Steer Clear of the Short Side

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Why take a bet where the best return is 100% and the downside is unlimited?

Baccarat and Blackjack are two casino table games that offer the best odds in the house. Nonetheless, on average, you'll lose 1-2% of your money each time you make an optimal bet.

Compare that to making a single bet on the NYSE Composite Index. On average, for each year that you keep your money invested, you'll make 8-10%. Why then do folks engage in the practice of shorting stocks? They've effectively placed a bet where, off the bat, the odds are about 8-10% against them.

When you look carefully at the economics of shorting, it makes no sense to take the bet. The lowest price a company's stock can go to is zero, but there's an unlimited upside. An unleveraged short position has a maximum payoff of 2:1. That is, you'll double your money if the company's stock price goes to zero. On the other hand, the potential for loss is uncapped and infinite. Why take a bet where the upside is a 100% return at most and the downside is going bankrupt?

Because there is no limit to how high or how fast a company's stock price can rise, anyone who shorts even a single share of stock can never stop watching the tape. Odds are very high that I'll go to my grave without ever having shorted a stock. My quality of life would go down dramatically if I were forced to watch every wiggle in the market. Sometimes, while on vacation in some remote corner on the planet with no access to even week-old stock prices, I don't have a worry in the world about my 100% long unleveraged portfolio, with the 8% to 10% long term odds in my favor.

The Overvaluation Argument

I routinely hear very convincing arguments that certain companies are ridiculously overvalued and it's painfully obvious that the only thing that can happen to them is a share-price decline. Indeed, when a cheapskate like me looks for stocks to buy, I almost always find most of them trading at lofty prices that cannot be justified.

However, it’s is not worth shorting a company that trades at even 10 times its intrinsic value because management can (and indeed is incentivized to) take certain actions to convert the overvalued stock into a correctly priced one with no decline in price. For starters, they can issue a boatload of stock at the inflated price, which would make the stock price more rational.

For example, let's say a public company has land worth $100 million and no other assets or liabilities. Let's say its market cap is $1 billion (100 million shares outstanding at $10/share). It's trading at 10 times intrinsic value. What a great short candidate! The company then does a secondary offering and issues, say, 500 million shares at $10 each.

Now its assets are:

- Cash (from the offering): $5 billion
- Land: $100 million
- Total assets: $5.1 billion
- Market cap: $6 billion

It went from being 10 times overvalued (1,000%) to just 17.6% over intrinsic value. The shorts just got hosed.

Management can also go buy real assets with their inflated currency. This happens frequently, and it did on a grand scale when AOL merged with Time Warner at a ridiculously inflated AOL stock price. The merger has tempered the fall in AOL’s stock price mainly because of Time Warner’s very real assets. If AOL remained an independent company, AOL shorts would’ve done far better.

Another management strategy would be to seek a buyer for the business. The odds are in their favor to end up selling the company at a premium to its already inflated price. Among the 10,000-plus publicly traded companies in the U.S., plenty of hungry CEOs are looking for acquisitions, primarily so they can be knights of even larger castles – regardless of the price.

Timing is Everything

Warren Buffett does not short individual stocks. The Oracle of Omaha is on record saying that he and Charlie Munger have never been wrong about companies they thought were great short candidates, but they’ve almost always been wrong on the timing. Once you short a stock, there is no way to predict when the price will fall. While you’re waiting indefinately, you’re also responsible for all the dividends that the company pays out.

Having some short positions as a hedge is considered acceptable investment philosophy, but I disagree for all the aforementioned reasons. With over 100,000 publicly traded stocks worldwide, you could hedge virtually any scenerio in a long-only unleveraged portfolio with no derivatives. Every business reacts differently to macro factors. Some do well in recessions, while others prosper when the dollar is strong. Still others benefit from rising interest rates. So why not create a portfolio that is likely to weather most storms well and still keep the 8% to 10% house advantage on your side?

If you still remain unconvinced, then let's delve into the mechanics of a short squeeze, which is truly a sight to behold. Capitalism has a few other things to offer that are as entertaining as witnessing a short squeeze.

Some of the most heavily shorted stocks have short interest ratios higher than 50. That is, based on average daily volume, it would take 50 or more days for the shorts to exit their positions. If a heavily shorted stock sees it stock price rise, then some shorts start wanting to close out their positions. This means they have to buy back the stock. As they buy shares, the stock rises further, which causes panic among the remaining shorts who also now want to close out positions.

You get the picture. The door isn't big enough, and pretty soon there's a stampede happening as the stock price soars, causing more short-covering panic and more buying pressure.

I should correct myself: A short squeeze is only entertaining if you're watching from the sidelines.

To sum up, as Buffett says, why try to jump over 7-foot hurdles when you can walk over 1 foot bars? Shorting stocks is simply a sucker's bet.

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