. In 1906, he shorted Union Pacific Railroad. Within a few months, the San Francisco earthquake hit and the stock crashed. Livermore made about $250,000 on the trade. A year later, Livermore thought the stock market was overvalued and shorted heavily. The stock market crashed in October 1907 and Livermore made about $3 million.

Livermore lived large. He had an estate on Long Island and a 300-foot yacht, which he used to commute every morning to Wall Street. Livermore quickly became famous on Wall Street. In fact, his nickname was the "Boy Plunger." But Livermore had his detractors. Among them was J. P. Morgan, who was angered and (and perhaps envious) that Livermore had made a fortune from the panic of 1907.

Livermore was not always a winner. In his lifetime, he declared bankruptcy four times. For example, in 1915, he made some bad trades and accumulated $2 million in debts. However, after two years, he paid off all the debts using money he earned in the stock market.

He shorted the market in 1929 and made another fortune (some estimates are $100 million). But many people believed that Livermore was the cause of the crash and economic bad times. As a result, Livermore received multiple death threats and had to hire a full-time bodyguard.

Interestingly enough, in 1934 Livermore went bust again. He was able to pay off all his creditors and even start his own financial advisory firm, but in 1940 Livermore committed suicide.

One of Livermore's contributions to investment theory was the book he wrote in 1923, *Reminiscences of a Stock Operator.* Here are some of the many great investing rules from the book:

Profits always take care of themselves but losses never do.

There is only one side to the stock market; and it is not the bull side or the bear side but the right side.

The speculator's chief enemies are always boring from within. It is inseparable from human nature to hope and to fear. In speculation when the market goes against you, hope that every day will be the last day—and you lose more than you should had you not listened to hope—to the same pioneers, big and little. And when

> the market goes your way you become fearful that the next day will take away your profit, and you get out—too soon. Fear keeps you from making as much money as you ought to. The successful trader has to fight these two deep-seated instincts. He has to reverse what you might call his natural impulses. Instead of hoping he must fear; instead of fearing he must hope. He must fear that his losses may develop into a much bigger loss, and hope that his profit may become a bigger profit. It is absolutely wrong to gamble in stocks the way the average man does.

Never act on tips.

"The Park Bench Statesman"

Another famous short seller was Bernard Baruch. Born in 1870 into a working-class family, he started his career as an office boy on Wall Street after college. He worked hard and eventually became a partner at the Wall Street firm of A. A. Housman & Co, with a seat on the New York Stock Exchange. By age 30, he was a millionaire.

One of Baruch's most famous short sells came in 1901. At the time, Amalgamated Copper Company attempted to monopolize the copper market, driving competition away—and prices up. However, Baruch thought that higher prices would lead to lower demand. He was not convinced that the copper market could be cornered, so he shorted the stock. He was right and made about $700,000 on the trade.

Over time, Baruch collected papers that defended the practice of short selling. In 1913, he published the collection in a book called *Short Sales and the Manipulation of Securities.* Baruch did not use his name on the book because he was often blamed for falling stock prices, as a result of his short selling. Besides, he had to testify before Congress regarding his involvement in short selling.

Baruch thought the book would help reduce the U.S government's pressure to restrict short selling. In the book, Baruch details many real-life examples outside the stock market that parallel short selling. Don't homebuilders sell homes before they are made? Don't farmers enter contracts to sell crops before they are harvested? In other words, short selling was really not all that unusual. In fact, Baruch argued that short selling was a critical part of the financial system.

Ultimately, it was not short selling that Baruch became known for. During World War I, he joined the Council of National Defense and then became the chairman of the War Industries Board. He subsequently became a close adviser to presidents Harding, Coolidge, and Hoover. In this role, he did not have an official title and, consequently, he got the nickname "park bench statesman."

The Roaring Twenties and New Regulations

The 1920s saw a huge surge in the stock market, as the economy grew at a rapid pace. While the railroad was the driving force in the 1800s, it was radio and autos that drove economic growth in the 1920s.

In the 1920s bull market, investors tried to find the best ways to make money. One approach was to form a pool of capital. One of the most notable was organized by William Durant. Interestingly enough, he was also the founder of General Motors.

With his massive pool of capital, Durant could manipulate stocks for profit. One target was International Nickel, a mining company based in Canada. It was a favorite for short sellers because of its erratic performance. As for Durant, he used his pool of capital to drive up the price of the stock 60 points, trying to corner the stock. Then more and more investors shorted the stock. As the stock went higher, the shorts were forced to cover at higher prices. Basically, the short sellers were forced to buy Durant's stock at inflated values.

As stock prices increased more and more, there was a rush to buy stock. Everyone wanted to get rich. It was a mania. And a major factor driving the stock prices upward were the market manipulations of capital pools like Durant's. But by the middle of 1929, the market was starting to falter. Big investors were sensing that the market was overvalued and began to take profits. Then, in October, the stock market crashed.

As usual, short sellers took the blame. Didn't they make money when the stock prices fell? Wasn't it their heavy selling of stock that ended the bull market? Ironically, though, short selling actually was light during the late 1920s compared with previous decades. Savvy investors had already learned that shorting stocks when the market was booming was a quick way to lose money.

When the market fell in 1929, there certainly was no shortage of abuses to point out. One of the most notorious was that of Albert Wiggin. No doubt, he was on the fast track of finance in the first part of the twentieth century. By age 36, he was the youngest vice president of Chase National Bank. By 1911, he was the president of the bank. At one point, he served on 59 boards of directors.

When the markets were falling in October 1929, he helped form a banker's pool, which was supposed to help prop up stock prices. Yet at the same time, for his personal account, he was actually shorting 42,000 shares—of Chase, his own bank! It was a profitable trade, netting him a cool $4 million. He did not even have to pay for the stock he covered; Chase lent him the money to do this. And he did not have to pay taxes on the trade because he used a tax loophole.

The nation was in outrage and as a result, President Herbert Hoover launched a Senate investigation into the practice of short selling. Consequently, Congress passed key legislation that resulted in wide-scale regulation of the securities markets. The Securities Act of 1933 required complete disclosure of any offerings of securities to the public. Then the Securities Exchange Act set up the federal regulatory agency for the securities agency, the Securities and Exchange Commission (SEC). Also, the Federal Reserve was given the power to regulate margin requirements.

The first chairman of the SEC was Joseph Kennedy, who practiced many of the antics of Wall Street during the 1920s. In appointing the Kennedy patriarch and stock market insider, President Franklin Roosevelt chose someone he thought would know "where the bodies lie."

In the Securities Exchange Act of 1934, Congress drafted Section 10(a), which gave the Securities and Exchange Commission wide powers to regulate short selling. To this end, the clause provided a definition of short selling: the sale of a security that the seller does not own or that the seller owns but does not deliver.

When the stock market tumbled again in 1937, the SEC wielded its powers under 10(a) and created clause 10(a)-1. Interestingly enough, this clause has remained virtually intact until today. It is the uptick rule, which briefly states that an investor cannot short a stock if the price has decreased (this is explained in more detail in Chapter 3).

Why the new rule? The SEC believed that short selling could result in undue downward pressure on a stock price. However, if a short sale can only be conducted when the stock is up, then this problem would be avoided.

The SEC and Short Selling Rules

Over the years, the SEC has conducted a variety of studies on the effects of short selling. They include:

- 1963 Study. The report demonstrated the relationship between short selling and price patterns. It showed that short selling volume increased as markets declined and that the uptick rule did not prevent the ill effects on stock prices that Congress intended. The report called for better record keeping of short sales.
- 1976 Report. This study found that data collection on short sales was lacking, making it difficult to study the overall effects of short selling.

  The SEC proposed the temporary suspension of the uptick rule in an effort to determine whether there was indeed a relationship between short selling and falling markets. The SEC received 12 comments from the industry to the proposal and 8 were against. Two of the dissenters were the NYSE and the AMEX

  In 1980, the SEC withdrew its proposal to indefinitely suspend the uptick rule.
- In 1991 the House Committee on Government Operations published a report on short selling. The report said that short selling was confusing to most investors and that the uptick rule was not necessarily helpful for protecting investors.

  Additionally, the report indicated that short selling provided an effective means of providing liquidity to markets and could stabilize volatile situations. Also, the report suggested that investors overemphasized the power of short sellers on affecting prices.

In October 1999, the SEC made yet another attempt at changing the rules of short selling. It did this by publishing a so-called Concept Statement. It was an attempt to get comments from the industry to see if the uptick rule was still viable. While the proposals were extensive,