FOOL ON THE HILL

The Short-Seller's Mindset

Even after the bursting of the tech bubble, stock promotions and scams are still all too common. Whitney Tilson shares his tips -- and those of famed short seller Manuel Asensio -- on how to avoid these traps. Long-term investors should keep these tips in mind even if they never short a single stock.

By Whitney Tilson
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I just finished reading *Sold Short*, a new book by famed short-seller Manuel Asensio. In it, he describes numerous long-running battles with companies that were, in almost all cases, engaged in nefarious, outrageous, fraudulent activities.

I'm not at all surprised that many companies engage in such behavior. The stock market has long been fertile ground for promoters and scoundrels. Nor am I particularly surprised that so-called analysts, even those at major brokerages, unwittingly -- and, in many cases, knowingly -- aided and abetted stock promotions.

What was surprising to me, however, was the extent of the denial on the part of investors. As Asensio describes in case after case, investors -- ranging from individuals to money managers at the largest, most prestigious institutions -- refused to acknowledge the truth despite overwhelming evidence that they had been victims of a scam and clung irrationally to their holdings.

It's hard to admit a mistake and even harder to sell at a loss (as I discussed in my columns, "To Sell or Not to Sell" and "Never Too Late To Sell"), but it would seem that these natural inclinations could be overcome with hard evidence. Maybe not.

How can you avoid getting into such a predicament? The easiest way, of course, is not to own the stock of a questionable company to begin with, so allow me to share some tips -- drawn from Asensio's book as well as my own observations -- on how to identity them.

None of these characteristics are, by themselves, conclusive, but when you see them -- especially more than one of them -- be careful!

- No profits or -- worse yet -- little or no revenues.
- "The underwriters of the initial public offering have a tainted reputation." (Asensio)
- Switching auditors.
- Delayed filing of financial reports.
- A product "in a sexy, hot field with hard-to-quantify, hard-to-understand performance specifications" (Asensio). In particular, be wary of companies promoting new medical breakthroughs. One such example is **Sunrise Technologies International** (Nasdaq:

SNRS), which I panned in my January column, "Stocks to Avoid." (As I predicted, the stock is well on its way to zero.) Asensio cites other examples, including **Chromatics Color Sciences** (Nasdaq: CCSI), **Zonagen** (Nasdaq: ZONA), and **Hemispherx Biopharma** (AMEX: HEB).

- A company claiming to have discovered new sources of (or methods of extracting) natural resources, such as oil or gold. Remember Solv-Ex, Bre-X, or Crystallex International? (As I look at this list, I'm coming up with a new warning flag: natural resource companies with names that end in "x.")
- Cute, dumb ticker symbols. Asensio cites the case of Systems of Excellence (Ticker: SEXI), which "went bankrupt in 1996, only after, according to the SEC, it had become the most important case of Internet stock-touting fraud ever."
- A blizzard of press releases. I find there tends to be an inverse correlation between the quality of a company (and its management) and the number of press releases it generates.
- A high short interest. (Anything above 5-10% of shares outstanding is cause for concern.) This is easy information to gather. I use Yahoo! Finance's "Profile" feature. (Data for Sunrise is available online as one example. In the bottom-right corner of Yahoo! profile page, under the heading **Short Interest,** you can see that 15.1% of Sunrise's shares are sold short.)
- A company suing -- or even responding to -- short sellers. Asensio says it best: "How many times have we seen officials of outright blatant scams blame their troubles on short sellers? No legitimate company with a real business would bother wasting valuable corporate resources, including valuable management time, suing a short seller.... When investors see public companies expend vast resources to silence their critics, they might want to tread carefully."

Listen to short sellers
I don't short stocks because -- as I discussed in "Good Time to Short Stocks?" -- it is an extremely difficult and dangerous activity. Unlike investing on the long side, where a lack of talent and a poor track record don't seem to be much of a barrier to managing large sums of money, incompetent short sellers quickly go out of business.

Those who remain and thrive really do their homework. So when you see a stock panned publicly by Asensio or David Tice or a credible investigative journalist with sources among short sellers like TheStreet.com's Herb Greenberg, don't go anywhere near it! Sure, the shorts could be wrong, but why take the chance? Of the thousands of stocks in the investment universe, surely there are better ones than those broadly targeted by short sellers.

Very rarely have I owned a stock targeted by shorts, but when it's happened, I'm grateful, not resentful. It doesn't advance my thinking very much to read an analyst's puff piece about a stock I already like and own. What I really benefit from is a smart person -- be it a short seller, journalist, or fellow investor -- making a bearish case for the stock. Listening to short sellers paid off for me last year when I dumped many of my technology holdings before they collapsed.

Unfortunately, however, embracing criticism is not the typical reaction by those who have been lured into a stock promotion. Instead, "shoot the messenger" is the order of the day. You would not believe the hateful emails I receive every time I criticize a stock. For daring to question the future viability of Sunrise, for example, one reader accused me of "cooperating with the short interest" and expressed hope that I suffer "total vision damage and have to always look at the world through blury [sic] vision. All in the name of profit for yourselves. I wish nothing but the worst for you and your kind." Take a look at Sunrise's latest 10-Q and tell me if you can come to any other conclusion than this company will soon be bankrupt.

Conclusion
Love him or hate him -- and he is widely reviled by the stockholders of many companies he targets -- Asensio's book is well worth reading. I'll let him give the last piece of advice:

"There are two things that every investor can do to foil stock fraud: Don't be cynical, be skeptical. And be informed. Due diligence does not mean perfunctory, one-source research. It does not mean taking as gospel the pronouncements of a broker or some financial pundit. And it most definitely does not mean taking the advice of some stranger phoning at dinnertime from a boiler room in New Jersey."

-- Whitney Tilson

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