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The Art of Shorting

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Warren Buffett, Michael Price, Mario Gabelli, Walter Schloss, and Charles Royce are not the typical guest lecturers at a business school class. Then again, the Columbia University Graduate School of Business isn't just any business school, and professor Bruce Greenwald's class is anything but ordinary. Greenwald teaches the value investing course at Columbia and also authored *Value Investing: From Graham to Buffett and Beyond*. In part three of this five-part series, Greenwald talks with Fool contributor Matt Logan about the dos and don'ts of shorting.

TMF: In the past, Bill Miller has put shorts on to lower his net long exposure.

Greenwald: Oh yes. I would also do shorts.

TMF: What's your feeling about shorting as a hedging technique?

Greenwald: Yeah, let's talk about shorts. I think the value discipline is so good, that you don't want to restrict yourself by a lot of these formulaic rules that they [the value crowd] have. And one of the most restrictive is the no short selling. And you understand why they're nervous about short selling. One is the tax treatment of short gains is just ridiculous. It's all ordinary income. Second thing is that there is this property that, as the stock goes up and the short goes against you, your risk goes up as opposed to going down. When you're long and the stock goes down, it's a smaller part of your portfolio. When you're short and the stock goes up, it's a bigger part of your portfolio. But I don't think that that argues for not shorting, I think that argues for being careful how you short.

But I think there are two rules that you want to apply to shorts. One is you don't want to cover a short for a long time because of the tax consequences. And as long as you're doing that, the paradox of short selling is that in short sales, you have to be much more long-term oriented than in long because you don't want to cover. You don't want to trade out of it. What that means, I think, is that as a rule, the shorts you want to do are the shorts where the intrinsic value of the stock is essentially zero, relative to the price at which it's trading. Now it could be 20% of the value at which it's trading, but you don't want to short asset-rich stocks or stocks like **Microsoft** (Nasdaq: MSFT) that have a lot of value there that could go up or the perception of it could go up. Because you're going to get killed. You want to do the Winstars of the world, where there's no value there at all when you analyze the competitive situation. And it's got a market cap of $12 billion. And it's got $14 billion in debt.

So the first rule of shorting is that you have to take a long-term view. And you have to have a big margin of safety. You want to make sure that there's relatively little value. Yeah, but there are a lot of opportunities like that.

The second thing, again, to manage the risk of the short, is you really want to be able to handle at least a double in the price after you short the stock. You want to run a test, you've really got to stick with it with a short. You don't want to bail. Well, I guess you could bail out and take the short-term loss, but you really don't want to be forced to sell out at a ridiculously high price. You want to stick with it.

So I think that you want to be much more circumspect about how much you're going to short. Right now, people are 50% in cash. They're value investors. They're sort of 50% in cash, and they've got 50% in other things. I think a 20% short position would not be bad. I think a *big* short position is much more dangerous. Because if it goes against you and the mania is persistent, you could get killed.

The third thing is -- and this is sort of an aspect of modern value investing, and it's a risk control measure with respect to value investing -- looking for a catalyst. What Mario Gabelli actually looked at -- you know, he was going to buy these stocks on private market value where the valuation information starts to get a little dicey because private market values, which are takeover values (which is what Bill Nygren does), are in fact related to market values. And if the market is crazy, the private market values may be crazy, too. So what he looks for whenever he takes that risk is for what he calls a catalyst. Somebody, some event that's going to take him out -- a recapitalization, a stock buyback. On a smaller scale, a takeover, a change in management. He's always looking for something like that. Whenever the risks are high in a value investment, you want to try and look for a catalyst that's going to get you out of it.

So suppose I'm going to short something like -- this is actually a short I did; I really don't invest much myself -- **Juniper** (Nasdaq: JNPR), there was no way it was going to be worth anything because it was going up against **Cisco** (Nasdaq: CSCO). If it got into the market against Cisco, it meant there were no barriers to entry, and everybody else was going to be able to follow, and that Juniper would just be dead, too. If it didn't get in against Cisco, it was dead anyway, so there was no way Juniper was going to make a big amount in the long run. And they had a huge market cap. So I shorted it at about 180 and it went to 280. I think it actually went to about 330.

TMF: Ouch.

Greenwald: Exactly. And then, of course, I shorted more because the value rose. I didn't do a lot of this. Now it's down around $23 a share.

TMF: It worked out in the end.

Greenwald: It worked out in the end. But I think the mistake I made was -- and this is the last point I'd make about shorting -- in shorts, much more than longs, you obviously want to look for a catalyst. You want to look for something that's going to undermine the stock price. Paradoxically, in shorts, you're in for the long term. You want to short things you're going to hold for 20 years once you do it. But also, that's where you want to do short-term earnings forecasts. Because in the shorts, they're mostly *very* overvalued, and what you're looking for is an earnings disappointment. So that *there* [as opposed to long investments], you do want to look at short-term earnings, just to see what's going to happen. And it's not because you're going to short based on the short-term earnings forecast, but you're going to pull the trigger when you think there's a reasonable prospect that earnings are going to be disappointing. So the value is not going to be there. And you look, say, in the case of Winstar, you look at the telecom industry. And you look around at a surrounding event where profits in telecom are going to evaporate, because you think that's the sort of news that will undermine Winstar.

TMF: So you're not just looking for the typical, overvalued and yet growing company? You don't want to short **eBay** (Nasdaq: EBAY), for instance, just because you think it's rich?

Greenwald: No. eBay is the classic case of something you don't want to short. Because eBay, there's real value there.

TMF: And if you wait long enough, the value will catch up with the price.

Greenwald: Exactly, so you can't short that one forever. You want ones that really are essentially mania stocks. I think **Google** is a better one, because we know that there has been a succession of search engines. eBay has big competitive advantages. It would be hard to compete against eBay. Google, on the other hand, if you have a better search engine -- we went from **Yahoo!** (Nasdaq: YHOO) to AltaVista and then finally to Google. But if you go to another one, the appeal of Google will evaporate fairly rapidly.

TMF: Right, and the boys in Redmond are busy working on its competition.

Greenwald: Exactly. So in one case, there's real value underlying it. In the other case, the value is really highly problematical. So eBay might be worth a half to a third of what it's trading on. But Google is probably worth about 10% to 15%. The values of these things do grow in general for the eBay-type thing, so you don't want to risk shorting that, because you can't do it forever. The second thing you want to look for is a collateral earnings disappointment, something that would take the bloom off Google, so that you at least thought about the risk that Google could triple in a month. And that is a risk.

Tomorrow: Bruce Greenwald explains how to identify a franchise.

Read Matt Logan's complete interview with Bruce Greenwald:

- Value Investing 101
- To Hold Cash or Not?
- The Art of Shorting
- Identifying Franchises
- The One Investor to Bet On

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Fool contributor Matt Logan owns shares in Berkshire Hathaway, but none of the other companies mentioned. The Motley Fool has a disclosure policy.

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