Evil's Good: Book of Boasts and Other Investments

by Simon Cawkwell

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Sample Chapter: THE ART OF SHORTING

"As for the virtuous poor, one can pity them, of course but one cannot possibly admire them."
- Oscar Wilde, the Soul of Man Under Socialism.

My first book, *Profit Of The Plunge (POTP),* was published in 1995 and covered short-selling. It was the first book in the UK so to do. It has enjoyed a mild success but not that great a success. It is now out of print. But Tom Winnifrith of t1ps.com thought that a further book might assist — partly to update *POTP* but also to include my views on buying equities for the long term. Given that I am widely believed only to short stocks this book is an opportunity for me to correct this misunderstanding.

Several readers will note that I have reproduced extensively from *POTP*. I do not apologise for having so done — after all, both *POTP* and this book are primarily intended as books to assist investors with the nuts and bolts of short-selling. But, equally, I have cut out much of the merely illustrative parts of *POTP* in the belief that events have taken over and fresh illustrations have become available. However, I make not even a hint of an apology for including my engagement with Maxwell since the DTI report into the activities surrounding the flotation of Mirror Group has now been published — in early 2001 or more than eleven years after the frauds were committed. I have read this report and it changes nothing that I originally wrote. I would only add that the tone of the report is very much determined with the benefit of hindsight. Many think that that is not available in real life.

What is a short?

Short-selling (or going a 'bear') is the process of selling stock which one does not own in the expectation of buying it back later at a lower price and thus realising a profit. Because there must always be the possibility that no stock is available when one comes to buy to close the short-sold position, there must always be the theoretical possibility that one can lose all that one has. Indeed, so awful is such a prospect that some otherwise apparently sensible people claim that one can lose an infinite amount of money. But, however much money is in the world, the total is surely finite. So one can dismiss the 'infinite' argument against short-selling as the commentary of the cowardly and ignorant — and one always does well by ignoring that lot.

The morality of short-selling

It has often been remarked to me that short-selling is somehow ‘bad form’. Such commentators opine that, in life, if one has nothing positive to say, one should say nothing. It is further argued that short-selling is a negative statement in itself and therefore contrary to society’s best interests. But all that a short-seller is doing is reflecting upon his perception of the truth. By the time that a company has entered the short list to be sold, the change in its circumstances has either occurred or is about to occur in any event. It can be argued that rescue finance and/or a rescue order might be deterred by a seemingly artificially depressed price. But that seems a most improbable scenario. Besides, God help the over-confident short-seller that meets the buying orders of a broker for the client who reckons the short-seller has made a mistake about the supposedly beleaguered company.

I would also add that forever talking up the value of assets (which process notably occurred through the agency of the Conservatives and their leader in the mid-1980s, particularly in relation to houses) is much more dangerous: when such bubbles are punctured, the fallout is socially much more serious. The proper conclusion is that accentuating the negative to excess is just as unwise as accentuating the positive to excess. Further, if one buys stock in the normal manner, one is invariably encountering a seller. Is this seller to be pilloried for being negative? Let us not forget that all market-makers are frequently short.

It might be thought that because investment institutions do not generally engage in short-selling there is some reason for this policy based on morality rather than profit. But investment institutions must be careful to avoid offending the managements of potential future investments; so short-selling would not be their natural inclination. Further, such institutions are run by fund managers who are almost invariably proscribed from short-selling on their own account. Were institutions to confront the possibility of their fund managers short-selling through their own broker for their own account but ahead of major disposals by their employers, a major temptation to abuse their clients’ interests would have to be faced. It can, of course, be argued that managers’ own long positions could be handled and thus abused in the same manner. But the temptation thus arising would be much less frequent unless the fund manager’s personal portfolio matched his employer’s — and, then, if he is honest, he might just as well invest in his employer’s fund.

I would mention that there have been a number of instances of rights issues in recent years, which, had investors been better informed, would never have been taken up. One that comes to mind was that by Cedar in 1999 for £60m of convertible loan stock when Cedar’s shares stood at around £6. Tim Steer, then of Collins Stewart, wrote an inspired circular entitled TIMBER which ravaged Cedar’s accounting practices and which I helped to bring to a wider audience via t1ps.com. Unfortunately, it never received enough of an airing through organised short-selling practice and the rights issue succeeded. It never should have. Cedar shares were around 5p when I last looked. In effect, scarce capital has been blown on a bad project.

I should add that a friend, now 80 years old, had a father who, he says, wrote in the 1930s against short-selling. He has often promised to let me have a copy of this tract. But to date he has not been successful. This may be just as well since the chances of the argument being successfully developed strike me as practically zero.

Unlimited losses?

I noted above that in practice the idea that one can rack up unlimited losses from shorting is tosh. However, one cannot rule out facing technical conditions, which can be extremely expensive to surmount. This is not a game for wimps. I am here reminded of the bear 'squeeze' which arose in Acorn Computers about fifteen years ago at a time when that company was experiencing commercial difficulty. Although short-sellers were entirely correct to expect declines of the order of 50%+ from the points at which they sold, there was not that much stock about or to be offered by later sellers. As a result, the market-makers (all of whom were perfectly well aware that Acorn Computers was standing at too high a price) simply declined to offer short-sellers stock to enable them to satisfy their short-sale bargains. This was the making of a classic bear squeeze. Before long, one or two short-sellers lost their nerve (this often happens with a short-seller who has not taken the trouble to work out his strategy but, instead, has idly left his decisions to trade to another) and ran for cover. This drove up the price. And only those who had done their homework (and were thus able to resist any argument to justify the new and much higher price) stood their ground.

It has been pointed out to me that the American drinks firm, Snapple, was ludicrously overvalued for a long time and that the shorters held their position confident that they would get justice in the end. In the event, however, Snapple was taken over by Quaker Oats and the shorters were roasted. The fact that the acquisition of Snapple subsequently destroyed Quaker Oats was no comfort at all.

Indeed, as it happens, there have been some famous short squeezes in the US Resorts International, the casinos concern, in the latish seventies which bust a number of short-sellers.

If I were asked to remark upon a general rule as to the potential loss on a short position, I would reply that a dogmatic view is not possible. The fact is that a takeover bid can be at a 100%+ premium to the current price particularly if market conditions are about to turn to the bull tack. The fact is that a highly geared company, even if in its last months of life, can advance quite spectacularly in percentage terms if the market senses that a rescue can be dreamt up. On balance, one should reserve for a loss of the order of 100% of the opening sale proceeds on each position and, on this basis, never commit oneself to an exposure in excess of 10% of one's net wealth. One must always judge whether one's personal balance sheet is excessively geared even though short-sale positions tend to do better when general market conditions are generally bearish.

Some short-sellers of the past: speculative positions; rapid downward price movements caused in the unwinding of speculative positions; who benefited?

(i) Vanderbilt and three corners

A complete history of short-selling would have to encompass the development of stock market regulation and much else besides. Obviously, there is insufficient room even remotely to permit such a tedious recital. Further, it would be incomplete in one sense because, as far as I am aware, there are no detailed records of trading on (for instance) the London stock market in Victorian times. And I must presume that there are many exchanges around the world whose history has never been closely recorded. For instance, while we are about it, I would not mind betting that the story of Shanghai, to name but one centre, would interest many. The Shanghai story will also remain untold.

Nowadays, one should not, if a director of a company, short-sell the company's stock when a rights issue is on the way. This is because it would be an insider trade. (Mind you, I saw that very conduct several times in the late 1980s.) However, there were no such inhibitions in New York during the nineteenth century. Indeed, it would have been regarded as foolish not to have taken advantage of such an opportunity. That said, one should not be too sanctimonious about Americans: in 1912, Rufus Isaacs, later the first Marquess of Reading, bought American Marconi stock for himself and his Cabinet colleagues ahead of the publication of a contract between the Government and the English Marconi Company. The contract had been negotiated by himself on behalf of the Government. His brother, Godfrey, was a director of English Marconi. Isaacs still became Lord Chief Justice.

There were then many examples of companies controlled from Wall Street by financiers who sold short their companies' stock and then delivered by the simple expedient of selling a 'property' (an industrial concern) to their company in exchange for shares. Strictly speaking, this was not short-selling — because the directors knew they would not be going short by the point when delivery would be compelled. But, technically, until the stock had been issued, they would have been short.

This technique of introducing 'properties' was a clear opportunity to 'water' stock. In nineteenth century markets, there was a lot of stock watering' — a term derived from the practice of cramming cattle with salt so that the satiation of their resultant thirst pushed up their weight at the point of sale. Many varieties of derring-do were rampant in nineteenth century New York. But, undoubtedly, Vanderbilt's two Harlem corners and his Hudson corner still provoke some admiration for his forthright manner during their development.

The New York and Harlem Railroad joined Wall Street at the southern end of Manhattan to Harlem in the north. It had restricted trading opportunities since it was licensed by the Common Council of New York, the local authority. In early 1863, it occurred to some members of that Council, who presumably owed some duty of fiduciary care to the electors (rather, as I must suppose, did the Marquess of Reading) that it would be a good idea to go long of Harlem stock, grant a franchise to Harlem, and then sell the stock that they had acquired. I am quite sure that it had never occurred to them that this was or would be an undisclosed profit for which, by today's legal standards, they would be obliged to account to the electorate. Further, today, they would be regarded as having breached the obligation of a servant or agent to avoid a conflict of interest. They simply regarded it as a perquisite of election to the Common Council.

Harlem's stock had been standing at $6 in October 1857, attaining $28 by early January 1863. As one of America's financial and commercial titans, Cornelius Vanderbilt took control in the opening months of 1863. The price rose — to $87 by early May 1863. There were 57,000 shares in issue. These figures give some idea of the true forces behind the subsequent movement. I regret that I do not hold indices for either the New York Stock Exchange (NYSE) or railroad stocks in general to allow for adjustment for relative strength. But it is very probable that Harlem had far outperformed the market by early May 1863 notwithstanding the inflationary conditions caused by the Civil War. Harlem may indeed have seemed overbought. The Common Council members schemed first to acquire Harlem stock and then to sell a franchise to Harlem (both of which they did) to extend its operations for 10% of the turnover generated and a flat annual charge of $25 per railcar — a charge, all told, to the franchisee of approximately $300,000 pa. This figure was rated by the market as highly profitable to Harlem. The scheme had the undisclosed distinction of an intention to repeal the franchise after the Common Council members had short-sold the stock.

The combined effect of the Councilmen's initial long positions and Vanderbilt's further purchases caused Harlem to touch $116.25 by 18 May. At this point, the Councilmen clandestinely liquidated their longs through the market to, as it turned out, Vanderbilt and his associates and proceeded to go short. The price declined to $109 by 1 June and $106 four days later. By 9 June it stood at $97.5 and crashed to $83 the following morning, only to recover to $89 that afternoon. However, by 17 June, it stood at $77. And, on 18 June it was traded down to $69.5, even if jumping to $79 in the afternoon.

The Councilmen then decided to cover their shorts. But, being professional men, they did so after announcing that the franchise to Harlem had been rescinded. After all, it helps to see that stock is to hand when one wishes to buy. However, the stock only fell to $72 on the announcement of the rescission. This was because Vanderbilt was supporting the price. It was then that the squeeze started and, two days later, Harlem had risen to $94. By 27 June, it had touched $106. It was then that the Councilmen met and rescinded the rescission subject to their being allowed to close their shorts at $94.

One contemporary writer remarked that: “it may seem anomalous that Harlem should rise 30% on the repeal of the grant and fall on the repeal of the repeal”. Many would agree even now. But there was still a short position and, despite civil unrest in New York quite otherwise occasioned, Harlem showed massive strength throughout July and hit $135 by 4 August and $179 on 24 August. The highest bargain was 500 shares at $180. And that was that. The corner was settled and Vanderbilt let the price drift. By December, Harlem stood at $87.5 — which was probably about where it should have been all along. The approximate decline in value of the company from its high was $5,000,000. This is a helpful sum today. But then, it was astronomic.

Astonishingly, Vanderbilt, who must have had the coolest of cool heads, a sort of cucumber of the century, was simultaneously handling a quite separate operation in Hudson railroad stock. Its price had declined to $123 by 20 June 1863 as a result of a sustained bear-raid. Vanderbilt instructed his brokers to buy all stock that was to hand. He then pulled the masterstroke. He sold his stock and simultaneously bought call options to get it back. This was leaked by Vanderbilt to the short-sellers, who, knowing that such a transaction is very expensive finance in effect, judged that Vanderbilt was short of cash. Accordingly, they sold the stock again through the market to, of course, Vanderbilt, who then exercised his options and called for his stock. The bear-raiders looked round for some. It just was not there and Hudson, on 9 July, hit $180 for cash settlement because Vanderbilt had made it plain that he wanted his stock and would not countenance delay — I presume that any failure to deliver under the then rules of the NYSE would have seen the defaulting short-seller bought-in (q.v.) at market price.

This price contrasted with the simultaneous price for delivery of stock two weeks later of $150. I expect that such quotations were borne in mind by Goldman Sachs when they squeezed the London market in Maxwell Communication Corporation stock some 128 years later. Vanderbilt then lent stock to the market at 2% per day. Nice business if you can get it. And Vanderbilt got it. Having got it, he forced the bears to close and, that done, the price withered away to $140 a week later. Child’s play, really. In 1864, only a year later, Harlem, which was clearly one of those stocks one never holds (because they are only for buying and selling), re-emerged as a scam vehicle. For, despite the New York Councilmen’s experience in 1863, some New York State senators, based in Albany, took up long positions and then spread the belief that legislation to assist Harlem’s position would be passed. This took the stock up from the low $100s to $149 by mid-March. The senators and their associates closed their longs, opened their short positions and awaited the Senate’s judgement. This was indeed that the legislation sought for Harlem would not be passed. And, by 26 March 1864, Harlem had fallen back to $101.

Vanderbilt watched all this and proceeded to build his corner. In fact, he bought so much Harlem stock that his total holding exceeded Harlem's entire issued capital by 27,000 shares. His control of Harlem meant that he knew that there was no chance of more shares being issued. So from its low of $101, Harlem advanced to $122 by 31 March and, by 18 April, to $195. Incidentally, the 18 April sixty day delivery price was $168 — as clear a backwardation pursuant to a bear squeeze as one could ever use by way of illustration. By mid-July, it touched $285. Vanderbilt had played the same stock twice and won.

En passant, I do not think Vanderbilt can have been a very nice man. For it is recorded that, at the outset of the Hudson squeeze, referred to earlier, he had advised his own son to sell 10,000 Hudson shares at $110 — just so that he could get hold of stock. But his son, judging that his father would or might deceive him, bought rather than sold. This made the son a substantial profit. It will be seen that today's legislation covering disclosure of holdings, particularly directors' holdings and concert parties would make Vanderbilt's game much harder to copy. Indeed, it is probably impossible. I qualify 'impossible' because I reckon that it is wise to assume that anything is possible in a stock market.

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