Alan M. Newman's Stock Market

CROSSCURRENTS

COMMENTARY EXCERPT - APRIL 24, 2006

"In reality, investors have been blindsided by an industry so eager for profit that they will take practically any route, including those that harm shareholders of the very companies they sell to customers."

Myths Exposed & An Amusing Irony

In our last issue, we made reference to a concerned investor who appealed the SEC's denial of his Freedom of Information Act request for failed deliveries of NovaStar Financial stock. The SEC granted the appeal and the response of data for 2005 was shocking, showing as much as 6.5% of the outstanding capitalization shorted but not delivered to the new owners, known as a naked short position. But then our concerned investor received SEC data for 2004. Beyond shocking. Beyond astonishing. *In the fourth quarter of 2004, failures-to-deliver ran as high as 12.5% of outstanding capitalization, one of every eight shares authorized to trade.* At the same time, total short interest was about 11.3 million shares on an authorized cap of roughly 25 million. Thus, those who *thought* they "owned" NFI could count at least 36.3 million shares in their presumed possession, 45% more shares than the company had authorized to trade. It is high time we admit the truth. *The short selling mechanics of the U.S. stock market are clearly broken, certainly not in all cases but sufficiently in some cases to harm shareholders dramatically.*

Incredibly, the industry does not want you to hear the arguments. The hedge fund community, readily able to play the short side, does not want you to hear the arguments. The public has purposely been kept in the dark, since journalists wish to ignore the arguments as well. No wonder, since the conduit provides so much information from the very same hedge funds. *Misinformation.*

Thus, we keep on hearing it over and over again. Short selling must be a good idea because short sellers tend to do better and short sellers alert investors to bad companies. But the common wisdom is no wisdom at all, just claptrap meant to mislead the public. *Of course short sellers tend to do better.* When investors take the long side, the *best* they can do is buy from the existing float. Demand versus a *fixed* supply. However, when short sellers transact on massive levels, either via shorting or by buying put options, the supply of shares increases, in some cases, dramatically beyond what has been authorized by the company. *When supply overtakes demand, prices must fall.* How can put options result in an expansion of supply? As we have previously explained, market makers step in to hedge their sale of puts and short the stock. *They may even be able to get away with never borrowing the shares and delivering to buyers on the other side of the transaction.* All the buyer receives is a brokerage statement that *purportedly* shows the shares in the account, when in truth, *the shares are not.* All that is "owned" turns out to be a bookkeeping entry representing a wager on the price of the shares.

For the most part, recognition of these circumstances is still wanting. Incredibly, some journalists are so off-base with their subjective commentary that they have entirely missed all relevant points. Holman W. Jenkin's, Jr. recently wrote in the WSJ (tinyurl.com/zarkn), *"Naked shorting doesn't create any new claims on a company. It only creates claims, in the form of IOUs for stock, on parties involved in a stock trade."* Given the fact that investors in many situations are robbed of their full right to vote on corporate matters, the journalist's view is *provably* false.

As to the oft promoted rationale that short sellers are "good for the market" since they expose bad companies, again, nothing could be further from the truth! *It would never be in the best interests of short sellers to expose the problems of bad companies or stupid investments before the public was "all-in,"* buying and lifting prices to ridiculous levels! Why is this circumstance *not* obvious to everyone?! The correct view is that if a hedge fund analysis reveals problems, a public revelation will remain under wraps until as many as possible have bought and the share price is as high as it is likely to go *and* those in the know have positioned their accounts short, *the rationale being to ensure the largest possible profit from an expected downside!* Thus, we expose the myth that short sellers are "good for the market." *They are not.* The public and of course, many mutual fund managers and pension funds, are always capable of being dramatically

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wrong. The proof is in the pudding. Enron and Worldcom were arguably two of the largest scams in stock market history, but the problems of neither company were revealed until investors had already gulped up wealth in enormous quantity (*Ed note: we cannot resist pointing out that many of these investors were index funds, by their very franchise, necessarily and permanently blind and ignorant to the possibility of investing stupidly*). Both companies were eventually amongst the very largest in terms of capitalization *before* the first negative reports appeared. Ironically, it makes far more sense to believe that sophisticated short sellers would be most willing to at least temporarily conceal any evidence that would drive prices down, in the hope that a better short selling opportunity will present itself. There will never be a profit motive for shorts to reveal their analyses until investors have been sucked in to the max! *Short sellers do not perform a public service!*

Worse yet, the system as currently structured actually *encourages* negative "research" by hedge funds and corroboration by journalists eager for a breaking story. Since short selling mechanics tend to create additional supply beyond what companies have authorized, there is an implicit guarantee that very heavily shorted companies will see their price decline, *regardless of any positive corporate fundamentals.* A score for the short seller and a score for the journalist. Since human nature is what it is, the temptation to abandon ethics and to screw the investing public is irresistible. Thus, we can completely understand the law suits by Biovail and Overstock, subjects the mainstream media glosses over as if in a trance. These two lawsuits will serve as a true litmus test for the industry and offer proof beyond any doubt that not only are there bad players, but the industry itself is corrupt, taking extreme advantage of its own customers. The scope of this scandal has yet to be fully detailed, but we believe it is enormous.

Even short sellers are concerned! Two class action lawsuits brought by hedge funds are now in the works (see http://tinyurl.com/psgo5), charging that brokers have effectively delivered *nothing* for their supposed services rendered. Specifically, short sellers have been charged "negative rebates" in order to short certain hard to borrow stocks. In some cases, like for Overstock, the *vigorish* to locate borrowable stock may be as high as 2% per month, or 24% per annum. However, if the resulting transaction was actually "naked," with the stock not actually borrowed nor delivered to a buyer on the other side of the transaction, *the short seller has in effect paid the broker a fee in return for nothing.*

Arne Alsin, the portfolio manager of no-load The Turnaround Fund, purchased five blocks of stock in Overstock during the first quarter and claims there was a failure to deliver shares in four out of the five purchases, with delays for delivery lasting as long as three weeks. Alsin states, "*Nobody can tell me why shares were not delivered within the requisite three-day settlement period....Either they had my property in their possession and decided to keep it for awhile, or they sold the shares to me without having possession. While the first possibility is a serious infringement of the rules, the second possibility is particularly disturbing.*"

We believe Mr. Alsin has stated the case most politely. In reality, investors have been blindsided by an industry so eager for profit that they will take practically any route, including those that harm shareholders of the very companies they sell to customers. At this juncture, we believe the brokerage industry itself is quite vulnerable to its own practices and as a result, *broker-dealer stocks could soon be susceptible to a prolonged short selling debacle, a most amusing irony.* A groundswell reversal in perceptions has commenced. After an 81.5% advance over the last year, broker-dealers have already factored in all the best case scenarios available. *For the brokers, from here on, it may all be downhill.*

Alan M. Newman, Editor
April 24, 2006