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A Simpler, Safer Way to Profit When Stocks Go Down

SELL SHORT

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Sell Short

To my wife, JJ, for her infinite patience, invaluable support,
and the world's most loving red pen.
And I promise, more to come.

Sell Short

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Introduction

There is something almost sexy—if anything remotely related to investing and trading could be called or considered sexy—about shorting stocks. Just as the term "politics" often conjures up visions of smoke-filled rooms filled with faceless deal-making by men of power, shorting evokes images of men in bright suspenders with cigars and whiskey snifters discussing what company they should kill next on the stock market.

Ah, investing in the time of visual media.

I don't wear suspenders and I don't smoke cigars, yet I collect rare whiskeys and I short the hell out of stocks. Technically, I invest against stocks and markets and have made my subscribers obscene amounts of money since my newsletter service, *ChangeWave Shorts,* came into existence in the fourth quarter of 2006. My analytical approach is that of an investor—I stick to fundamentals; and my positions are those of a trader—a mix that has kept me and my subscribers ahead of Wall Street. This approach also kept me in the fray when the Securities and Exchange Commission (SEC) suspended the traditional shorting of financial stocks in September 2008. And that is what this book is all about—a marriage of fundamental investing and trading techniques to make spectacular profits on what the Street calls "the short side" of the market. The fundamentals tell me, and you, what is wrong with a company or market segment; the trading tool enables you to take maximum advantage of that weakness in a relatively short period of time. And, with shorting, time is on our side—a stock or segment may take six months or a year to rise 10 percent or 20 percent or 40 percent; that can all be given back on one day when bad news or a major catalyst tells investors something is wrong with the company they did not know of before.

You can short anything—stocks, bonds, ETFs, indices, futures—and you can use a variety of techniques: outright shorting by borrowing shares, buying puts, writing calls, writing spreads, and so on. You can even short a raging bull market rally. All of this seems mysterious and unapproachable, but it is not. So-called experts like to hide behind jargon and charts that look more like the diagram of a new form of pasta rather than admit that shorting stocks is about making money on something that goes wrong—and spotting what is wrong is something all of us can do, right now.

This approach fits current trends in the market and among individual investors. Five years ago at a Money Show—a trade show for individual investors—when we asked several hundred subscribers to various ChangeWave services how many actively traded, the show of hands was 10 percent to 15 percent. When we asked that question in August 2008, the response was roughly 85 percent. The jargon and speed often linked to the term "trading" may make a more traditional investor take pause, but that should not be the case. Puts and ETFs—the two principal instruments used to short lousy companies and market segments—are as easy to buy and sell as most stocks. And when you marry weakening fundamentals to trading tools such as a put you create tremendous opportunities for short side profits. Trading is not hard—it may be new, and to a certain extent requires a bit more of your time—and when married to weakening fundamentals creates tremendous opportunities for short side profits.

In this book I will show you how to select a fundamentally weak—and weakening—company and stock, market segment, or index, independent of market conditions. I will then show you how to use a variety of trading techniques, depending on your tolerance of risk and your financial goals, on how to best go about making money when a dog of a stock finally goes down. Along the way I will use many examples from my service, including e-mail from subscribers—people just like you—on how and what they did, and the money they made.

This is not a trading system, nor is it a set of hard and fast rules for a particular kind of fundamental analysis. Rather it is a method geared to individual investors, financial advisors, and money managers unfamiliar with and (probably) uncomfortable with putting money to work on the dark side. This method works in a very unambiguous manner—in 2007, with the S&P up 3.7 percent, the average position in my short newsletter service, *ChangeWave Shorts,* was up 50 percent.

If you flip pages—before or after buying the book—do not be fooled by the language I have opted to use. I have tried very hard to avoid jargon, charts, complexity, and other tactics used by others to show how smart they are and how dumb the reader is. You are not dumb, you are very smart, having taken a critical step in your financial future or the future of your clients—you have decided to go short. You have been my guide in writing this book and it is designed to answer this question: What does the individual investor need to know to make money on the short side?

I have been writing for both institutional investors and individuals for seven years and the key to getting a point across is to imagine a dialogue with a subscriber or someone attending one of my seminars at a Money Show. As part of the preparation of this book I have not just imagined this dialogue but reached out to my subscribers, attendees at my seminars as well as hedge fund managers, advisors, stock brokers, and other money managers, not to mention the professionals at the Chicago Board of Options, ChicagoOne, the exchange for single stock futures, and two brokerages specializing in options trading, Options Express and ThinkorSwim. Critical input was given by Jerry Scheinman, managing director of Alcyone Capital. I have also solicited the input and advice from that media star and options guru, Jon Najarian of OptionsMonster; Bryan Perry, money manager and editor of *The ChangeWave Tactical Trader;* and the founder of ChangeWave and the man with the best understanding of what drives individual investors perhaps to be found anywhere, Tobin Smith. I also want to thank all the people at ChangeWave who put up with me every day: Dave Durham, Chris Marett, Howie Present, Chip French, Dawn Pennington, Val Maczak, Greg Tucker, Kim Gerdes, and Emily Norris.

But the most important contributor was my toughest critic and greatest supporter, my too long patient wife, Jackie Judd, a far better writer than I could ever hope to be (with two Emmys and various other awards to prove it) and a never-ending source of whatever I needed when I needed it.

And my thanks to you for buying my book, and if you are still debating whether to buy this book I ask you to consider the following story. In October 2007 I noticed lots of coupons at casual dining restaurants—being marketed and being used—and asked our survey group at ChangeWave to do a restaurant survey. They did, and using a simple set of survey data from ChangeWave Research, plus third-party data available to anyone, and a few tax deductible dining experiences, led me to recommend the shorting of Ruby Tuesday in the fall of 2007. A couple of months later my conservative subscribers were up about 500 percent, the aggressive ones 1,500 percent. And they could even check out my arguments and enjoy the salad bar at the same time—my teenage sons prefer the ribs or mini hamburgers. Did I think Ruby Tuesday was going out of business? Nope. Did I think Wall Street did not understand how their business was going to be hit by competition and the recession not yet called a recession? You bet. Not so complicated after all.

You can do it—put your doubts away—find your inner contrarian that has made you money on the long side, and come join me on the dark side where the brightest profits can be found. Now.

CHAPTER 1

The Schadenfreude Component of Your Portfolio

German is a rich language that has many expressions and words that do not translate with the vigor and depth they hold in their original form. One is schadenfreude, the German word for "taking delight in the misery of others."

In this book, I am going to teach you how to profit (and at parties and other places you can brag, revel) from financial schadenfreude. My definition of schadenfreude is simple—"making delightful profits in the misery of stocks." I know this sounds awful, and is a play on words, but successful shorting is nothing short of fun. You may be happy when a company has great earnings or gets an FDA approval for a new wonder drug to treat bald men with erectile dysfunction but there is nothing like the rush when some dog of a company misses big time, or does something else stupid and blows up completely . . . especially if you have money in the right place at the right time.

I was sitting on the Washington set of Fox Business News when Bear Stearns began the last stage of its volcanic meltdown on Friday, March 14, 2008. My recommendation to short Bear was just seven trading days old. It was about 9:55, the producer was speaking in my ear and giving me a five-minute warning; I looked up at the monitor and saw the stock was absolutely melting. I pulled out my Blackberry, typed an alert to subscribers, sent it to my editor, and closed the position with a 287 percent gain. And when the anchor began asking me about Bear, about seven minutes later, I was on fire—in a true state of financial schadenfreude. Why? Because I was right—Bear was a dog, a dog among many Wall Street dogs, and it had just completely blown up.

Why did this feel so good?

Because **stocks fall a lot faster on bad news than they climb on good news,** excepting a little biotech getting a major FDA approval or a company being acquired at a ridiculous price. Short positions work a lot faster—when they work. In fact, I closed Bear too early. The following Monday the stock went from $25 to $2 and the puts I closed would have been up 800 percent. Many of my subscribers did hang on and made that 800 percent in less than two weeks.

Growth in the Shorting of Stocks

Shorting is now a common occurrence and variations such as naked shorting have been in the headlines for many months. In mid-2007 the SEC ended the uptick rule, and one year, lots of volatility, and $100 billion in shares later, shorting became as natural to many investors as going long. In the past years dozens of Exchange Traded Funds (ETFs) designed to short (or double short, more on that later) have come into being. Put volume has exploded in the last year and, the last indicator and my favorite indicator of the growing acceptance of shorting, my newsletter *ChangeWave Shorts* has added a great many subscribers. It isn't just the profit opportunities presented in a volatile and down market—it is people coming to understand that there are two sides of a trade and what is so wrong about playing the downside of a stock movement? If you have never shorted a stock or bought a put, and are about to do so, you are not an explorer or pioneer—you are an early settler on a new frontier.

What sent you to this frontier? You want to make money and fast profits based on great trades.

The Contrarian View

Most investors and traders going short are contrarians—they do well going against the grain. You may not view yourself this way but you have already bought the book so take another look in the mirror. What really is a contrarian? It is the person looking at the bounce in homebuilding stocks in January 2008 as analysts cried a bottom must be near—the contrarians drove around in their cars and saw abandoned home sites and more and more for sale signs. It is the trader saying I don't care if the stock is down 50 percent and that is a historical trough, the damned restaurant is giving away coupons left and right and the parking lot is empty most of the time. And it is the newsletter writer—moi—who hears analysts saying Citigroup will never cut its dividend but spends time with überanalyst Meredith Whitney (totally brilliant, now with Oppenheimer), reads the SEC documents and says those guys at Citigroup are toast (a formal analytical term for being in deep trouble), the other analysts are wrong. Thirty-five points to the downside later, the position had made a great deal of money showing the great value of being in early, ahead of the herd on Wall Street.

If you have only invested on the long side, remember that many great long side investors are also contrarians—a fellow by the name of Buffett calls it value investing but the deep value he finds is only found in stocks other people hate, making him the ultimate contrarian.

The corollary to being a contrarian is to **avoid the crowd**. The madness of crowds. The momentum players. The headline traders. This does not mean you avoid a great opportunity because other people may see the same thing—or if it has downside momentum—I just think you should avoid going short simply because momentum is there. I know, some of the great trading systems of the past few years are built around momentum indicators—go for it if you will—but that is not what true shorting is about. Momentum trading is agnostic to the long or the short side and because the relative value of indicators changes as the market changes, momentum systems work and do not work based on market conditions. On the other hand, going short is about lousy companies—and lousy companies and declining market segments—as measured by fundamentals. Momentum passes; fundamentals are forever.

Instead, think contrarian, against the crowd, against and ahead of wrong Wall Street expectations. Ah, yes, those famous Wall Street expectations. If you keep reading, I will show where and how to gauge those expectations to better measure your own, hopefully contrarian and therefore profitable views. The bottom line: There is a great deal of money to be made investing against the Four Hs that drive Wall Street: headlines, hysteria, hype, and hope.

Getting Started—Where in Your Portfolio?

What percentage of your portfolio should you allocate to shorting? Sorry, the question is not that simple. The funds you use for shorting stocks should be from your trading account and/or high risk capital—and that means it lies somewhere between 0 percent and 100 percent of your capital. When allocating capital, remember, you are not shorting the market, you are shorting lousy companies or lousy market segments that will fall regardless of or in spite of the market.

Getting started involves certain tasks:

- Determine what part of your portfolio will fund short investing.
- Determine what percentage of your capital goes to the short side.
- Determine how big each position will be.

I cannot and should not recommend to you how much money should be in the high risk or trading part of your portfolio. That being said, I ask you to look at the market itself as an asset subject to traditional asset allocation. What exactly do I mean? Traditional portfolio allocation says to diversify your portfolio along traditional lines—small cap, big cap, aggressive growth, domestic markets, foreign markets, emerging markets, income stocks, and so on. What is missing from traditional asset allocation formulas is the market itself. The market is always there; trading is always going on; there is a potential winner and loser for each trade; the trading of the market generates huge revenues every day. So consider the playing of the downside as playing the market itself, and this is a new slice of the asset allocation pie.

The first task is to determine where the capital you use to short stocks comes from—what part of your portfolio. One view is since you short a stock based on fundamentals, using the same logic as going long, you should use any funds you currently allocate toward buying equities. Another view is that since I am recommending you use puts—and, as you will see, without sell stops in most situations—you should only be using high risk or trading funds for shorting stocks. My view: **Start with funds you would normally allocate toward the higher risk component** of your portfolio, funds from a trading account, or funds you are currently using to trade options. As you get comfortable with the process, you can add funds from other parts of your portfolio as long as you remember puts can expire worthless.

The second task is to determine how much of your portfolio—your high risk funds—goes to the short side. It all depends on the opportunity. But since my first rule is to play defense, and the second is to wait for the great trade, it is best if each position is no more than 5 percent of the capital you have allocated for the short side, preferably less. Since you are shorting lousy companies, markets, or market segments, each judged to be going down for unique reasons, your decision to invest is based on the opportunity, not on a portfolio allocation mechanism, or some abstract decision about how the general market is moving. If you follow my lead, you don't or should not really care, except in extreme circumstances, where the market is going. You are exploiting an individual opportunity to make a profit, end of story.

Apart from this advice, **always let common sense take over**. Many successful investors and traders balance their portfolios with short positions in recognition that there is as much bad news and downside weakness in equities, bonds, and markets as there is upside. Warren Buffet does not short stocks but he made a massive bet against the U.S. dollar with a variety of investing instruments, in essence creating a short position against the greenback. If he can go short to exploit an opportunity or to provide some balance to his holdings, you can as well.

When to Short?

Your delight, your profits, your early retirement, your ridiculous case of wine—they come from being agnostic about the direction of the market and being right about a stock or market segment when most other investors are wrong.

When should you short a stock? While each trader has his own preferences for going short or long, several rules of thumb will help you get started and ultimately drive how you spot potential opportunities.

- **You short when you see bad news and disaster coming for a specific company or market segment, not based on a view**