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## Investing

# Short-sellers hammer retiree investors

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The depth of the correction in the first quarter of 2001 challenged even the most sanguine of investors, asset managers and other investment professionals. The contrast with market conditions before March 2000 is stark.

This year, the stream of new investors has dried up. In addition, the little-known practice of short-selling may have had a significant, yet invisible impact. Short-selling, legitimized as a bona fide trading option by the Securities Exchange Act of 1934, was amended to include Nasdaq securities in 1974. We argue that since its inception, it has been a growing malignancy in the markets; exploiting bear markets and amplifying the negative impact on the portfolios of more traditional investors.

Many economic factors contributed to the decline of the markets. The psychological and emotional climate was one of doom and gloom. Even seasoned investment professionals seemed surprised by the dramatic fashion in which the dot-com bubble burst. It was recounted repeatedly in the media and reinforced by the pronouncements of pundits and politicians. These economic and psychological influences, contributing to the lack of buyers, remind us that "fear can be a more powerful emotion than greed."

While fear might be more powerful for most people, it is not for all. Some investors choose short-selling one of the most risky investing strategies available. Short-selling is the practice of selling stock the investor does not own. Once it is sold, the investor is literally "short" the stock. First, the investor borrows shares of stock from a brokerage (later paying it back with interest). The investor then sells the shares on the open market. After the stock price falls, the investor buys back the stock and returns the shares to the brokerage.

A short-seller makes a profit from the difference between the purchase price and the sales price (less commissions, applicable dividends and other transaction costs). This is the opposite of almost all other investments. Most importantly, short-selling is only profitable when the majority of investors in a specific stock, or the equity markets in general, are suffering losses.

In order to reduce the ability of short-sellers to profit from the misery of others in a bear market, short-sellers must adhere to the "up-tick

rule." It states that the transaction immediately before the short sale must have been executed at a higher price than the prior transaction. The transaction before a short sale must be an up-tick. It only takes one rise in a stock's price for the sale to take place and allow the short seller to make money on the continuing falling value of the stock. Short-sellers carefully monitor individual stocks to take advantage of up-ticks in falling stocks.

Short-selling is an approach seldom used by retail investors. Usually, professionals put it into practice attracted by the thrill of the risk and the potentially large profits. The recent past has been a boom time for short-selling, which makes profits from the loss in value of a traditional investor's stock. These profits can be large because as the stock value goes down, investors buying stock in anticipation of a rise in its value, are faced with additional, perhaps artificial, pressure to sell. The negative impact of a short-seller's success is often greatest on investors who use traditional vehicles and practices to grow their net worth.

Ironically, the real risks of short-selling are faced not by the investor borrowing stock but by the fastest growing sector of the population: the 64-year-old widow, living on a fixed income, with a balanced investment portfolio. Retirees are among the investors least able to bounce back from the loss of a substantial part of their life savings. Forces outside their control are manipulating these people's financial health. Short-selling contrasts vividly with the normal ups and downs built into equity markets.

To be fair, it is only just to examine the dangers faced by short-sellers. One of the most frequently occurring, faced by a short seller when a stock is on the rebound, is a phenomenon known as the short squeeze. As already stated, short-sellers must buy back the stock they sold because they must cover the loan from the broker. If the price of the short stock is heading higher, the short seller wants to get out of the short position. Moreover, it is likely that short-sellers of a specific stock will all want to do this at the same time. If another investor recognizes that there are many short positions in a stock, he or she might buy the stock to drive up the price. Once the short-sellers start buying shares to cover their position, the price rally can become frenzied.



Short-sellers want out, at any price. This is a classic short squeeze.

Short-selling is a significant influence in driving stock values and market indices down. This has resulted in many losing their hard-earned nest eggs; as the value of pension funds and many other retirement investment vehicles has tumbled. Perhaps it is time to review this malignancy in the stock markets. Can a practice virtually unchanged for 70 years, that is so detrimental to the growth of an individual investor's portfolio, still be given legitimacy in modern times? Short-selling has a particularly onerous impact on the fortunes of retirees, most of whom are looking for their net worth to grow steadily and conservatively after earning the contents of their portfolios through a lifetime of hard work.

John Valentine is an expert in portfolio management and in developing high net-worth strategies. He gained valuable experience at retail investment houses such as Shearson Lehman Hutton and later, through strategic partnerships with several successful money management firms including Navellier Associates and Frank Cappiello, before starting his own asset management company. He is the Principal Investment Advisor at Valentine Capital RPG.

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