

Short Sellers Under Siege

Blaming short sellers for financial chaos—as 15 nations have done since July—is making scapegoats out of investors who keep the market honest, Bill Fleckenstein says. He predicted the Dow would fall to 8,500 weeks before October's crash.

By KAMBIZ FOROZHAR

Photograph by BRIAN SMALE

ASIX-FOOT STUFFED GRIZZLY bear guards the entrance to the offices of Fleckenstein Capital Inc., located on a quiet, leafy street in the Capitol Hill neighborhood of Seattle. The bear sends a clear message: The man inside, Bill Fleckenstein, founder and president of the firm, is a short seller and proud of it.

Fleckenstein, 55, has emerged as one of the most-outspoken defenders of what has been depicted by everyone from the chief executive officer of Morgan Stanley to the Archbishop of Canterbury as a renegade class of investors. Since world markets began their most serious plunge in decades in July, 15 countries have banned or restricted short selling, including the U.S., Canada, the U.K., Germany, France, Switzerland, Australia and Taiwan. Commentators around the world have labeled short sellers as hyenas, jackals, vermin and vultures.

Fleckenstein says that investors who bet that stocks will decline, as short sellers do, are simply

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bears. And he says they are not to blame for the market meltdown. "Short sellers didn't lower the fed funds rate or tell people to take out mortgages when they shouldn't have," he says. "Now we are the bad guys, the ones wearing black hats."

Fleckenstein's offices are a monument to his trading strategy, in which investors borrow stock from institutional investors and then sell it in hope of buying the shares back at a lower price before returning them to the lender. The grizzly bear was wearing a "Dow 10,000" baseball cap when the index was still at 11,000. A large sign on the wall of Fleckenstein's three-room office suite advises, "Protect Your Right to Arm Bears."

THE LONG-HAIRED SEATTLE native is one of a corps of pessimistic investors who have been blamed for market manipulation since the 17th century. The recent attacks began after a rapid deterioration in the share price of Bear Stearns Cos. in March. When Bear Stearns's stock fell 47 percent on Friday, March 14, the U.S. Federal Reserve stepped in and that weekend brokered the sale of the investment bank to JPMorgan Chase & Co. Later, Bear Stearns Chief Executive Officer Alan Schwartz told Congress that the firm was toppled by rumormongering and abusive trading—often euphemisms for short selling. The Securities and Exchange Commission launched an investigation that was still in progress in mid-October.

After Bear Stearns's demise, each new crisis in the banking sector raised alarms about short selling. When the share prices of Goldman Sachs Group Inc. and Morgan Stanley dropped sharply on Sept. 17, Morgan Stanley CEO John Mack declared in a memo to his staff, "Short sellers are driving our stock down." And in testimony before Congress on Oct. 6, former Lehman Brothers Holdings Inc. CEO Richard Fuld singled out "naked" short sellers as one of the culprits in the Sept. 15 bankruptcy of his firm. Naked short selling occurs when a short seller tells his broker to sell shares that the seller has not yet borrowed. On Sept. 17, the SEC ruled for the first time that naked short selling was a fraud.

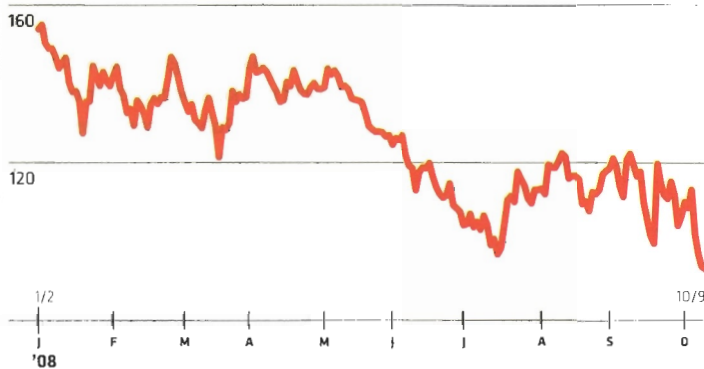
In the U.K., the campaign against short sellers also goes back to March, when the Financial Services Authority said it suspected that "false rumors" linked to short selling led to a sudden drop in the share price of HBOS Plc, the country's biggest mortgage lender. An FSA investigation found no evidence of abuse.

In September, when Lloyds TSB Group Plc agreed to buy HBOS for a fifth of its value a year earlier, both Archbishop of Canterbury Rowan Williams and Archbishop of York John Sentamu continued to blame the short sellers, with Sentamu calling them "bank robbers." The 2007 annual report of the Church of England shows that its 5.5 billion pounds (\$9.6 billion) of assets included a £34.5 million position in HBOS and £40.4 million in Barclays Plc, whose stock also plunged in September

Failed Remedy

Share prices of companies continued to plunge after the Sept. 19 SEC ban on short sales. The ban expired on Oct. 9.

BLOOMBERG U.S. RESTRICTED SHORT SELL STOCK INDEX



*Class B shares. **American depository receipts. Source: Bloomberg

COMPANIES ON BAN LIST; BY MARKET VALUATION, IN BILLIONS

General Electric	\$254
Berkshire Hathaway*	205
HSBC Holdings**	195
JPMorgan Chase	184
Bank of America	160
IBM	158
BHP Billiton	134
Wells Fargo	124
Citigroup	112
China Life Insurance**	104

and October. The Church of England Pensions Board at the end of 2007 managed another £850 million, including £8.5 million worth of HBOS shares.

In response to the furor, the FSA banned short selling of the stocks of banks, insurance companies and securities firms from Sept. 18 through the rest of the year. A day later, the SEC imposed its own ban on short sales of 799 financial stocks. It later added 170 additional companies, including International Business Machines Corp. and Sears Holdings Corp. The SEC ban, after one extension, expired on Oct. 9, six days after passage of the \$700 billion U.S. bailout plan for the banking system. During the period the ban was in effect, the Standard & Poor's 500 Index lost 17.7 percent of its value.

The short sellers say they are scapegoats for the real villains in the meltdown. "The shorts who warned about the real estate bubble have been proven right," Fleckenstein says. "Now the government has changed the rules overnight. They're blaming the shorts and bailing out the ones who lost all the money and almost took the financial system down."

MANUEL ASENSIO, 53, president of New York-based Mill Rock LLC, says he and his brethren keep the stock market honest by going after companies with rotten accounting, dubious business plans and excessive debt. "There was a legitimate reason as to why the financial stocks went down; it was mispriced securities on their balance sheets that caused the problems," he says. Mill Rock is a hedge fund that holds long and short positions in equities and invests in distressed bank loans.

After mid-2007, when two Bear Stearns hedge funds collapsed, investors had every reason to believe financial shares would decline, says George Feiger, CEO of investment manager Contango Capital Advisors Inc., which oversees about \$2 billion in Berkeley, California. "Short selling is an expression of doubt, not a criminal activity," Feiger says. "The management at Lehman, Bear Stearns and Merrill kept saying everything was

fine. Then, every few weeks, they'd write off billions."

In fact, by early 2008 financial shares were so volatile that James Chanos, founder of Kynikos Associates Ltd., which runs a \$5 billion short-only fund, says he stopped shorting them. "We have the least amount of financial shares short in our portfolio than we've had in four years," Chanos told Bloomberg TV on Oct. 13. "We're looking elsewhere."

The power of short sellers has been greatly exaggerated, says Douglas Kass, founder of Palm Beach, Florida-based hedge fund firm Seabreeze LP Holdings, which manages \$200 million. "The dedicated short pool totals about \$5.5 billion," Kass says. "Dedicated" short-selling firms run funds that do nothing else. "That's too small to have an impact," Kass says.

The ban on short selling has exacerbated the financial crisis by driving dozens of hedge funds to the edge



Kass of Seabreeze says the short interest in stocks is too small to move markets.



Asensio says what killed financial companies was poor management.

of bankruptcy, says Richard Baker, president of the Managed Funds Association, a hedge-fund-industry lobbying group. Quantitative hedge funds were put in the most jeopardy by the ban, he says. They use sophisticated computer algorithms to choose a group of stocks to buy. They then hedge the bet by shorting a second set of stocks. Their response to the short-selling ban has been to cut back on all trading, Baker says.

Convertible bond funds have been hurt the most by the ban. Investors who buy convertible bonds—bonds that can be converted to stock at a certain price—usually short the same company's stock as a hedge against a fall in the price. Financial companies sold more than \$30 billion of convertible bonds in the first nine months of 2008. In September, convertible bond arbitrage was the worst-hit hedge fund strategy, plunging 16.6 percent, according to Chicago-based Hedge Fund Research Inc.'s HFRX index, against a 6.9 percent fall for the industry.

Most academic observers agree with Kass that the power of short sellers is exaggerated. "In the current

played little or no role in the 2008 market downturn.

Kass, for instance, points out that Morgan Stanley offers no data supporting CEO Mack's contention that short sellers were responsible when his company's stock price retreated 44.5 percent to an almost 10-year low of \$22.55 in the three weeks ended on Sept. 18, the day short selling was banned. Morgan Stanley shares closed at \$9.68 on Oct. 10, down 82 percent for the year.

Data from custodians and brokerages compiled by London-based Data Explorers Ltd. show that as of Sept. 16, about 2.9 percent of Morgan Stanley's outstanding shares had been loaned to short sellers, down from more than 7 percent in July.

According to Short Alert Research, a Charlotte, North Carolina-based firm that produces research for short sellers, from early July to late September short interest in 33 investment banks and brokers plunged by 33.3 percent. Yet, share prices still declined.

"It was the longs getting out," says Fleckenstein. "Probably the insiders."

crisis, shorts are like flies on a carcass on the side of a road," says James Angel, a finance professor at Georgetown University in Washington who studies short selling. "We should focus on who or what killed the animal."

UNDER CERTAIN CIRCUMSTANCES, short sellers can manipulate stock prices—either through concerted action or through a "feedback loop," says Itay Goldstein, a finance professor at the Wharton School at the University of Pennsylvania. A feedback loop is simply a chain reaction. An example might be when creditors refuse new loans to a company after reports surface that there is heavy short interest in its stock, Goldstein says. Short interest is the total amount of shares that have been borrowed by short sellers. The credit pullback leads to a further share decline and a decrease in the value of the firm. "It's hard to tell whether the recent market decline is due to manipulative attempts," Goldstein says. "The conditions were such that this is quite possible."

The short sellers have marshaled statistics in an effort to prove they

The first recorded ban on short selling took place in the Netherlands in 1609, when Issac Le Maire, a Flemish merchant and former board member of the Dutch East India Company, formed a secret society of short sellers to drive the company's stock price down, says Edward Chancellor, author of *Devil Take the Hindmost: A History of Financial Speculation* (Farrar, Straus & Giroux, 1999). Part of Le Maire's scheme was to form a French company to compete with the Dutch trading firm. The Dutch East India Company then persuaded the government to ban short selling.

In 1792, the New York state legislature forbade short selling after the U.S.'s first-ever stock market crash. Just five weeks later, two dozen brokers signed the Buttonwood Agreement, which created what later became the New York Stock Exchange, where short selling was allowed.

Short sellers were widely blamed for the wild gyrations of the stock market after the crash of 1929—and for good reason, says Charles Geisst, professor of economy and finance at Manhattan College in Riverdale, New York, and author of *Wall Street: A History*. “During the year prior to passage of the Securities Act and Banking Act in 1933, there was a massive bear raid on

Removing the uptick rule overthrew 71 years of stability,’ says Manhattan College’s Charles Geisst. ‘That’s what broke the camel’s back.’

Wall Street,” Geisst says. “Some executives were shorting their own stock.” The Securities Act created the SEC.

In 1938, the SEC adopted the “uptick” rule, which allowed short sellers to borrow a company's shares only when the shares were on the rise. The SEC eliminated the rule in 2007, and also relaxed its rule on naked short selling—decisions that brought a storm of criticism on the head of SEC Chairman Christopher Cox a year later when the markets melted down. The two actions “overthrew 71 years of stability,” Geisst says. “That’s what broke the camel’s back.”

FLECKENSTEIN, SITTING AMONG stacks of newspapers and analyst research reports in his Seattle office in late September, says the SEC's short-selling ban and the federal government's \$700 billion bailout package just postpone the day of reckoning. “Capitalism is all about boom and bust,” he says as he scans e-mails and monitors stock prices. “To ban short selling is to say that the government is going to determine what stock prices should be.”

Fleckenstein got a degree in mathematics from the University of Washington in 1976 and then worked for three years as a software engineer. In 1979, he joined investment bank Kidder Peabody & Co. as a broker. Three years later, he left to form a private investment advisory firm, managing money for pension funds and wealthy individuals. In 1996, he started Fleckenstein Capital, which from the beginning was a short-only fund specializing in technology stocks.

The fund was launched in a time of unbridled enthusiasm for all things technological. The Internet boom was unfolding. Even as early as 1996, Fleckenstein thought the run-up in stock prices of the companies was unwarranted.

His fund did well until 1999, when the tech-oriented Nasdaq rose 86 percent. Even though his short positions were in hardware companies rather than dot-coms, Fleckenstein's fund took a beating. “Internet stocks were trading at a wacky number,” Fleckenstein says. “That meant legitimate companies, with real business and revenue, were trading at a higher level than they were worth.”

Chanos says he stopped shorting financial stocks in early 2008.



At the end of 1999, Fleckenstein's investors, including Microsoft Corp. co-founder Paul Allen, had to provide him with more funds.

Fleckenstein declines to disclose either the size or returns of his fund. One Fleckenstein investor, Tor Braham, head of technology mergers and acquisitions at Deutsche Bank AG, says he couldn't be happier with his returns, though he won't disclose what they are. He says he invested with Fleckenstein in April 2000—when technology and Internet stocks were coming off their all-time peak. The Nasdaq has fallen more than 50 percent since then, as of Oct. 10, generating big profits for investors who bet against it. "Fleckenstein has been saying for a long time that the economy is going to get into trouble because of leverage," Braham says. "He's very thoughtful as to the bets he takes on companies and doesn't do things he doesn't understand."

Fleckenstein places most of the blame for the crisis in housing and mortgage-backed securities at the feet of former Federal Reserve Chairman Alan Greenspan. Fleckenstein has written a book on the topic called *Greenspan's Bubbles* (McGraw-Hill, 2008). Over three years starting in January 2001, Greenspan and the Fed slashed the fed funds rate to 1 percent from 6 percent. Fleckenstein says it was this extremely aggressive monetary policy that led to the housing bubble and mortgage-market abuse. "Financial companies learned there was no risk," he says. "They didn't even pay attention as mortgage defaults exploded."



Fleckenstein says his research shows mortgage defaults took their first sharp jump in February 2007; yet, he says, few leaders in either the government or financial industry sounded an alarm until it was too late. "How inept are our leaders when they missed something so obvious," he says.

Like his fellow short sellers, Fleckenstein sees no profit in optimism. He told Bloomberg News on Sept. 24, when the Dow was at 10,825, that he expected it to bottom out at 8,500. As of Oct. 10, the index stood at 8,451. He insists, however, that it gives him no joy that his grizzly bear's "Dow 10,000" hat is now out of date. **B**

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Exploring Short Interest

You can use the Short Selling Restricted (SSR) function to monitor bans on short selling in countries around the world. Type SSR <Go> and click on the circle to the left of a country's name to display a list of stocks the nation's ban applies to, as shown below.

Click on the Credit Crunch Overview button on the red tool bar for the Credit Crunch Overview (CCRU) function. CCRU lets you monitor Bloomberg's indexes of short-sale-restricted securities and displays headlines of news stories on the credit crunch as well as a menu of related functions.

You can use the Short Interest (SI) function to display data on the number of shares of a selected stock that have been sold short. Type MS US <Equity> SI <Go>, for example, to track short interest on Morgan Stanley. The short-interest ratio on the New York-based bank reached 3.1729 in August before the SEC ban went into effect. That means that the number of shares sold short was equivalent to more than three times the average number of shares that trade each day.

Type OVI <Go> to use the Largest Option Volume Increase function to display stocks with the largest increase in put volume. Put options grant the right but not the obligation to sell shares at a specified price on or before expiration.

JON ASMUNDSSON

BUKNSHRT 89.80Y as of close 10/14		Index SSR			
98) Output to Excel		99) Credit Crunch Overview			
<input type="checkbox"/> All	<input type="checkbox"/> Australia	<input type="checkbox"/> Austria	<input type="checkbox"/> Canada		
<input type="checkbox"/> France	<input type="checkbox"/> Greece	<input type="checkbox"/> Iceland	<input type="checkbox"/> Denmark		
<input type="checkbox"/> Italy	<input type="checkbox"/> Korea	<input type="checkbox"/> Netherlands	<input type="checkbox"/> Ireland		
<input type="checkbox"/> Switzerland	<input type="checkbox"/> Taiwan	<input type="checkbox"/> UK	<input type="checkbox"/> Pakistan		
<input type="checkbox"/> 91) All Short Sell	<input type="checkbox"/> 92) Naked Short Sell				
		Short Selling Restricted			
		<input type="checkbox"/> Today's Additions			
		<input type="checkbox"/> Today's Deletions			
		Total: 33			
Ticker	Name	Industry	Market Cap	CDS	Dbt/Equy
1) ADM LN	ADMIRAL GROUP PLC	Insurance	2406.01	n/a	0.00
2) ADN LN	ABERDEEN ASSET MGMT PLC	Diversified Finan	824.53	n/a	21.56
3) ARBB LN	ARBUTHNOT BANKING GROUP PLC	Diversified Finan	53.74	n/a	55.16
4) ATST LN	ALLIANCE TRUST PLC	Closed-end Funds	1698.25	n/a	n/a
5) AVV LN	AVIVA PLC	Insurance	11826.77	141.20	87.92
6) BARC LN	BARCLAYS PLC	Banks	20591.29	71.00	1226.61
7) BRE LN	BRIT INSURANCE HOLDINGS PLC	Insurance	521.16	n/a	20.52
8) CBG LN	CLOSE BROTHERS GROUP PLC	Diversified Finan	733.83	n/a	219.07
9) CSM LN	CHESNARA PLC	Insurance	123.08	n/a	13.99
10) EIIB LN	EUROPEAN ISLAMIC INVESTMENT	Banks	51.12	n/a	70.02
11) FCAM LN	F&C ASSET MANAGEMENT PLC	Diversified Finan	307.95	n/a	37.30
12) FPV LN	FRIENDS PROVIDENT PLC	Insurance	2091.35	n/a	54.32
13) HBOS LN	HBOS PLC	Banks	4611.65	85.80	1224.64
14) HSBA LN	HSBC HOLDINGS PLC	Banks	103962.30	0.00	298.03
15) HWY LN	HIGHWAY INSURANCE GROUP PLC	Insurance	149.67	n/a	21.54