LONG & SHORT
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It's a Tough Job, So Why Do They Do It?
The Backward Business of Short Selling

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The shorting life is nasty and brutish. It's a wonder anyone does it at all.

Shorts make a bet that a stock will sink, and nobody else wants that: Not company executives, employees, investment banks nor most investors. That's why most manipulation is on the other side; fewer people object when share prices are being pumped up. For most on Wall Street, the debate is whether shorts are anti-American or merely un-American.

Yet in all the paranoia about evil short-sellers badmouthing companies, what is lost is how agonizingly difficult their business is. They borrow stock and sell it, hoping to replace the borrowed shares with cheaper ones bought later so they can pocket the price difference as profit. It's a chronologically backward version of the typical long trade: sell high and then buy low.

For one, companies targeted by shorts try to silence attempts to publicize negative information. Two long-standing targets, discount Internet retailer Overstock.com and drug maker Biovail, are suing short-sellers, accusing them of conspiring to spread misinformation to drive down their stocks. The Securities and Exchange Commission subpoenaed journalists -- and then quickly retreated -- to investigate the relationship between short-selling hedge funds, the media and a small independent research firm.

Many hedge funds -- the sophisticated investors who are the bogeymen du jour -- try to avoid shorting. They simply can't stomach the pain. Often, hedge funds only do it to be able to call themselves "hedge" funds -- shorting is the classic way to hedge risk on long buys, after all -- and charge those fat fees. Assets at hedge funds almost tripled in the past five years, yet short activity on the major exchanges hasn't even doubled.

The biggest problem with the business is that the market is stacked against the technique. Stocks tend to go up over time. Shorts swim against this tide.

Under trading rules instituted after the 1929 crash, a short position can only be taken when the last trade was at the same price or higher, so they can't drive down the price by selling and selling.

There is also theoretically no ceiling on potential profits from a long position. A stock bought at $10 can go to $20 for a 100% gain and then to $30 for a 200% gain. But 100% decline is as good as it gets for a short. The opposite is true, too: long losses are finite but short losses can be infinite. Many hedge funds have reduced their shorting for this reason.

Why put so much time and energy into something that can inherently not pay off with a multiple bagger?

What's more, shorting can be expensive when the shares available to borrow are scarce. Prime brokers, the investment-bank folks who facilitate hedge-fund trading, charge interest on popular shorts. Look at this week's rates: It cost 25% to short Martha Stewart Living Omnimedia and 24% to borrow Overstock. So, you wouldn't make a dime on the misery of Overstock CEO Patrick Byrne over the course of a year unless his shares tanked by almost a fourth of its value.

Given all that, how do the shorts fare? A study by Yale's Roger Ibbotson and his eponymous research firm's chief investment officer, Peng Chen, found that short-biased hedge funds fell 2.3% per year on a compounded basis after fees from 1995 through March 2004.

Sounds like a lousy business to me. So why bother?

The curious thing is those negative returns are actually quite impressive when you consider what shorts are supposed to do -- hedge risk. The researchers calculated that the market, measured by the appropriate benchmarks, was up 5.9% a year in that period. That means short sellers started each year trying to climb out of a hole almost 6% deep. And, on average, they did, by 3.6%. That shows their stock-picking skill and ability to reduce market risks for clients, who presumably invested in those funds to hedge their long positions elsewhere.

Short-sellers obviously are in it for the money, but in talking to them for many years, I can tell you they are a quirky bunch who love ferreting out bad guys. The dirty secret of the SEC enforcement is that the major financial frauds are frequently uncovered by short-sellers. The shorts had Enron and Tyco in the cross hairs before anyone else.

Shorts aren't always right. They shorted Sears, trumpeting its struggling retailing and troubled credit-card divisions. They shorted Amazon and eBay in the bubble years, failing to see that some Internet wonders wouldn't go bankrupt. But it is a myth that shorts can easily profit from misinformation because the market is merciless in dealing with erroneous information.

Amid all of the targets' litigiousness and outcry, short-sellers' influence over the markets is vastly overstated. Here's an example: Gradient, the independent stock-research firm being sued by Overstock and Biovail, started covering Overstock in June 2003 when its shares were traded around $13 and the company was expected to be profitable in 2005. Over the next year and a half, as short-sellers and Gradient bashed the company to anyone who would listen, the stock topped $76 a share. The company ended up losing $1.29 a share last year -- yet the stock remains above $22, higher than where Gradient first picked it up. That's some market-moving power.

Mr. Byrne, Overstock's overlord, has been the most vocal in his assault against shorts and

journalists who have shorts as sources, including me. But it isn't the short-sellers who cause Overstock to lose money or to miss earnings estimates. It isn't the shorts who screwed up Overstock's information-technology installation. It isn't the shorts who caused Overstock -- just yesterday -- to restate its financials going back to 2002.

By seeming to side with Overstock when it started seeking information about its complaints against the shorts, the SEC chills its best sources and hinders the market from doing its job. It was the shorts who lost money in Overstock for months and months -- until most investors realized they were right.