THE LONG OF THE SHORT

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The general perception is that shorting stocks is inherently treacherous. It's more accurate to say that investors make it much more perilous than it has to be by consistently making the same error: Shorting overvaluation alone.[1]

Overvaluation may be the basis of the short, but it's not enough.
Never short unless there's an *imminent, unmistakably negative catalyst*.

The most suspect, blatantly overvalued companies are frequently the most dangerous to short. Like many things, this seems at first contradictory because it is counterintuitive. But it's entirely logical.

If there's no sound basis for valuation to begin with, *any* price is reasonable.

Our primary means for challenging a valuation is to contrast future projections with past performance. But what if the company has little operating history to speak of? Without a past, the credibility of the future arguably rests on rhetoric – what the market can be convinced to believe about an utterly unknowable fate.

To provide an example, many shorts got burned when Amazon went from $200 per share to $400. But the fact that it reached $200, a stratospheric multiple of demonstrated revenue and earnings, was a crystal-clear warning that it had every reason to go higher. With little financial history to contradict even the most absurd projections, why *wouldn't* it go to $300, $400, or more?

Another common misperception is that shorting entails a very different analysis than going long. In terms of rigour, the two should be indistinguishable. Both are ultimately a study of value versus price. Where they do however diverge is the consequences for error. The value investor's mistakes are typically punished much less severely than the short's miscalculations.

This should be expected. The market eventually corrects most inefficiencies, and prices over the long term tend to rise regardless. Of course, even shares purchased at a steep discount to intrinsic value can remain undervalued for extended periods. Absent a company-specific catalyst, and overlooked by a supposedly-efficient market, the share price stutters. Such stocks are called "value traps" for a reason, and they are undeniably problematic. And yet, unless one overpaid, what's the worst likely outcome? Dead money – the investor doesn't make much, but she doesn't lose much either.

The consequences for shorting without a sufficient catalyst on the horizon are very different.

Capital stagnates in a value trap; in a misguided short, it *strangles.*

Traditional value investments benefit from catalysts but don't depend exclusively upon them because businesses with long operating histories are the ones most effectively priced by the market. It makes sense that the more financial data the market has to compare the price to, the more efficiently priced the security should be.

By the same token, the less factual information available, the more susceptible the price will be to the whims of a categorically uninformed consensus. More than one extremely intelligent investor has incurred punishing losses from a short position simply because, in the absence of a price-correcting catalyst, the shares continued to climb much higher. Importantly, for many it *didn't matter* that they were eventually proven correct. As JM Keynes famously said, the market can remain irrational much longer than you can remain liquid.

[1] For the unfamiliar, shorting a stock or "going short'" is essentially buying low and selling high, but in reverse order. Instead of purchasing shares with the expectation of selling them after the price has risen, one sells them at a high price with the goal of buying them back at a lower price, capturing the difference as profit. Brokers enable investors to sell shares they don't own by lending them shares for a fee, provided the investor eventually returns the same number of shares to the broker.

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This is why the negative catalyst that triggers the anticipated price decline should have all the subtlety of a grand piano dropped from 500 feet on a grasshopper. It should be undeniably cataclysmic, such as fraud or a development that draws the very basis of the business model into question.

It suffices to say that, if practiced properly, shorting should be no more speculative than going long. That said, there are certainly fewer opportunities to do so. Overvaluation may be common, but imminent, unmistakably negative catalysts are not. Looking back, my longs probably outnumber my shorts by over 30 to 1.

This alludes to another reason why so few investors are successful at shorting: With authentically attractive opportunities so very rare, they resort to shorting shares that are *only* overvalued. Because the notion of a “hedged” portfolio of shares balancing shorts with longs seems inherently prudent and careful, investors naturally want to believe that constructing such a portfolio is possible. But what works in theory may prove much harder in practice. Even Alfred Winslow Jones, who introduced the concept and created the first “hedged fund” in the 1960s, apparently considered himself lucky to break even on his shorts.[2]

Perhaps that’s why “hedged funds” eventually dropped the “d.”

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[2] “The portfolio managers will tell you that… their most difficult job is picking good short sales.” “He and the other hedge-fund managers normally consider themselves lucky to break even on their short portfolios.” “The Jones Nobody Can Keep Up With,” *Fortune Magazine*, April 1966, Carol J. Loomis, pg. 247.

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