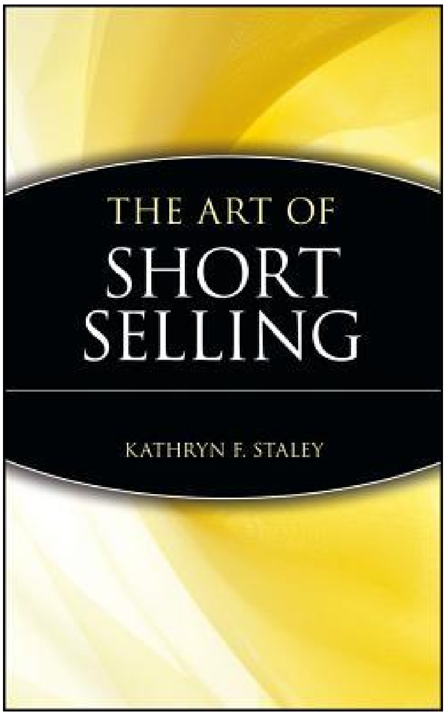

The Art of Short Selling

Kathryn F. Staley

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Imagine selling a stock or security you don't own at a high price, buying the shares later at a lower price when the stock falls, and then pocketing the difference for a handsome profit. This timely guide takes readers through the entire process of short selling, from what it is to exactly how, when, and why to sell short. Up-to-the minute trading examples, guidelines, and pertinent regulations clearly illustrate the most current applications and techniques of short selling.

The Art of Short Selling Details

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Author	:	Kathryn F. Staley
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From Reader Review The Art of Short Selling for online ebook

Yes & Not Yes says

This IS about short selling, but its also about how to read financial statements to find the beginning signs of a bad or unprofitable company. Very good read.

Senthil says

spellbound

Karthikeyan Mylswamy says

As I am not into short selling, this book felt little dry. But the author was clear with the concept and definitely a good read.

I thank the author for getting us to know about the mysterious world of short selling.

Matthew says

Superb. I've heard Kathryn Staley speak and she is sharp, thoughtful and dry, a very charming combination. (http://www.frankvoisin.com/2012/05/15...) This book is on hedge fund reading lists but I hadn't felt compelled to pick it up until after I heard her speak and then I felt I really should. No regrets there. Instead of theory, she discusses case study after case study. The chapters are loosely organized by type of short sell candidate. A brief background is given, then a summary of the short thesis, then a discussion of how the trade actually played out, in terms of corporate events, street reaction and market pricing. There are a lot of lessons to be drawn, which she then summarizes in a more theoretical final 13th chapter. This is good but don't expect anything unique, amazing and game-changing -- the value of the book is really in the overall tone/attitude/stance (which demonstrates her mindset) and in the historical case studies. I'd apply a one-star deduction as the examples do feel dated and I think that financial statement manipulation may have evolved and become more sophisticated as analysts have learnt from precisely books like this one (for up to date examples, read the Bronte Capital blog in its historical entirety). Besides the analysis she also gives useful practical tips such as checking the short interest relative to the free float to see how far the idea has also been used and whether you might be exposed to a short squeeze. And finally, admirable for this quote of final advice: "Short sellers are entitled to their opinions, as are executives and analysts. And so are you. Do not take it too seriously; it is only money."

Godfrey says

If you were hoping for a book that blindly cheerleads the work of short sellers, you came to the wrong place.

Kathryn F. Staley is a charming writer, incisive thinker, and this excellent and ageless work is as full with well-told stories of short selling gone horribly (and I use the word horribly advisedly) as of it gone well; and both types of stories are incredibly informative.

Some of my favorite quotes below:

“The main weakness of professional short sellers—an inability to judge the timing of collapses—is a strong argument for attention to short selling by any entity that owns stocks. Short sellers are consistently years too early when they sell stocks. Stockholders are always slow to sell even when the evidence is irrefutable and the future for profit bleak. The years of irrational price behavior in a deteriorating company provide stock owners with years to sell a problem stock. Portfolio managers or individuals who attempt to educate themselves about the reason for escalating short interest in stock holdings can radically improve [their] returns by avoiding torpedo hits—they can use the weakness of the discipline as a strength.” (page 13)

“Roberston feels valuation bets on price alone make bad short sales: There must be either a fundamental change in the outlook for the company or a major misconception by the stock-buying public.” (page 24)

“DiMenna shorts five types of situations: frauds, earnings disappointments, hyped stocks where he can shoot holes in Wall Street’s consensus expectations, industry themes were macroforces are negative, and deteriorating balance sheets. He reassesses short positions continually and, before he shorts, tries to determine the catalyst that will cause a stock to fall. He generally will not short stocks with strong relative strength and earnings momentum solely on the basis of overvaluation. Typically, he waits for these stocks to break before getting involved. He avoids short candidates in a crowded field unless the company is terminal.” (page 25)

“The Feshbachs do not find company visits or Wall Street analysts productive ways to gather information. Talks with management are not fruitful: ‘The company didn’t get to be a good short without management’s help.’ Wall Street is no help: ‘That’s the place to get the bull story, not the bear story. The bias negates their usefulness to us in a lot of incidents.’” (page 29)

“Analytically, Chanos says he does not do anything that is very different from other managers, but his use of return on invested capital as a key indicator is unique. ‘Using this, we’ve been able to find companies that are not what they appeared to be.’ His calculation is: earnings before interest and taxes divided by average total capital (which is defined as total liabilities plus equity minus current liabilities plus short-term debt or, to say it another way, the return on all interest-bearing liabilities plus equity plus deferred taxes and short-term debt. ‘That ratio will reveal a lot of wormy companies and poor businesses. It’s a tough number to screw around with.” (page 35)

“The single most important section in a prospectus is the risk-factor section called ‘Investment Considerations.’ The company always tells you why it will fail.” (page 58)

“Does this work—is the prospective return worth the risk for the stockholders? The second question is: How soon will the new company run out of money? Shorts almost always judge correctly if the business is dying. On the timing of the demise, they are seldom right. Someone is usually available to buy stock, loan money, offer short-term bank debt long after the company is in nearly terminal condition. Add two years to a short’s best projection, and you might only have a couple more years to wait.” (page 64)

“View the IPO document as a business person. Does the business make sense? Can prices be high enough to support the capital investment in glitzy store interiors? Can the necessary expansion be funded?” (page 81)

“The very backbone of a bull market is growth—new products, new presentation, new technology—spectacular growth opportunities that offer an investor the portfolio appreciation of the next Xerox. Short sellers itch to short these stocks. More savvy investors know how to own them, then sell them twice.” (page 93)

“When a company switches or expands its business line into something completely different, it generally means management fears that growth will slow in the main line.” (page 108)

“DO YOUR OWN WORK.” (page 142)

“The first and biggest reason for failure in stock selection on either the short side or the long side is too little work. Particularly treacherous on the short side, the absence of a carefully reasoned case can have painful consequences.” (page 223)

“Most exceptional short sellers are investors, not short-term traders. On occasion, they might make profitable trades abased on temporary imbalances in the financial statements. But on the whole, even if they know the company cold, it is impossible to be prescient about the timing. When they make those bets, they do it with the knowledge that they are departing from fundamental wisdom; and, if the bet does not work quickly, it is smart to exit. Novices, fools, and retail brokers sell short for quick trades.” (page 225)

“‘The mistake is always shorting the company that’s not that bad.’ He used the example of New England Critical Care, Systems Software Associates, and L.A. Gear. The analyst has to be convinced that the core business will be overwhelmed by the problem and not just hiccup. ‘The biggest mistakes we’ve made are where we’ve seen a company that is overstating earnings but where the internal engine of the business is still strong.’” (page 233)

“Or, in the words of Bernard Baruch, ‘No law can protect a man from his own errors. The main reason why money is lost in stock speculation is not because Wall Street is dishonest, but because so many people persist in thinking that you can make money without working for it and that the stock exchange is the place where this miracle can be performed.” (page 248)

“The sixth step is to keep paying attention: If you decide not to short a stock after the preliminary analysis, it might be a great idea next year. If you do short it now, watch it. Events move so slowly in the financial world that it is hard to maintain concentration.” (page 274)

“The facts are somewhere, free for the digging.” (page 275)

“Hard work is outmoded, so if you do a little, you will be far ahead. Analysts look at company PR rather than fundamentals and financials, and that provides opportunities and longe periods of market inefficiencies.” (page 275)

Nam KK says

The Art of Short Selling by Kathryn is a proper companion with books like Quality of Earning by Thornton O'Glove or Creative Cash Flow Reporting by Charles Mulford, or Financial Shenanigans by Schilit. Nevertheless, it was written twenty years ago, when the writer assumed that readers were well familiar with companies described in the book. Therefore, the author threw in details and if you are a reader born twenty years later, it seems like you are reading Sherlock Holmes: you follow the details, and the argument seems to make sense, but you don't really know the whole story to have a clear understanding.

The book was on my reading for a good six to nine months. It is a big relief for me to finish the book, so that I could work on others.

Brian Zheng says

Recommended by a few high profile fund managers as a must read and the best book about short selling. A very analytical book. The author categorizes different type of short selling opportunities which is supplied with large number of examples in 80s and 90s. The last chapter is especially helpful as the author lay out the research framework for a shortselling opportunity.

Gabriel Pinkus says

Very thorough, very informative, very simple.

I'd like to develop the habit for myself of reading financials with the skepticism of short sellers. Going long with the skepticism of a short seller would prevent looking for confirming evidence which leads to self-serving bias and other unfortunate biases inhibiting rational investment decisions.

Thank you, Kathryn!

I think this book would have been a bit better if Kathryn included some shorts that did NOT work out. You want to learn about when a philosophy has worked and when it hasn't in order to better judge it.

Mike S says

Great introduction to short selling based on fundamentals (not for day traders). Thorough discussion with lots of examples, the author illustrates her points very clearly, this book was written a few years ago but it's still a very good read. I would recommend this book to anyone who wants to know what it takes to be a successful short trader.

J Brown says

I thought that it would be a lesson in stock prices, when to get in and out, and how. Instead the book was filled with classic examples of short sales and the mechanics behind the companies that were sold short. There are a few good bits of wisdom peppered throughout the book dealing with the growth and lack there of companies. It also provides a "quasi-timeline" of short selling eras if that is what you would call them. It also details the average life span of a short seller in a few places.

Asif says

Pleasantly surprised with this book as I had low expectations to begin with. The actual book was fun and even for an analyst like me with 8 years of experience I managed to get a lot of new insights. The writing is direct and to the point without the storytelling flair that people like Michael Lewis has managed in his books.

Plato So says

the philosophy and practical details are good, but examples are a little far fetched and perhaps too colorful in word choice

InvestingByTheBooks.com says

There are very few books on fundamental short selling of stocks but this is one of the more well-known ones. It covers many aspects of the trade very well but leaves others out. Unfortunately we are still waiting for the definite book on shorting, preferably written by some of the veterans of the game.

There are three parts to the book where the first gives an okay background to the area and its practitioners. Short candidates are categorized into companies that a) lie to investors through their accounting, b) have expensive valuations and c) will be negatively affected by external events. Signals used by those shorting are according to the author a) accounting warning flags, b) signs of "insider sleaze", c) stellar stock price rises, d) cash consuming companies and e) overvalued assets or ugly balance sheets.

Then the absolute bulk of the book is a number of rather old case studies meant to exemplify different types of short selling cases – although not exactly linking to the categories in part one. The author has had good access to commentary from a number of veteran short sellers through interviews. I still think the author could have drawn more explicit deductions from these, as they now mostly resemble a line-up of successful war stories.

The storyline is that clever short sellers first see something that daft Wall-Street analysts or long-only investors couldn't detect. Then the investment case either takes longer to pan out than expected or the short sellers are tormented by violent short squeezes causing pain but in the end they are always vindicated and the company lead by the evil managers dwindles into disaster. Finally, there is a short wrap up where Staley draws some general conclusions about the field but also gives a historical account of shorting.

Kathryn Staley have, as I understand it from the sleeve of the book, worked with both hedge funds and brokerages in trying to find stocks to short. She has taught financial statement analysis for AIMR, the Association for Investment Management Research and "reads balance sheets and footnotes for fun and profit". Despite her experience as a short seller there is very little of technical detail in the book as it is written in an anecdotal, almost journalistic, style. As an example, if Days Sales of Inventory is one of the most reliable signs of trouble as is claimed, how is the ratio calculated, what are the pros and cons of using it and which other indicators are useful to complement it with? Even though the title points to the "art" or short selling I think the "craft" could have deserved some space.

Even though the tone can sometimes become a bit too idolizing the strong aspect of the book is that you get a fair grip of the psychology of shorting and above all of the character of short sellers. Their contrarian nature is described as ambitious, cynical, driven, single minded – even pigheaded – and sometimes frugal and anti-social. They are curious, hard working and find pleasure in finding the truth and being smarter than the gullible investment crowd as stocks blow up. The author describes an almost moralist disposition since short sellers enjoy exposing the corporate fraudsters who waste the shareholders money. I also like how the book defuses short selling and shows how very similar the research into investment cases is on the short side and the long side. Long-only investors can actually learn plenty from the attention to accounting detail among short sellers.

Despite the mixed review the unfortunate truth is that there aren’t many other books to recommend instead so the book could still be worth purchasing. We are still waiting for the definite reference book on shorting.

Russ says

Staley is to short selling what Graham and Dodd are to security analysis. This is a wonderful book about the taboo subject of selling short. It is loaded with stories about actual events as well as instruction on the art of short selling. At 20 years old, it feels a little dated but strangely appropriate for the current state of the stock market. If you've ever wondered about selling short or consider yourself a short seller, this is the book to read.

Johnny says

"Growth is a good stock to own and a great stock to short if you can time both sides of the pyramid."
