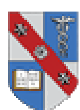

Ludwig von Mises Institute
Tu Ne Cede Malis

THE Free Market

September 2000
Volume 18, Number 9

In Defense of Shorts
Christopher Mayer

Dictatorships always immediately ban short selling," wrote Fred Schwed, Jr., in his fun 1940 book on investing, "since it is axiomatic with them that no professional pessimists are going to be tolerated." Indeed, the long-vilified bearish practice called short selling involves a sale of borrowed stock with the anticipation that its price will fall, allowing the bear to buy it back and pocket the difference. When a bear buys back stock he has sold short, he is said to cover his position.

Those unfamiliar with Wall Street are naturally skeptical of this business of short selling. How can one sell what one doesn't own? Some may remember Daniel Drew's clever ditty "He who sells what isn't his'n must buy it back or go to pris'n." Interestingly enough, Drew was himself a famous short seller.

The mechanics of short selling are simple. A bear goes to his broker and places an order to sell 1,000 shares of XYZ Corporation stock at its current market price of $100 per share. The broker borrows the shares from another client (unbeknownst to the holder) and sells them on the market. The proceeds of the sale, in this case $100,000, are deposited in the short seller's account. If the stock falls to $90 per share, the short seller is in a position to buy back the stock at $90 per share, or $90,000 and pocket the difference as profit (in this case $10,000). If the stock goes to $110 per share, then the short seller has a losing position that will require him to come up with an additional $10,000 to buy back the stock and close out the transaction. In this scenario, he has lost $10,000.

There are a variety of nuances to the above that short sellers must factor in. For example, short sellers don't usually earn interest on their proceeds from the initial sale and they must keep the proceeds with a broker and with margin as well. As another example, they can only take a short position on a downtick of the stock price. However, the mechanics of short selling are not as important as the conceptual understanding of how a bear in a short position makes money.

Short Sellers Vilified

Since they profit when the price of their stock falls, short sellers are portrayed as rapacious speculators. As Hilary Rosenberg notes in *The Vulture Investors*, "Because they profit on bad news, the short sellers have gained a reputation as cold opportunists." The above-quoted Fred Schwed includes a tongue-in-cheek chapter on the short seller, which he titled "He of the Black Heart." John Rothchild observes in his book, *The Bear Book*, that "Known short sellers suffer the same reputation as the detested bat. They are reviled as odious pests, smudges on Wall Street, pecuniary vampires."

Occasional short seller Alan Newman, a financial strategist for HD Brous, a New York brokerage, can relate. He told Wired, "Shorts are vilified. . . . The overwhelming view of the public is, `Don't short my stock-it's un-American.' But if I see a wildly overvalued stock, I'm certainly entitled to speak my opinion and to trade on it. That doesn't mean I'm a villain." More than a uniquely American phobia, the short seller is reviled around the globe. At various times short selling has been banned in England, France, Japan and other countries.

The Defense

Bernard Baruch compiled a variety of papers defending short selling and published them in 1913 under the title of *Short Sales and The Manipulation of Securities*. Interestingly, Baruch declined to sign his own name to the pamphlet, even though it was widely believed at the time that Baruch was its compiler.

For some time prior to the publication of Baruch's booklet, government commissions of various kinds throughout the country had been looking into restricting the activities of short selling on the theory that short selling per se was wrong and that it reduced the market price of the securities so shorted (as if the American citizen has a inalienable right to rising stock prices). In his slim volume, Baruch compiled passages by politicians, economists, financiers, professors and others that defended short selling.

The short selling method is not peculiar to financial markets only. It has roots in business transactions of all kinds. Baruch cited the New York State Commission on Speculation (1909) which reported to Governor Hughes that "Contracts and agreements to sell, and deliver in the future, property which one does not possess at the time of the contract, are common in all kinds of business."

Manufacturers of all kinds make contracts to deliver certain goods before they are actually made. Homebuilders sell homes before they are constructed. Farmers enter into contracts to sell goods well before harvest. Seen in this light, short selling is no longer seen as peculiar, since the same principle applies. The basis of all entrepreneurial activity is this matter of appraising the present against the future, of delivering an end product or service whose price is greater than the cost of production.

Baruch also cited a variety of sources opposing the notion that short selling depresses the prices of the stocks shorted. He cited Horace White, Chairman of the Hughes Commission, who wrote in the *Journal of Political Economy* (1909): "The selling of property for future delivery, by persons who do not immediately possess it, is believed by many to depress prices artificially, to the disadvantage of the producer. This is a fallacy, since every sale requires a purchase of equal magnitude."

The error is compounded by the reporting of the financial press who often say that investors were selling when the market is down and buying when the market is up. In fact, in either case, the number of shares sold always equals the number of shares bought. There can never be any net selling or net buying.

It was a popular notion of the day, also mentioned in Baruch's pamphlet, that when the market fell, the short sellers helped steady prices; by covering their positions they become buyers. However, if short selling alone cannot drive prices down, then it logically follows that buying alone cannot push prices up.

The Market's Policeman

The real value in short sellers is that they are the market's policemen. In contrast to those talking heads that are continually pumping this stock or that stock, short sellers are looking for bad news, adverse developments, fraud, questionable accounting, and inflated earnings.

For example, Manuel Asensio is a prominent short seller who has prospered by targeting companies that he believes are misrepresenting their businesses to investors. Another example is Howard Schilit's Center for Financial Research and Analysis, which alerted investors to the problems at MicroStrategy-and helped short sellers earn a lot of money. Schilit's company is a private company. It was not the SEC that saved future potential investors, but a private, profit-seeking company.

Short sellers also can spread false rumors and create bad news to drive a stock down and make money. Such rumors would not be a problem in a truly free market where investors would be necessarily knowledgeable (owing to the market's natural selection process) and careful not to trade on any rumors without confirmation. In today's SEC-regulated and government safety-net laden marketplace, people expect government to look out for them. This lulls them into a false sense of security. Obviously, even in today's hyperregulated markets fraud still occurs and false rumors are spread daily.

In a truly free market, private organizations like Schilit's and short sellers like Asensio would be depended on by investors to provide accurate information. These private organizations would have strong incentives to perform, unlike government bureaucracies. Private companies have paying clients and they have their own money on the line. Their clients would move to another firm if their own firm fails to deliver.

The SEC has no voluntary paying clientele and no competition. Its income is guaranteed regardless of its performance. That more private organizations don't thrive today is probably due to the SEC's presence. Why would people want to pay for a private service that would audit and monitor companies when the SEC already exists, mulcting taxpayers as it does? In a truly free market, companies would likely voluntarily provide information to such organizations, as they currently do with Dun & Bradstreet or *Standard & Poor's*. The difference is that these organizations do not perform audits and they also rely heavily on SEC documents.

Short sellers are a necessary part of financial markets and are not to be feared. As Washington Post columnist David Ignatius recently wrote, "Just as a healthy forest needs vultures and worms that feed on death and decay, the financial markets need what are known in the business as short sellers." And just as short sellers provide balance to perennial bulls, they also show how a market can police itself. Individuals acting in their

own interests and engaged in voluntary exchanges can provide for the wants of investors without the aid of government regulators.