1998 SPECIAL DOUBLE ISSUE

BusinessWeek

DECEMBER 29, 1997 / JANUARY 5, 1998

A PUBLICATION OF THE McGRAW-HILL COMPANIES / $3.95

The Global Slowdown: What It Means To You

WHERE TO INVEST

Stocks Bonds Mutual Funds Global Markets High Tech Real Estate Market Gurus 1998 Earnings Estimates Much More

BONUS *The Great Bull Market— a special fold-out poster*

Internet: www.businessweek.com America Online: Keyword: BW

SHORTS

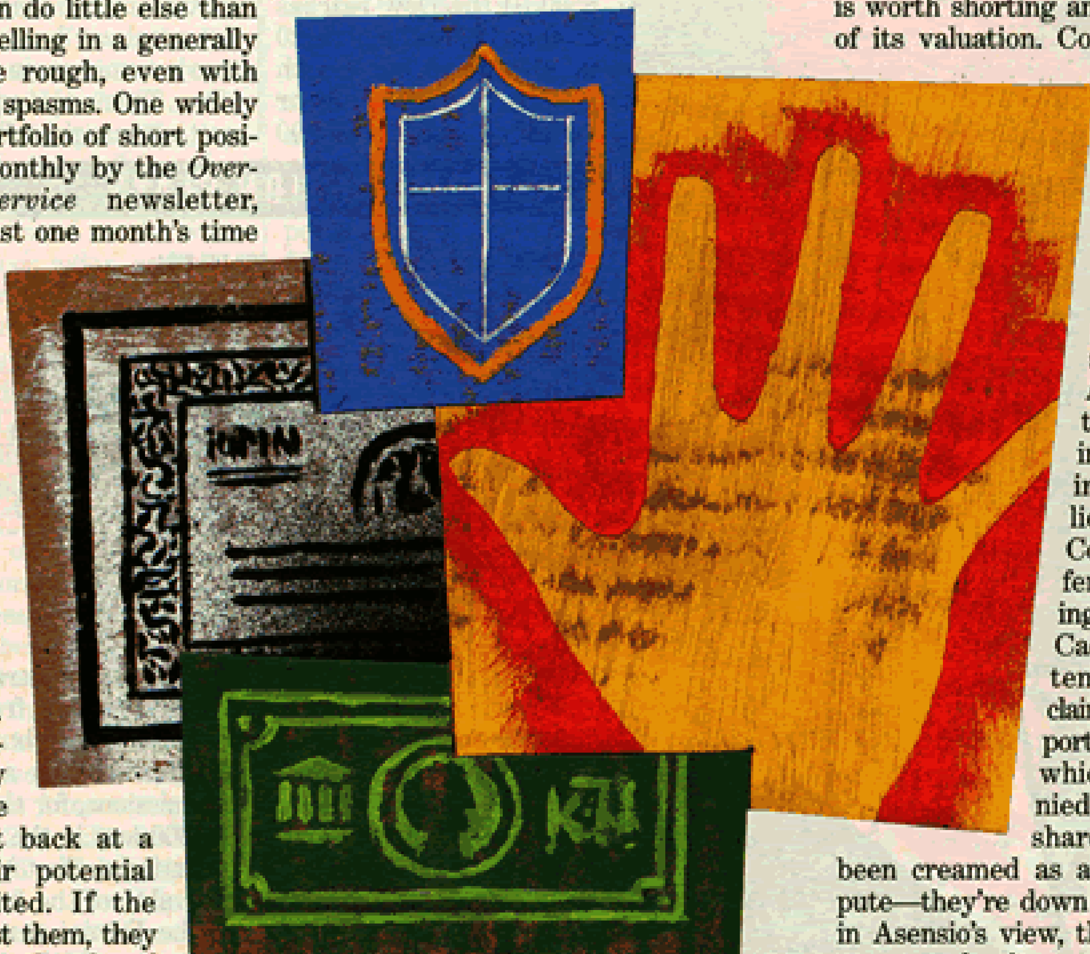
How to Soar with Falling Stocks

Short-sellers see trouble ahead for gambling stocks and some big names in software

Nowadays, short-selling can seem mighty tempting. Whether it is the Oct. 28 sell-off, the Dec. 12 stampede from tech stocks, or the frequent declines among microcap stocks, shorts make money when other market players can do little else than suffer. But short-selling in a generally up market can be rough, even with the recent market spasms. One widely followed model portfolio of short positions, published monthly by the *Overpriced Stock Service* newsletter, climbed 7.5% in just one month's time because of the late-October turbulence. But for the year it was up just 6.4% through late November, far below the 21.7% gain in the Dow Jones industrial average.

The bull market isn't the only thing that makes short-selling perilous. Since shorts borrow stock they don't own with the hope of buying it back at a lower price, their potential losses are unlimited. If the market goes against them, they can be subject to the dread "buy-in," where the broker buys back the stock they've shorted. Still, a few well-chosen shorts can put spice in a portfolio—just as long as you don't bet the ranch.

AGGRESSIVE ACCOUNTING. Some shorts select companies on the basis of broad industry or economic themes. For example, Clifford W. Henry, who runs the Worthington Growth hedge fund, is taking a hard look at selected software companies, including Oracle, the German software giant SAP, and J. D. Edwards & Co. He notes that some of their software applications are more adaptable to resolving Year 2000 issues than mainframe packages, which has helped sustain their share prices. However, he believes that the increase in sales realized by these companies will subside as 2000 approaches. "It's a bit like retailers buying in advance of Christmas," says Henry. Thus, he feels, they are possible shorts in the months ahead.



Another short-selection technique is to doggedly analyze financial statements with an eye toward companies that may be using aggressive accounting. One company that has begun to draw the attention of shorts for this reason is Computer Learning Centers Inc., which operates 14 instruction centers across the country. The stock has climbed threefold so far this year, giving the company a nearly $500 million market capitalization. Longs believe the company's prospects are strong. But shorts are taking a hard look at the company's methods of accounting for revenues. Not all shorts are convinced on that point. One prominent short, Manuel Asensio, isn't quite sure that the company's accounting is faulty. But he still feels the stock is worth shorting anyway, on the basis of its valuation. Computer Learning's Chief Financial Officer Charles Cosgrove says the company's accounting is above reproach.

RISKY BET

Short-selling in a bull market can be rough. One popular portfolio rose just 6.4% for 11 months—vs. the Dow's 21.7% gain

Shorts also keep an eye peeled for potentially troublesome legal disputes. Asensio, who runs the Asensio & Co. investment boutique in New York, believes that Avant! Corp. is likely to suffer from its continuing legal dispute with Cadence Design Systems Inc. Cadence claims that Avant! stole portions of its database, which Avant! has denied. The company's shares already have been creamed as a result of the dispute—they're down 47% this year. But in Asensio's view, the decline does not present a buying opportunity but rather a continued short-selling opportunity. He feels Avant! shares are likely to decline further, even in the absence of bad news on the legal front. The stock is now at about 16, and "the best case scenario is it declines to 10. The worst case is zero," says Asensio. (An Avant! spokesman, Matthew Lifschultz, called that forecast "laughable" and said he thought Asensio was attempting to create a "self-fulfilling prophecy.")

Biomedical companies are also frequent short targets. They are often the object of excess investor enthusiasm and can be difficult to understand—which can give an edge to the intense research methods employed by many shorts. One short, noted for his savvy short-selling of biomed outfits, has taken a short position in a Berkeley (Calif.)

SHORTS

company called BioTime Inc., which is developing a synthetic blood substitute. The product is billed as superior to others on the market—but is far pricier. This short-seller is wagering that it won't fly and believes that shares of BioTime are heading toward 7 or less, vs. a current share price of 19.

FOOD FADS. Short-sellers often target companies with gimmicky products or ones that seem to pander to the latest fad in nutrition. Food Technology Service Inc., for example, has been one of the standout performers to date, beginning the year, at less than $1 a share and climbing nearly sevenfold this year, to $6\frac{1}{16}$. The company operates a food-irradiation facility and is marketing its process to food growers and producers. That's a hot way of dealing with food-borne bacteria—but short-sellers are wagering that the stock is a bubble that is about to burst. They believe that competition in the field of food irradiation will bury Food Technology.

Gambling stocks have also attracted flocks of investors—and short-sellers. One short, a specialist in microcap issues, has lately begun to wager against Multimedia Games Inc., a Tulsa company that runs satellite-linked bingo games, many in conjunction with Native American tribes. The company was trading at just $5\frac{1}{16}$ at yearend 1996, but since has climbed almost threefold to a recent price of $14\frac{15}{32}$. This short believes that Multimedia's price is way overblown and will soon cascade back down to the single digits.

The prospect for painless dentistry drives a company that also has begun to draw attention from short-sellers. Milestone Scientific Inc. makes products for use by dentists—including a painless needle that has begun to interest investors. The stock has climbed more than 250% in the year to date. But one short maintains that "the only pain will be felt by investors" and is wagering that the enthusiasm for the stock is likely to wane—and fast.

Short-sellers are often among the first to throw cold water on high-flying companies. That can be perilous, because companies that are "three-baggers" today can become "ten-baggers" a year from now. Still, shorts are targeting companies such as Cellstar Corp., which retails cellular phones and climbed more than threefold this year until a recent plunge. Even so, the company's market capitalization is $640 million—ludicrous, in the view of one prominent short-seller who's betting heavily against the company. Likewise, Objective Communications Inc., which develops video communication systems, is drawing short-sellers for roughly the same reason—what they see as insane valuations. The company went public at $5.50 per share on Apr. 3 and since then has skyrocketed almost 200%—to a recent price of $15\frac{3}{8}$.

SQUEEZED. Tiny stocks like Objective are volatile—which can make them, well, adventurous for short-sellers. Sometimes people who short such stocks wind up in "short squeezes," in which brokers seek to push prices upward and punish shorts by forcing them to buy back their shares at a higher price. You're less likely to be squeezed if you short larger issues—though the profit potential is less. One hedge-fund manager who mainly goes long is shorting two fairly large and respectable regional banks, Nashville-based First American Corp. and Capitol Bancorporation Ltd., based in Lansing, Mich.

Unlike many stocks that are targeted by shorts, there's nothing wrong with the two banks—except their share prices, which, in the view of this hedge-fund manager, are simply too high. First American recently acquired another bank—at far too steep a price, he believes. And Capitol, he notes, is trading at about 30, which is 23 times projected 1998 earnings for the company. The stock, he says, is really worth 16 times 1998 earnings, or about 21. But, he adds, "There are no asset-quality issues. This is purely a pricing situation." Gentle words for a short-seller. But then again, "pricing issues" are what put some investors on yachts—and others into the poorhouse.

By Gary Weiss in New York

STOCKS THAT SHORTS SEE HEADING DOWN

COMPANY	STOCK PRICE*	YEAR-TO-DATE CHANGE
AVANT! CORP. Shorts are wagering that legal problems will soon submerge this company.	$16\frac{3}{8}$	–47%
BIOTIME Makes artificial blood. Shorts feel a cheaper product poses a competitive challenge.	$19\frac{3}{8}$	113
CAPITOL BANCORP A standout performer among regional banks—but far too pricey, says one skeptic.	$30\frac{3}{8}$	121
COMPUTER LEARNING CENTERS A huge gainer this year, shorts feel it is overvalued and uses aggressive accounting.	$57\frac{1}{4}$	201
FIRST AMERICAN CORP. A Tennessee bank with a lot going for it. But shorts feel it overpaid for an acquisition.	$49\frac{1}{4}$	71
FOOD TECHNOLOGY SERVICE Food irradiation has put this company in the driver's seat, pushing the stock high. Too high, say skeptics.	$6\frac{1}{16}$	593
GUMTECH INTERNATIONAL Shorts question the profit potential of this small chewing-gum company.	$8\frac{5}{16}$	36
MILESTONE SCIENTIFIC Manufactures disposable dental equipment. Shorts are wagering its high-flying stock will soon tumble.	$17\frac{3}{8}$	258
MULTIMEDIA GAMES Bingo is choice for this company, which shorts are wagering will fall back into the single digits.	$14\frac{15}{32}$	182
OBJECTIVE COMMUNICATIONS This recent IPO has soared since it went public. Shorts feel the company's prospects don't justify the price.	$15\frac{3}{8}$	180**

*As of Dec. 15

DATA: BW, BLOOMBERG FINANCIAL MARKETS

**Since IPO, Apr. 3, 1997