Short Selling & Attacks

"It's ruined a lot of people. You can go broke doing it. ... It's a whole lot easier to make money on the long side. You can't make big money shorting because the risk of big losses means you can't make big bets." - Warren Buffett on Shorting

From CNBC on 9/18/18:

Most of the 'big shorts,' who thrived during the financial crisis, have faltered since 2008

- Many of the biggest winners on Wall Street who made billions during the financial crisis have suffered in the last decade.
- Hedge fund managers David Einhorn and John Paulson have underperformed significantly versus the stock market in recent years.

Tae Kim | Leslie Picker

It's difficult to stay on top.

Last weekend marked the 10th anniversary of Lehman Brothers' bankruptcy, which many investors regard as the seminal event of the financial crisis.

While most investors on Wall Street lost money a decade ago during the depths of the crisis, some investors thrived and earned their place in the annals of financial history.

They're the subject of movies, books and speaking engagements. They've inspired others to follow in their path to uncover the makings of the next downturn.

They shorted the crisis and made billions. But for many of them, the decade since was not as favorable, in fact, it's been detrimental.

Take John Paulson. His assets under management have plummeted by more than three-fourths since the years after the crisis. There's also David Einhorn, whose fund is down more than 25 percent this year with his losing bets against high-flying technology stocks.

Here are more details on four key financial crisis winners and their stories over the last decade.

1. David Einhorn

Einhorn scored one of the most prescient calls of the entire financial crisis.

In May 2008, just a few months before Lehman Brothers declared bankruptcy, the hedge fund manager said at the Ira W. Sohn Investment Research Conference that the investment bank was a risk to the financial system and questioned its accounting. He confirmed his firm Greenlight was short Lehman during that speech.

But Einhorn has struggled in recent years. The Greenlight Capital fund returned a meager 1.6 percent in 2017 versus the S&P 500's 19.4 percent gain, according to an investor letter. The fund is doing much worse this year with a nearly 25 percent negative return through the end of August.

The hedge fund manager has said his fund's underperformance was due to his value investment style being out of favor in the current market environment.

2. Meredith Whitney

Meredith Whitney is regarded as the star analyst of the financial crisis. Her biggest call was on Citigroup.

In October 2007, she said Citigroup needed to reduce its dividend due to mismanagement, which sparked a large decline in the bank's shares.

Her negative call had an almost immediate impact as the bank's CEO Chuck Prince resigned days later and the company cut its dividend in two weeks after her report.

But Whitney didn't achieve as much success during the bull market. In 2010, she predicted a meltdown in the municipal bond market on the CBS program "60 Minutes" that never happened. Whitney started a hedge fund that quickly closed in 2015 after negative returns, according to The Wall Street Journal. That same year, Whitney joined Arch Capital Group.

A spokesperson for Arch Capital confirmed she is still employed at the company and manages some of its equity investments.

3. John Paulson

The most lucrative bet against the housing bubble was made by Paulson.

His hedge fund firm, Paulson & Co., made $20 billion on the trade between 2007 and 2009 driven by its bets against subprime mortgages through credit default swaps, according to The Wall Street Journal. Paulson's personal earnings were about $4 billion in that time period.

But the good returns didn't last and his firm lost many billions in recent years.

The assets of Paulson's firm fell to $9 billion earlier this year from $38 billion in 2011, according to Bloomberg. The drop came after several of its funds underperformed significantly.

The Paulson Partners Enhanced fund declined 35 percent last year and fell 49 percent in 2016, while Paulson Partners dropped more than 40 percent over the past four years, according to the media outlet.

4. Steve Eisman

Steve Eisman was a key character in Michael Lewis' best-selling "The Big Short" (“Eisman had a curious way of listening; he didn’t so much listen to what you were saying as subcontracted to some remote region of his brain the task of deciding whether whatever you said was worth listening to, while his mind went off to play on its own. As a result, he never actually hears what you said to him the first time you said it. If his mental subcontractor detected a level of interest in what you had just said, it radioed a signal to the mother ship, which then wheeled around with the most intense focus. ‘Say that again,’ he’d say.”) and was depicted by actor Steve Carell in the movie based on the book.

The hedge fund manager bet against subprime mortgages by buying hundreds of millions of dollars in credit default swaps. The trade worked so well that his hedge fund at FrontPoint Partners more than doubled in size to $1.5 billion from $700 million during the financial crisis, according to Lewis' book.

But in the following years he had much less success.

Eisman left FrontPoint to start his own fund named Emrys Partners in 2012. After two years of mixed performance versus the market — including a 3.6 percent gain in 2012 and 10.8 percent return in 2013 — he closed the fund in 2014, according to The Wall Street Journal.

He then joined Neuberger Berman as a portfolio manager in September 2014 and now manages about $767 million, according to the firm's website.

However, academic studies have shown that short interest data can be a valuable tool. From Dan Rasmussen of Verdad on May 7, 2018:

In Praise of Short Sellers

Short selling is perhaps the most difficult investment strategy.

Markets go up over time, so short sellers are starting with a negative expected return bet and have to generate massive alpha just to break even. They then must do the hard work to uncover hidden information, expose financial wrongdoing, identify mispriced risks, and warn of deteriorating market conditions. The companies they are shorting often fight back.

To make it even more difficult, there are structural risks. Short sellers must then borrow the shares, post collateral, and pay a loan fee. Loan recalls, changing loan fees, margin calls, and regulatory changes make their jobs even more difficult.

Short selling is difficult, costly, and risky. And short sellers have not had the best run of late, with the HFRI Short Bias Index down almost 11% in 2017. Institutional investors have been pulling money from short sellers, leaving allocations near all-time lows.

We believe short sellers are more important, and more valuable to the proper functioning of markets, than their recent performance or current assets under management might suggest. Short sellers may uncover hidden risks, and their trades might make stock markets more efficient.

A growing body of academic literature argues that short interest can identify stocks likely to underperform the market – and that this signal can complement better known market signals like value and momentum. This research suggest that if there is substantial short interest in a stock, long-only investors would do well to beware.

A 2008 Journal of Finance article found that stocks with high short interest underperform stocks with low short interest by a risk-adjusted average of 1.07% per month (14% on an annualized basis).

More recently, the economists Alexander Ljungqvist and Wenlan Qian examined every report published by short-sellers over a five-year period. They found that when short sellers published a report on a company, the company's shares fell by 8.2% on average on the day the reports were issued. Three months later, the shares were down an average of 21.9%, and a year later, by 56.8%. These short-selling reports were presenting valuable information that served to correct major market mispricings. A quarter of the companies identified in these reports ended up being investigated by the US Department of Justice or the Securities and Exchange Commission.

The risk of short selling helps explain why short interest data is so predictive. Researchers have found that the predictive power of short interest is particularly strong among stocks where the risks to short-selling are the highest (as measured by high variance in loan utilization and lending fees). Short sellers are disciplined by these risks to focus on tangible, near-term catalysts.

Long-only equity investors can benefit greatly from paying attention to what the shorts are doing. By using short interest data as a negative signal or risk management tool, long-only managers can benefit from the insights of the short sellers.

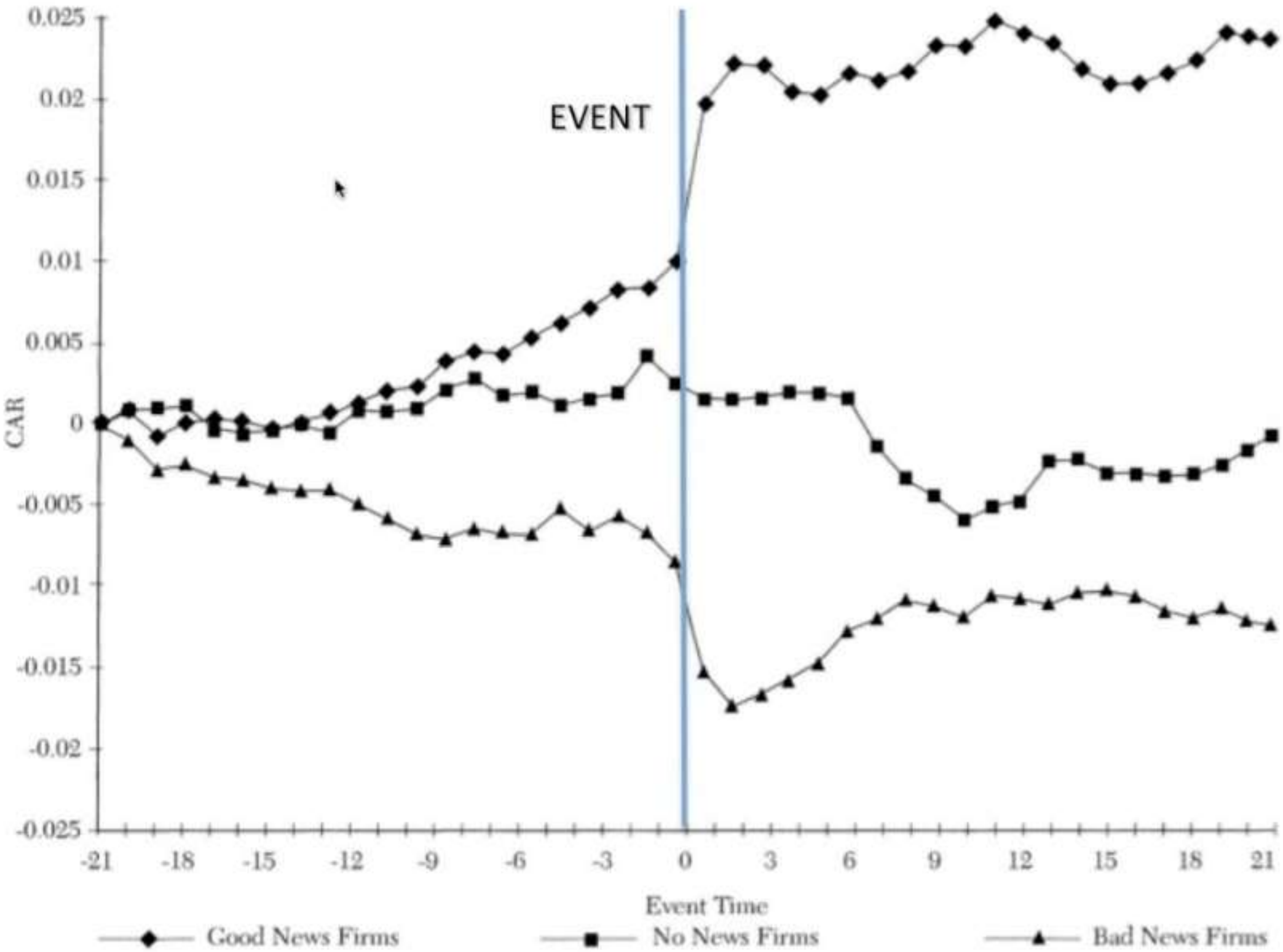
Our thoughts

The older of us spent a portion of his unguided youth in casinos**,** counting cards at blackjack, developing a system to beat horse racing (which turned $500.00 into $10,000.00 over a very long week), and fortunately getting 86ed from 2 Tahoe casinos over an attempt to get backing to hit a resurrected side bet at baccarat. Those were good days, which the younger of us never got to experience, since his youth was never unguided. So what does this have to do with shorting stocks? Well, occasionally I would be drinking with some friends and we would hit a craps table. While the odds are against you, you can get them fairly low by keeping your bets on the pass and come lines and always taking the odds. When the shooter is hot and the numbers are covered the fun can get loud. Occasionally, the party would be interrupted by a don't player whose bet against the shooter would immediately draw moans, sometimes jeers, from the rest of us. Inevitably, if the don't player won, he would slither away. And that is how short sellers used to act. However, those days are long gone, with the best of them, and even the wannabes, now launching elaborate, public short attacks after establishing their positions. So while HCM strickly playes the odds on the long side, how do we deal with the occasional short attack, which is currently the case with one of our stocks?

First, we treat short attacks as a negative event. As previously shared, we typically wait 3 weeks before selling. This allows the stock to partially recover (see the MacKinlay Study graph below), and time to see if the insiders are going to step back up to the plate. If there isn't renewed buying by the insiders, we sell. But what if the insiders do buy in reaction to a short attack? From **Insider Purchases after Short Interest Spikes: a False Signaling Device?** by Chattrin Laksanabunsong of Zacks Investment Management and Wei Wu of Texas A&M University on December 22nd, 2016:

"Do corporate insiders who purchase after short interest spikes possess positive private information? To address this question, we investigate the information contents of these insider purchases by examining the stock prices (Figure 3) and earnings surprises (Figure 4) following insiders' transactions. If insider purchases are driven by true positive information, we expect to see an increase in stock prices. Importantly, this increase should be long-lived, because it is backed by the subsequent revelation of positive news such as positive earnings surprises. On the other hand, if insiders do not possess positive information, the stock prices may increase in the short run, because the market may not be able to differentiate these purchases from those with true information. However, the increase in stock prices is likely to be short-lived in this situation. We find the cumulative abnormal returns associated with insiders' purchases increase significantly after insiders' transactions. However, they decay gradually in several months, and become indistinguishable from zero one year after insiders' transactions, suggesting the increase in stock prices is only short-lived. This hump-shaped pattern in stock prices is in stark contrast to the one associated with typical insider purchases, where the cumulative abnormal returns increase continuously, and remain significantly positive one year after insiders' transactions. To confirm our findings of the price pattern, we examine the earnings surprises following insider purchases with and without the presence of short interest spikes. Conditional on the absence of short interest spikes, we find the earnings surprises following insider purchases are significantly positive. In contrast, conditional on the presence of short interest spikes, the earnings surprises following insider purchases are actually negative, which again suggests these corporate insiders on average do not possess positive information."

MacKinlay: Event Studies in Economics and Finance 25



Event studies in economics and finance
AC MacKinlay - Journal of economic literature, 1997 - JSTOR

Figure 3. Cumulative Abnormal Returns associated with Insider Purchases

This figure plots the coefficients β_1 in Table 4, which represents the cumulative abnormal returns associated with the insider purchases conditional on the presence (red line) and the absence (green line) of short interest spikes. Cumulative abnormal returns are benchmarked by the returns of the corresponding DGTW portfolios.

$$CAR_{it} = \alpha_{industry} + \lambda_{calendar\ month} + \beta_1 Purchase_{it} + \gamma' X_{it} + \varepsilon_{it}$$

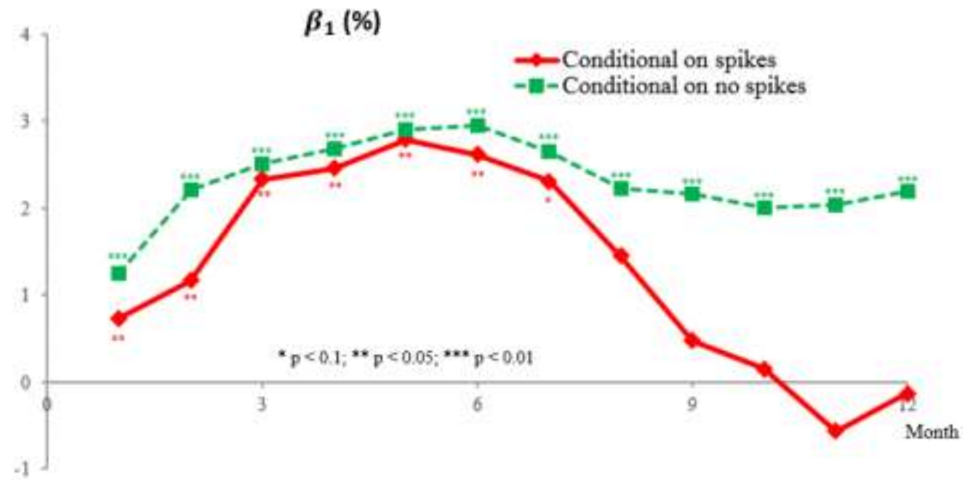
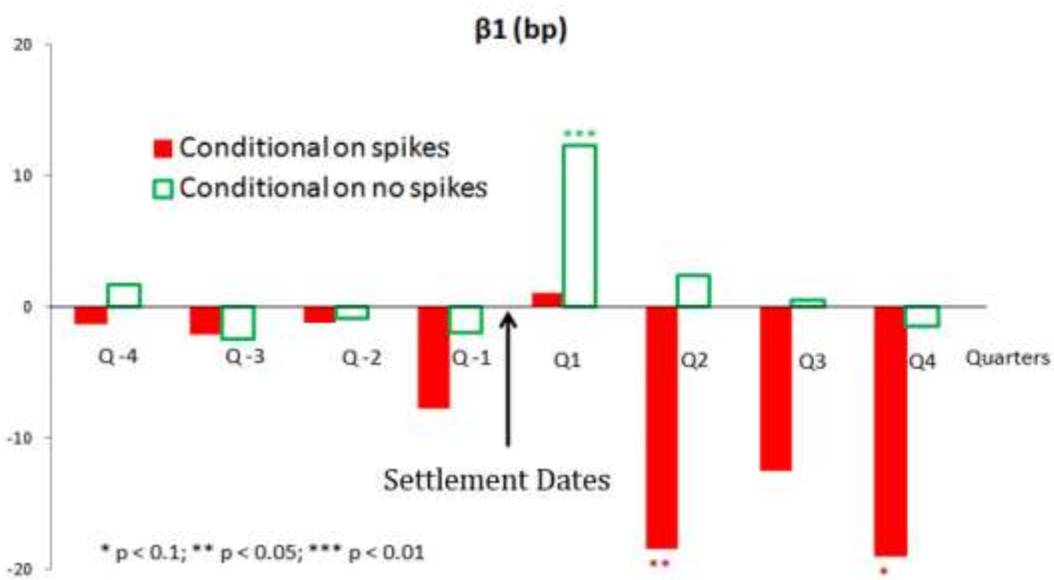


Figure 4. Earnings Surprises around Insider Purchases

This figure plots the coefficients β_1 in Table 5, which represents the earnings surprises associated with the insider purchases conditional on the presence (red bars) and the absence (green bars) of short interest spikes. Earnings surprises are normalized by stock prices in the end of year t-1.

$$Surprise_{it} = \alpha_{industry} + \lambda_{calendar\ quarter} + \beta_1 Purchase_{it} + \gamma' X_{it} + \varepsilon_{it}$$



On 7/11/18 FPI fell 39% on 32.5 times normal volume due to a short attack:

Insider Buying:

Trade Date↑	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
09/24/2018	1	PITTMAN PAUL A		100
09/20/2018	1	PITTMAN PAUL A		1,000
09/11/2018	1	PITTMAN PAUL A		2,778
09/10/2018	1	PITTMAN PAUL A		600
09/07/2018	1	PITTMAN PAUL A		3,000
08/31/2018	1	PITTMAN PAUL A		3,000
08/23/2018	1	PITTMAN PAUL A		6,457
08/20/2018	1	PITTMAN PAUL A		3,500
08/10/2018	2	PITTMAN PAUL A, BORENSTE		28,000
07/16/2018	1	DOWNEY CHRIS		954

We anticipate selling before the end of the year.