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SPECIAL REPORT

Short sellers: A rarer breed of investing

Organized to thwart shorts, adversaries now make strategy more difficult

By Alistair Barr, MarketWatch
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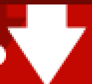
SAN FRANCISCO (MarketWatch) -- When asked if he knew of other leading firms specializing in short selling, the representative at the headquarters of Copper River Management LLC couldn't be very helpful.

"Where are the other three or four short sellers? If you can find them, give us a call," the person said, before declining to give his name and getting off the phone at the New Jersey-based investment firm.

A MARKETWATCH SPECIAL REPORT
WHO ARE THE SHORT SELLERS?



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.

Copper River, a $1.3 billion asset manager run by Marc Cohodes, is one of a shrinking group of firms that specialize in betting on stock declines. Others include Kynikos Associates, Kingsford Capital and Water Street Capital.

What was already a difficult and sometimes gut-wrenching strategy has only gotten harder in recent years. Nowadays, more of the companies that short sellers target are fighting back with lawsuits. They also mount sophisticated public relations campaigns against shorts. And if that weren't enough, there's a new crop of newsletters designed to "squeeze" short sellers.

"The game has become so stacked against the short seller that it's just not worth the periodic emotional and monetary high that comes from being right with a bearish bet," Joe Feshbach, who used to specialize in short strategies, told newsletter Value Investor Insight earlier this year.

Feshbach and his brothers Matthew and Kurt built a $1 billion hedge fund in the 1980's by aggressively shorting stocks. These days he runs a fund that does the opposite: investing in stocks and other securities he thinks have dropped too far on negative news such as government investigations, accounting errors and profit warnings. See related story.

"The business of shorting has only gotten tougher since my brothers and I left it in the early 1990's," he added.

Harry Strunk, president of Palm Beach, Fl.-based consultant Aspen Grove Capital Management LLC, has been tracking the performance of short sellers since the early 1990's. Back then, he followed as many as 25 short selling firms. That's down to roughly 10 now.

"It's a very difficult strategy," Strunk said. "The market trends upwards in the long term, so short sellers are swimming against the current. And there's a lot more risk involved."

"The hype surrounding aggressive, no-holes-barred short selling, combined with the controversy, made it very difficult for us."

Short sellers' potential returns are limited to how far a stock can drop, while their losses are in theory unlimited because shares can keep rising indefinitely, Feshbach said.

Managers also expose themselves and their investors to "inadvertent leverage" because they have to borrow stock in order to sell it short, he added.

Short sellers used to share some of the interest that was earned from the stock-lending process, but low interest rates have almost eradicated that

— *Manuel Asensio, investor*

benefit, Feshbach explained.

The "uptick" rule on the New York Stock Exchange and Nasdaq, means that shares cannot be shorted unless the price rises first. Investors who buy stocks don't have to wait until the price drops.

"I avoid shorting now, but not because of a moral principal," he said. "It's just bad business."

Strunk said some short sellers have opted to run hedge funds that take both long and short positions because it's a much easier and less-controversial strategy.

Asensio scales back

Manuel Asensio, one of the most outspoken and controversial short sellers, has scaled back in recent years and is now investing on both the long and short side.

Manuel Asensio

Asensio generated annual returns of more than 30% from 1996 to 2003 by aggressively shorting shares of companies including Diana Corp., Winstar Communications Inc. and Turbodyne Technologies Inc. (TRBD) . Diana and Winstar are now bankrupt.

But some of Asensio's targets, such as Hemispherix BioPharma Inc. (HEB) and Turbodyne, sued him, claiming defamation.

Asensio said he also clashed with Arthur Levitt when he was chairman of the SEC, as well as Harvey Pitt, Levitt's successor. In 2000, his firm paid a $75,000 penalty to settle charges brought by the National Association of Securities Dealers without admitting or denying the allegations.

"I spent six years in litigation on several multi-million dollar trials," Asensio said. "The hype surrounding aggressive, no-holes-barred short selling, combined with the controversy, made it very difficult for us. I don't know, maybe I went too far."

A Web site, called Asensioexposed.com, still tracks his legal tussles.

Asensio, a Cuban native who grew up in Brooklyn and describes himself as a radical liberal, said it would be even more difficult to set up a pure, aggressive short selling operation today.

Hedge fund salaries have jumped, so such a firm today would have to spend a lot more to hire analysts to research and track short ideas. Lawsuits from targeted companies also require hiring a personal lawyer plus a law firm for representation, Asensio added.

"The infrastructure necessary to run that type of business and the legal risks create an economy of scale that is very difficult," he said. "Layer on top of that the personal and financial costs of being deposed all the time and having personal liability, then it's not worth it."

That's a bad thing, Asensio argues, because short sellers help keep valuations of stocks accurate and ensure that capital is allocated more efficiently to the most upstanding companies.

"There's no benefit to society and financial markets from restraining the flow ideas, capital and the employment of that capital in the short-selling community," he said.

Legal push

A growing number of companies, supported by experienced class-action law firms, disagree, claiming short sellers conspire to force down shares of vulnerable firms.

John O'Quinn, who triumphed over tobacco companies in the 1990's, is leading the legal push that also includes two other Houston-based firms, Christian, Smith & Jewell and Heard, Robins, Cloud, Lubel & Greenwood.

The firms are representing Overstock.com (OSTK) in the Internet retailer's suit against short seller Rocker Partners and research firm Gradient Analytics.

Other companies suing with the help of O'Quinn's consortium include Internet Law Library, Nanopierce Technologies, Pet Quarters Inc. (PDEN) , Hyperdynamics Corp. (HDY) and Sedona Corp. (SDNA) .

The law firms have so far filed 12 suits involving 10 companies and are close filing another five cases. Ten more suits

are in the works and the total may reach 50 by early 2007. The law firms have spent $25 million so far preparing cases.

The focus of the attacks is on so-called naked short selling, which the group says is illegal. In naked shorting, a trader shorts a stock without first making the necessary arrangements to borrow shares.

PR, short squeezes

A cadre of public-relations firms are also supporting companies that do battle with short sellers.

Vancouver-based RGM Communications Inc. specializes in helping "junior public companies in bringing their corporate story to investors," according to the firm's Web site.

Most of the firm's Web site is devoted to exposing what it calls "the illegal practice of 'naked short selling,' 'death-spiral financing' and/or stock fraud."

Shareholders and companies that have been affected by naked short selling are encouraged to sign an online petition asking for the SEC to be investigated for not doing enough to stop naked shorting.

Newsletters too are devoted to "squeezing" short sellers. In a short squeeze, investors aim to buy so much stock that the supply used for borrowing dries up and the broker recalls shares already lent out. To return stock, short sellers have to buy them back, forcing the price up. As the stock rises, it can spur other shorts to have to cover their positions, fueling further gains.

Erlanger Squeeze Play, run by former Fidelity technical analyst Phil Erlanger, tracks short-selling activity to measure investor sentiment on stocks. Web site shortsqueeze.com provides short interest data and alerts to subscribers.

The Shortbuster Club was run by Ray Dirks at Sky Capital LLC, although a representative at the New York-based firm said it doesn't offer the service anymore and Dirks no longer works at Sky Capital.

Rocker noted some of these newsletters when arguing against more regulation of short sellers during Congressional testimony in 2003.

Rocker retired earlier this year in the midst of Overstock's lawsuit against the firm. Copper River said his departure wasn't related to the suit. ■

Alistair Barr is a reporter for MarketWatch in San Francisco.