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SPECIAL REPORT

Who are the short sellers?

With equal fervor, managers are both criticized and lionized, but low profile

By [Alistair Barr](#), MarketWatch
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SAN FRANCISCO (MarketWatch) -- Four hundred years ago, the Dutch government made short selling illegal. Two centuries ago, Napoleon banned the practice.

During Congressional hearings on short selling in 1991, Dennis Hastert, now speaker of the House, called it "blatant thuggery."

This year, the uproar surrounding shorts has reached a level unseen during the modern era, as a series of companies mount legal attacks over the allegedly underhand schemes that short sellers use to force down stock prices.

"CEO types have a visceral loathing of short sellers and portray them as nefarious people hiding in the shadows."

— James Angel, Georgetown University

The Securities and Exchange Commission, the National Association of Securities Dealers and the New York Stock Exchange are investigating. And in March, the issue went prime-time when "60 Minutes" reported on one of the most high-profile lawsuits, between SAC Capital, a giant hedge fund run by Steven Cohen, and Canadian drug company Biovail Corp. ([BVF](#)).

Until recently, short sellers operated on the fringe of the marketplace and weren't considered much of a force in the ups and downs of most share prices. And although the still-unfolding corporate backlash against shorts has resulted in much attention and fervent debate, many investors still know little about the people specializing in short selling, and how far-reaching they actually can be.

It turns out that if you buy a stock, there's a roughly 1-in-4 chance you're getting it from a short seller.

"CEO types have a visceral loathing of short sellers and portray them as nefarious people hiding in the shadows, attacking upstanding American companies," said James Angel,

associate professor of finance at Georgetown University, who studies the practice.



Thwarting the shorts

An array of adversaries is making it harder to be a winning short seller.

Case vs. 'naked' players

"Naked shorting" adds fuel to the debate over the legality of shorts.

Masters and maligned

Short sellers are criticized and lionized with equal fervor, but little is known about their influence.

Good, bad and the ugly

Some shorts expose fraud, but others end up becoming a scandal themselves by plying their trade.

"But the real short sellers are a small and shrinking niche community of the investment world who are our first line of defense" against unscrupulous stock promoters and over-valued shares, Angel added.

If the stock market is about allocating capital to the best businesses, short sellers act as a foil to that process, rooting out potentially weak, underperforming companies and betting against them. Traders sell borrowed shares and then -- if all goes according to plan -- buy them back at a lower price and return them to the lender. What's left over is profit.

Skeptical contrarians to the core, short sellers' interest is often piqued by a soaring stock price, super-fast revenue and profit growth and adoration by Wall Street analysts. The bigger the company and the more over-valued the shares, the larger the potential profit.

But shorts frequently target small, struggling companies that critics say are vulnerable to attack.

Indeed, the practice has become a big part of the U.S. stock market's daily gyrations. Short interest, a measure of stock held by investors using a shorting strategy, accounts for 2% to 5% of total shares outstanding on the New York Stock Exchange and the Nasdaq, according to Angel.

But this snapshot measure doesn't capture a lot of the quick trading of some market participants, Angel noted. When that's included, short selling ends up accounting for roughly one-quarter of the volume of trading.

"When you buy a stock, one time out of four you're buying from someone who is selling short," Angel said.

Much of that activity is from market makers who go short all the time to ensure customers' orders are processed quickly. And most hedge funds, by definition, take short positions to offset their "long" investments, often as part of an arbitrage strategy, Angel noted.

Traders who spend most of their time sniffing out short ideas are a rarer breed. Angel reckons these short specialists -- increasingly targeted by companies being shorted -- are responsible for about 1% of the short interest on the NYSE and Nasdaq.

Hedge Fund Research Inc. currently tracks 23 short-selling managers overseeing \$500 million in assets, although many short funds, aiming to keep a low profile, don't report assets and performance to the firm. Still, the money in short portfolios is considered a sliver of the \$1.1 trillion managed by the hedge fund industry.

Harry Strunk, a Palm Beach, FL-based consultant and hedge fund investor, began tracking short sellers in the early 1990's. Back then, Strunk followed 25 managers. Now he says that's down to roughly 10 as some managers have opted to include more long investments in their strategies, an easier, less controversial, approach.

But there are still several big short sellers plying their trade in an increasingly difficult environment.

The cynic

Jim Chanos is often the voice of the short-selling community and the example most cited by supporters of the practice who say it's the best

market-based way to root out corporate fraud.

Chanos is president of Kynikos Associates (kynikos is Greek for cynic). The firm is the largest fund specializing in short selling, overseeing almost \$3 billion in assets, according to an SEC filing last year. Founded in 1985, it's also been in the business longer than most short selling funds.

Chanos, who declined to be interviewed for this story, is best known as one of the first to spot problems at Enron before the oil trading giant collapsed in 2001.

"If he didn't ask questions about Enron, the stock would have gone to even higher levels and eventually fallen even further," said David Tice, manager of the Prudent Bear Fund

Alistair Barr is a reporter for MarketWatch in San Francisco.

(BEARX) , a mutual fund that puts most of its \$560 million in assets into short positions.

But other trades have been more profitable for Chanos, who focuses Kynikos' research effort on companies that have materially overstated earnings, are victims of a flawed business plan or are committing outright fraud, according to the text of Enron testimony he gave to Congress in 2002.

Chanos made money from uncovering accounting shenanigans at Boston Chicken in the 1990s. Other noteworthy bearish calls were on Sunbeam, Consec and Integrated Resources.

Before starting Kynikos, Chanos made his name as a short seller at boutique Gilford Securities by questioning the accounting of insurer Baldwin-United in 1982. The call sparked lawsuits against the firm, but ultimately proved correct when Baldwin collapsed in the biggest financial-services bankruptcy up to that time.

Kynikos' most successful trades have come from spotting debt-financed asset bubbles, such as the real estate market of the late 1980's and the telecom crisis at the beginning of this decade, Chanos told newsletter Value Investor Insight in an interview last July.

Technology companies whose products become obsolete are another favorite short for Kynikos. Cable TV companies like Comcast Corp. are suffering from this as TV is headed for the Internet and broadband access becomes a commodity, Chanos told Value Investor Insight.

Kynikos' returns have been volatile, but that is often the case with short-selling funds, which are typically included in a diversified portfolio of other investments as a hedge against market declines.

After generating returns of more than 120% in 1990, Kynikos' Ursus fund lost 31% in 1991, 15% in 1992, 44% in 1993, 41% in 1995 and 14% in 1996, according to a hedge fund investor who declined to be identified because the data are private. Ursus didn't recoup those losses until July 2001.

When he's not sniffing out fraudulent and over-valued companies, Chanos sometimes speaks out against more regulation of short sellers. He was also a moderate voice during the contentious debate surrounding the SEC's plan to regulate the hedge fund industry.

This year, he formed the Coalition of Private Investment Companies, a Washington-based lobbying group, to try to give the industry more of a say in future policymaking.

"Despite 200 years of 'bad press' on Wall Street, it was those 'un-American, unpatriotic' short sellers that did so much to uncover the disaster at Enron and at other infamous financial disasters," he said in Congressional testimony in 2002. "While short sellers probably will never be popular on Wall Street, they often are the ones wearing the white hats when it comes to looking for and identifying the bad guys."

Looking for the bad guys

The most controversial short seller is currently Rocker Partners LP, which spends much of its time scouring the stock market for potential wrongdoing by executives.

The \$1.3 billion, Milburn, N.J.-based firm is run by Marc Cohodes and, until earlier this year, David Rocker. Like Kynikos, Rocker Partners started in 1985.

Rocker retired this year and the fund was renamed Copper River Management LLC, but its strategy is unchanged. [See related story.](#)



Reuters

David Rocker

While the majority of Wall Street and financial journalists focus on companies' income statements, Copper River scrutinizes balance sheets. Warning signs include when receivables or inventories are growing much faster than sales. The firm also analyzes cash flow to find out whether companies may run out of money.

Copper River conducts its own investigations to dig up information -- interviewing industry experts, company managers, competitors and customers -- as well as buying research from outside the firm.

Once it finds an idea, it will take big short positions -- sometimes as much as 7% of its portfolio if it feels strongly about a particular situation. Copper River usually has between 40 to 60 positions at a time, with 30 to 40 being short sales.

Lernout & Hauspie, AremisSoft, Consec and Boston Chicken are among companies the firm has shorted that later went bankrupt, according to an affidavit filed by Rocker in February as part of the firm's legal battle with Internet retailer Overstock.com.

A bet that didn't work out, but was ultimately proved valid: shorting AOL Time Warner ([TWX](#)) because of concerns about how the company was accounting for the money it spent mailing discs offering free Internet-service trials.

"I'm proud of Rocker Partners' record of identifying many flawed companies which were, in fact, greatly overvalued," Rocker said in the February document.

Rocker has turned in more positive years than Kynikos's Ursus fund and avoided some of Chanos' big losses (although Rocker did lose 36% in 2003 when stock markets surged).

Last year, when benchmark U.S. stock indexes rose, Rocker returned more than 45%, its best year ever, according to a hedge fund investor who declined to be identified.

One of the methods that sets Rocker apart from Kynikos as a more aggressive short seller, is that the firm discusses trading ideas with other short sellers, analysts and financial reporters and also speaks about them in public.

Rocker has written stories about trading ideas in Barron's, published by Dow Jones. He's also written articles for TheStreet.com Inc. ([TSCM](#)), in which he owns a stake. (Rocker has said in the past that he exerts no editorial control over TheStreet.com).

Rocker and partner Cohodes also confront company executives with probing questions in

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public, during roadshows, conference calls and industry conferences.



Doing just that may have gotten the firm embroiled in its current legal tussle with Overstock.com ([OSTK](#)) .

At a June 2004 roadshow for a planned stock offering by Overstock, Rocker asked Chief Executive Patrick Byrne to explain why the company had missed revenue and profit targets set in 2001, according to Rocker's affidavit.

Rocker, who claimed Byrne evaded his questions, also wrote an article for TheStreet.com that took issue with Byrne's enthusiasm for the company's financial results.

More than a year of very public wrangling followed during which Byrne said Rocker and other short sellers were using the media to spread negative information about Overstock.

Earlier this year, the SEC opened an investigation and subpoenaed journalists from MarketWatch and Dow Jones Newswires and CNBC who have used short sellers as sources. The agency later backed off, but reserved the right to question reporters if it can't get information elsewhere. [See full story.](#)

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Overstock sued Rocker in August 2005, accusing the firm of conspiring with Gradient Analytics, a research firm, to force down shares of the company. The suit claimed Rocker told Gradient to include specific negative information about Overstock and asked it to go public with its reports only after the firm had bulked up on short positions.

Rocker and Gradient have denied the charges and. Rocker declined to comment for this story.

As the controversy surrounding short selling escalated earlier this year, Rocker announced plans to retire. The firm said his departure wasn't connected to the Overstock suit.

The Independents

Mike Wilkins, one of the managers of Kingsford Capital Management LLC, a \$1.1 billion Bay Area firm that specializes in short selling, has also been a film writer.

Wilkins co-wrote "The Independent," a movie that came out in 2000 starring Janeane Garofalo and Jerry Stiller and featuring appearances by Hollywood players Ron Howard, Peter Bogdanovich and Karen Black.

The comedy pokes fun at Hollywood while charting the career comeback of a B-movie director as he tries to film the life of a serial killer. Trouble is, the killer wants the flick partly done as a musical.

The healthy cynicism Wilkins brought to his portrayal of Hollywood also helps when scanning Wall Street for short ideas.

"On the short side, you try to dissect stories," he told the New York Times in 2001. "Having a background as a writer, you can tell what is factual and when people are making a leap."

Wilkins also co-wrote Roadside America, a guidebook of off-beat tourist attractions.

Wilkins met his Kingsford partner David Scially when Scially was a broker pitching short ideas to institutions including Greenbrae, Calif.-based hedge fund West Highland Capital. At the time, Wilkins worked at West Highland.

Before starting Kingsford with Wilkins in late 2001, Scially worked at Off Wall Street Consulting Group, a Cambridge, Mass.-based research firm that unearths buy and sell recommendations, often for hedge fund clients.

At Kingsford, Scially and Wilkins comb through the balance sheets and income statements of mainly micro-cap companies looking for symptoms of over-valuation or fraud.

They're also adept at spotting patterns in the background and past behavior of companies, management, analysts and investment banks. For instance, if an investment bank has a history of taking questionable companies public, that could raise warning flags at Kingsford.

The firm also checks in with companies' rivals and former employees and sometimes hires private investigative agencies to help them uncover information.

Wilkins and Scially are held in high esteem by other leading short sellers, partly because their research effort is focused on so many different short ideas, according to three people familiar with how Kingsford operates.

Whereas a firm like Rocker Partners may have 30 to 40 short positions, Kingsford will sometimes have more than 100 that don't take up any more than 2% of its assets, they said. This is difficult because researching short ideas takes so much time and resources.

Scially once went into so much detail when discussing a company with another short seller that the person asked him why he hadn't put a larger position on. Scially replied that Kingsford wanted to avoid big losses from individual trades, the person recalled.

Wilkins and Scially declined to comment for this story.

Best-kept secret

Institutional Investor Magazine described Gilchrist Berg, head of Water Street Capital, a Jacksonville, Fla.-based short selling firm with more than \$1 billion in assets, as possibly "the best-kept secret -- and arguably the best short seller -- in the hedge fund business."

A secret, that is, unless you're Julian Robertson, founder of Tiger Management LLC, one of the most successful hedge-fund operators.

Robertson first heard about Berg through Kidder, Peabody & Co., a leading brokerage firm they both worked at more than two decades ago.

"I didn't know him directly, but through someone else at Kidder," Robertson said in an interview. "He was recommended to me as someone who did some shorting -- and this was before shorting was chic."

When Berg started Water Street in 1987, Robertson was one of his first investors.

The Tiger chief is still invested in Berg's Polar fund, which focuses on short selling. Berg also runs Water Street Partners, which takes both long and short positions and counts Berkshire Hathaway Inc. ([BRKA](#)) ([BRKB](#)) and tobacco giant Altria Group ([MO](#)) as major holdings.

During a rare interview in 1997 with The Florida Times-Union newspaper, Berg said Water Street's investing mission was to "buy undervalued companies run by good people and short overvalued companies run by the opposite breed." He declined to comment for this story.

Searching for possible frauds is one of Berg's short-selling goals, Robertson confirmed, but he also looks for other situations where stocks are over-valued.

"He's a very good basic researcher of things he thinks are overvalued," Robertson said. "He'll go into stores to see how products are selling. His analysis and research is second to none."

Other short sellers said Berg is very secretive and doesn't discuss trading ideas, partly because he often focuses on small-cap stocks where trades can quickly become crowded.

However, Robertson said he sometimes talks about short ideas with Berg and added that the manager doesn't restrict himself to small companies.

Gilchrist has used his investigative skills and government contacts to successfully research government agencies such as Fannie Mae ([FNM](#)) and Freddie Mac ([FRE](#)) , Robertson

added.

"He's done very good work on government agencies," Robertson said. "He tries to get a feel for the regulatory environment for these firms."

Fannie has lost more than a third of its value in the past three years amid investigations into

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the mortgage giant's accounting. Freddie shares are roughly unchanged during the same period.

Water Street has generated solid gains using a strategy that's usually prone to dramatic highs and lows. That's made the firm a favorite of endowments and other institutions such as Yale University's endowment and Brigham and Women's Hospital, which is affiliated with Harvard's medical school.

Berg's Polar fund climbed roughly 40% a year in 2000, 2001 and 2002 and outperformed the S&P 500 15 years running, Institutional Investor reported. Gains in 2002 earned Berg an estimated \$95 million that year, making him the ninth best paid manager in the hedge fund business, according to the magazine. Still, Berg isn't immune to market volatility. His Polar fund lost 32% in 2003 as stock markets rallied strongly.

Mutual fund bear

David Tice, the Prudent Bear fund manager, is the antithesis of Berg when it comes to being accessible for the media.

As a mutual fund, individual investors can invest in the Prudent Bear for a minimum of \$2000 (investors in Water Street have to come up with at least \$1 million). Tice's investment record is published regularly and he sometimes discusses short ideas publicly.

Tice is also less aggressive than other short sellers. The fund avoids concentrated bets, keeping a diversified portfolio of short positions, and doesn't borrow money to ratchet up risk and amplify returns (a common hedge fund strategy).



Reuters

David Tice

He also won't short stocks that have strong upward momentum. Instead, he'll wait for shares to begin to head lower before taking a position. Another major difference: the Prudent Bear invests in precious metals companies.

That combination of short trades and gold exposure helped the fund return more than 10% during the first five months of 2006.

Before this year, performance was volatile as the fund lost money during years when stock markets rallied and made money when equities declined.

In 2002, when the S&P 500 shed more than 20%, Tice's fund was up 63%, its best year. It lost 34% in 1998 and 23% in 1999 as equities surged.

Tice started his own firm -- David W. Tice & Associates -- in 1988 to write research for other money managers. The firm's newsletter, called Behind the Numbers, focuses on hyped stocks that are likely to fall short of Wall Street expectations.

With an accounting background himself and a research staff that includes several accountants, Tice's team "tears apart financial statements and is critical of companies," he said.

Tice started the Prudent Bear fund in 1996, the same year that Alan Greenspan delivered his famous "irrational exuberance" speech. "It seems silly now, but we felt that the market was overvalued at the time," Tice said.

Tice is best known for criticizing Tyco International's ([TYC](#)) accounting before scandal sent shares of the diversified conglomerate tumbling and left Chief Executive Dennis Kozlowski facing decades in prison for stealing from the company.

But Tice wasn't shorting Tyco at the time because of a policy of not taking short positions on stocks when his firm's research is published.

Tice said he often shorts such stocks after reports go out, but in the case of Tyco, he waited for roughly two years.

"Kozlowski immediately tried to make it sound like we were trying to make money off our call," Tice recalled. "Partly because of that, we only shorted it a couple of years later."

One of Tice's current short ideas is Advanced Micro Devices Inc. ([AMD](#)). The chipmaker has gained market share from Intel Corp. ([INTC](#)) in recent years, but Tice thinks the market is under-estimating the impact of Intel's coming response.

"We think that price competition is not being fully appreciated by the Street," Tice said. "In fighting back, Intel is going to be even more aggressive about price cutting."

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