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Short guide to the shorts

Clouds over market bring joy to hearts of short-sellers

It's been a scary week on North American stock markets with indexes gyrating wildly and posting some big daily losses.

Typical investors can't help but feel queasy when faced with plunging stock prices. But there's one group of market players who like it best when the carnage is at its worst.

They're called short-sellers, a particular1y morbid gang to whom black is white; down is up; and bad is good.

Shorts, as they're known for short, take bets against individual stocks or whole markets. They make money when others are losing it. So this week's drop in share prices was a joyful experience, especially since they expect more trouble ahead.

"It's great news for the shorts," said Larry Woods, the bearish author of The Technology Review stock newsletter. "And this is just the beginning."

It you agree with bearish people like Woods that the markets are way too pricey and set for a big fall, you may want to consider taking a walk on the short side yourself.

But be forewarned. Short-selling ranks among the investing world's extreme sports, right up there with commodity-futures speculation and day-trading. It's not a game for widows, orphans or naive beginners.

Still, the topsy-turvy nature of short-selling makes it a fascinating corner of the markets, even if the vast majority of individual investors will never try their hand at it.

Here's how it works.

An investor goes to a broker and borrows shares in the target company. He or she then sells the stock at the current price. Later, the investor replaces the borrowed shares by buying them on the market, hopefully at a lower price.

The profit is the difference between what was earned by initially selling the borrowed stock and what was paid to repurchase it minus commissions and carrying charges.

Now let's talk risk.

DON MACDONALD
THE MARKETS

First, when you're short, you're betting against the odds since, as we all know, stocks tend to rise over time.

Second, your losses are, at least in theory unlimited.

With a conventional stock purchase, you're maximum potential loss is 100 per cent since a stock can't go below zero. But with a short sale, once the stock doubles, your losses are over 100 per cent and rising.

Above all, short-sellers fear what is known as a short squeeze. That occurs when the rising price of a heavily shorted stock forces shorts "to cover" their positions, or buy stock to replace the shares they have borrowed. This buying pressure sends the stock shooting even higher.

And don't expect to be popular if you go short. Professional short-sellers are often secretive, lone wolves who are detested by corporate executives, bullish Bay St. brokers and shareholders who don't take kindly to people betting against their stock.

"Everything is geared to rising prices. And obviously if you're expecting something to fall in price, that's a negative and reflects on anyone who's involved in that enterprise, said Arun Kaul, who sells stock short at **Hillsdale Investment Management** in Toronto. "That's why they hate us."

But perhaps mainstream investors should feel sympathy not loathing, for short-sellers.

After all, betting against rising stock prices hasn't exactly been a ticket to fabulous riches during the greatest bull market in history.

Indeed, many short-sellers who rose to fame, or more accurately infamy, during the 1980s, including such players as Jim Chanos and the Feshbach brothers, have fallen on hard times in the go-go '90s.

Still, if you believe the bears, it's sunny... er, cloudy skies ahead for short-sellers.

So what do they look for? In a word: trouble. And they're good at finding it. In fact, it's axiomatic that shorts do the best homework in the investment business since the game they're playing is so risky,

Instead of companies that surprise the market with rising profits, shorts look for companies that disappoint with deteriorating ones. They look for over-leveraged balanced sheets to go along with over-inflated stock prices.

They try to tease out hidden problems in financial statements, such as rising inventories and receivables, or just plain accounting chicanery. They look for companies that have missed interest payments on their debt and look to be heading for bankruptcy

Many stock-market experts believe shorting stocks is too risky for amateur investors. But it's not easy to find a professional to do it for you either.

Mutual funds are prohibited from shorting stock. There are several hedge funds in Canada that hold both short and long positions in an attempt to protect against market declines. But these funds generally require a $150,000 minimum investment because of Canadian securities laws.

Arun Kaul and his partner Christopher Guthrie run two funds where short positions on U.S. stocks are matched against long positions to produce a hedged portfolio.

The funds are the Hillsdale Long-Short American Equity Fund and a clone fund managed for Argentum mutual funds of Montreal. Argentum is hoping regulators will soon lift the $150,000 limit on their Argentum Market Neutral Fund, opening it to ordinary mutual-fund investors.

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