LESSONS FROM THE TRENCHES:
VALUE INVESTING,
ENTREPRENEURSHIP & LIFE

LESSONS FROM 15 YEARS OF SHORT SELLING

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SUMMARY

- Over the nearly two decades that I ran a hedge fund until I closed it last September, I was an active short seller.
- There were some epic highs - most notably identifying in early 2008 the bursting of the housing bubble and discovering in 2012 that Lumber Liquidators was selling formaldehyde-tainted, Chinese-made laminate flooring, both of which landed me on 60 Minutes - but overall I lost a lot of money over the years on the short side.
- Shorting is brutally difficult, especially during a long, complacent bull market like this one, which has inflicted great pain upon most short sellers.
- I advise most investors to learn about short selling - there are many important skills and lessons from which all investors can benefit - but not actually do it.
- That said, for some investors it makes sense.
- For them, I think the increasing level of overvaluation, complacency, hype and even fraud in our markets (can you say “bitcoin”?) make it a fantastic time to be looking at opportunities on the short side.
- Lastly, I think that short sellers are very healthy for our markets, especially the ones with the courage to go public with their bearish views.
SHORT SELLING IS NOT SIMPLY THE OPPOSITE OF LONG INVESTING

• In many ways, shorting appears to be nothing more than the inverse of long investing
• On the long side, investors generally seek companies with good management, strong growth, high margins and returns on capital, clean balance sheets, and sustainable competitive advantages - all at a low price
• Conversely, short sellers look for weak or dishonest management, low or negative growth, margins and returns on capital, high and increasing debt, accounts receivable and inventory, and weak competitive advantages - all at a ridiculously high price
• But shorting is not simply the opposite of long investing – it’s much harder and more dangerous
1) Your upside is capped and your downside is unlimited - precisely the opposite of long investing. When shorting stocks, you could be right 80% of the time, but the losses from the 20% of the time that you’re wrong could exceed the accumulated profits. Worse yet, a once-a-century storm such as the Internet bubble might wipe you out entirely. If there’s even a 1% annual risk of such an event, there’s a 40% chance of it happening over 50 years (and 63% over 100 years).

2) To prevent such an occurrence, most short sellers use stop loss limits, meaning they will start covering the short if it runs against them a certain amount. This means short sellers not only have to be right about a stock but also about the timing. If a stock rises significantly, many short sellers will be forced to lock in losses, even if they are later proven correct.

3) In order to short a stock, you first must get the borrow from your broker, who has the power to call in the stock you’ve borrowed at any time - or, worse yet, buy stock to cover for you. Brokers are most likely to do these things if the stock is rising quickly, and they’re probably doing it to other short sellers as well at the same time, so all of this buying pressure can cause a stock to rise even further, triggering even more covering. This vicious cycle is called a “short squeeze” and it isn’t pretty - I can show you the scars on my back.

Excerpt from Chapter 11 of More Mortgage Meltdown
4) Shorting has gotten much more competitive. There are now thousands of hedge funds (and who knows how many individual investors) looking for the same handful of good short ideas in contrast to a few dozen a couple of decades ago. This results in “crowded” shorts, increasing the odds of a short squeeze.

5) A short squeeze can also be created if the “float” - the number of shares that trade freely - is suddenly reduced. Such a case occurred in October 2008 when Porsche (OTCPK:POAHY), which owned 35% of Volkswagen (OTCPK:VLKAY), unexpectedly disclosed that it had raised its stake in Volkswagen to 74.1% through the use of derivatives. The German state of Lower Saxony, where Volkswagen is based, owns 20%, so that left a float of only about 5% of VW shares on the market. The short interest in VW was 13%, so moments after Porsche announced its higher stake, the mother of all short squeezes ensued and the stock instantly quintupled from $200 to over $1,000, momentarily making VW the most valuable company in the world. This was extraordinarily painful for many shorts.

6) Short sellers used to earn interest on the cash they held while they were short a stock, but this has disappeared due to low interest rates - and brokers even charge “negative rebates” on hard-to-borrow stocks, meaning that short sellers have to pay 5%, 10%, 15% or more in annual interest to get the borrow.
12 REASONS NOT TO SHORT (3)

7) The long-term upward trend of the market works against you.
8) Gains are taxed at the highest, short-term rate.
9) Shorting generally requires many more investment decisions, thereby increasing the chances of making a serious mistake.
10) It’s a short-term, high-stress, trading-oriented style of investing that requires constant oversight. For most investors, time is their most precious commodity - and shorting can suck up a lot of it.
11) Mistakes become more and more painful as they run against you, since a rising stock on the short side becomes a larger percentage of your portfolio. In contrast, if you make a mistake with a long position, it becomes a smaller percentage of your portfolio as it drops.
12) If you go public with your short thesis, a company can attack you in many ways: file a lawsuit (Fairfax), complain to regulators (who occasionally investigate) (MBIA and Farmer Mac), tap your phone (Allied Capital), etc. Also, expect to get flamed on message boards and in the media. Many people view short selling as evil and un-American.
10 REASONS TO SHORT (1)

1) If you're very good at it, you can make money over time. The list of people I'm aware of who have, cumulatively, made money on the short side is getting smaller and smaller as this bull market continues, but there are a few. I will explore how they've done so in future columns - and some of them will be sharing their secrets at my conference.

2) Every investor has a long book, but only a few short, so developing a well-articulated bearish thesis on a company or industry is a great way for an emerging manager to make a name for him/herself. This is what I did early in my career in 1999-2000, nailing the Internet bubble, and then again in 2008 with the housing bubble, which landed me on 60 Minutes. It doesn't get any better than that.

3) Having a short book allowed me to invest more aggressively on the long side, both in terms of overall portfolio positioning, individual position sizes, and willingness to take risks in certain stocks. Here are some examples:
   - I wouldn't have been comfortable taking my fund's long exposure up to 100% at times without meaningful short exposure;
   - I stayed longer (and therefore made more money) in certain high-beta long positions like Netflix and SodaStream because I was simultaneously short a number of similarly volatile stocks;
   - I felt comfortable owning certain economically sensitive stocks like CSX (railroad), Howard Hughes (housing/real estate), and Spirit Airlines because my fund had short exposure that would pay off if the economy weakened.
10 REASONS TO SHORT (2)

4) A short book typically pays off just when you need it most, during severe market declines, providing cash - and the psychological boost - to invest aggressively on the long side when it's most attractive. It also improves returns, thereby stemming investor redemptions, which is effectively another source of cash. This is exactly what happened to me in 2008 and early 2009, when my substantial short book cushioned the downturn - my fund was down less than half the market in 2008 - and allowed me to invest aggressively on the long side, which translated into big gains after the market bottomed in March 2009.

5) I sleep better at night with insurance. At the beginning of every year, I write a check for homeowner's insurance, and at the end of the year, when my apartment hasn't suffered a flood or fire, my insurance expires worthless and I have to buy it again. Is it a mistake to buy insurance that turns out to be worthless almost every year? Of course not.

6) The psychological rewards are enormous, especially to a value investor like me, as shorting is much more contrarian than buying an out-of-favor stock. It's also incredibly interesting and entertaining thanks to the preposterous lies and incredible cast of shysters, crooks, charlatans and promoters one encounters. I love betting against these cretins. For all these reasons, I found that making $1 on the short side to be much more gratifying than making $1 on the long side (however admittedly irrational this is).
7) Even if you never short a stock, having the mindset of a short seller is very valuable: it helps to develop healthy skepticism, know where to look for bombs on a balance sheet, and be able to identify value traps.

8) Being a short seller put me in the flow of short ideas, so I often heard/read about problems with companies whose stocks I was long (or considering going long), which saved me from some blowups.

9) One of my biggest problems over the years was an inability to sit on my hands and do nothing. Selling Netflix after it had gone up 5x - and missing another eight-bagger. Getting fatigued by Micron Technology and selling right at the bottom less than two years ago - and watching it rise 6x since then. The list goes on and on... Because shorting involves a lot of small positions and more frequent trading, it kept me occupied and therefore less likely to do stupid things with my long book.

10) Lastly, if you're running a hedge fund, many investors are going to have a problem paying your very high hedge fund fees if you don't do any shorting.

Conclusion: As these 10 reasons show, shorting can make sense for certain investors - but be careful! Don't get sucked in - as I did - to an extremely costly activity at which you are not well positioned to succeed.
DON’T GET SUCKED IN FOR THE WRONG REASONS

• Shorting is incredibly alluring for many reasons, so you must be very careful not to get sucked in – as I did – to an extremely costly activity.
• One of my friends who, like me, closed his fund due to underperformance, much of which came from the short side, wrote:

  We used to highlight the effectiveness of our shorting program, but we were way too slow to recognize the change in the market since 2008 and how the flow of funds and indexing made it nearly impossible to short successfully.

  It was so easy to focus on (and take out of context) the joy of an individual short working and not recognize the poor return on time, effort and capital that shorting has now become and the pain and anguish it has brought.

  There were way too many examples of fundamentals playing out as we expected, yet the market rewarding rather than punishing a stock.

  The other really disappointing aspect is the prime brokers’ mortal lock on that business and the opacity.
MY HISTORY WITH SHORTING

• I first shorted my first stock, Farmer Mac, in April 2002
• Slowly built short book to ~20% exposure by the end of 2007
  – Fairly costly over five years
• As we gained conviction that the bursting of the housing bubble was going to be really bad, we ramped up our short book in early 2008 to ~60%
  – Really paid off over 12 months
• Maintained large short book coming out of the crisis
  – Very costly
• After I re-launched on 1/1/13, I rebuilt my short book to ~50% exposure
  – Made a little money, but sucked up huge amounts of time
• Covered 80% of my short book in October 2014
• Despite small short book, had big year (+900 bps) in 2015 thanks mainly to Lumber Liquidators
• Short book killed me in 2016 and early 2017 (-1,100 bps)
• I covered all single-name shorts in mid-2017 (kept three ETF shorts), but it was too late...

Summary: Over my 15 years of short selling, I made a lot of money in 2008-early 2009 and 2015, but otherwise mostly took a beating
In a call with Munger in 2002 he told me:
• You’re right on MBIA: “the idea that anyone would ever think that MBIA is triple-A is so ludicrous!”
• From a societal perspective, what you and Bill are doing is great
• But if you go through life stepping on people’s air hoses, they’re going to hate you and attack you
• So my advice to Whitney Tilson is, don’t do it
• I shorted three stocks in my life and they eventually worked out, but not before running against me and causing me total misery so I stopped
• But every young guy seems to have to learn this for himself...

*Why didn’t I listen until 15 years later (and it was too late)???
LOOK FOR AN EDGE

• Whether investing long or short, the key to investment success is having an edge, typically important information, analysis or insight that isn’t widely known by other market participants

• For example, in the case of Lumber Liquidators (LL), my most successful short ever, someone who used to work in the flooring industry in China called me and told me that the company was buying toxic, formaldehyde-drenched laminate flooring and selling it to its American customers. Once I confirmed this story by having the product tested myself, I helped expose what the company was doing and the stock collapsed by more than 90%

• In contrast, on too many occasions than I care to remember, I shorted a stock based on hearing a compelling thesis but doing little work myself, which often led to severe losses

• The lesson here is simple: if you don’t have an edge, don’t invest!
HOW TO MITIGATE SHORT RISK IN A BULL MARKET

• Be extra focused on catalysts
  – Only be short the stock for short periods of time around expected catalysts (e.g., earnings reports, articles/presentations)
  – Be your own catalyst
    • Go public with your short thesis or feed it to someone who will (e.g., I gave what I’d uncovered about Lumber Liquidators to 60 Minutes)
“GUERRILLA SHORTING”

• “Guerilla shorting” is the name I’ve given to the process when a short seller:
  – Prepares an in-depth short report
  – Takes an extremely large short and/or short-term put option position
  – Publishes/publicizes the report
  – Exits or at least dramatically reduces the size of the position shortly thereafter

• There are many upsides
  – Can be an extremely high IRR (if the stock drops in response to the report)
  – No time & money expended on a long campaign like HLF

• There are also many downsides
  – You miss any long-term drop
  – While legal – you can trade on your own research – it strikes many people as market manipulation
  – The trading pattern is identical to market manipulation, so you’d better be prepared to defend your work and that you genuinely believe it
  – Does it pass the front page of your local paper test?
I’VE ONLY HAD SUCCESS WITH ONE TYPE OF SHORT

• Total frauds like those promoted by "boiler rooms" (the subject of the movie *The Wolf of Wall Street*) or the hundreds of Chinese companies that went public via reverse mergers, highlighted in the excellent new documentary, *The China Hustle*
• Stocks in overhyped sectors like cryptocurrencies, marijuana and alternative power
• Market darlings like Netflix and Tesla, whose stock prices appear to be far ahead of the fundamentals

I've tried these three approaches, with limited success. While the typical outcome is a stock falling 50-100%, I've also gotten destroyed on more occasions than I want to remember. Once a stock becomes totally disconnected from reality, there's almost no limit to how far it can soar. If a stock is trading at 5x its intrinsic value, why can't it trade at 10x...or 20x? I've seen it happen - and experienced it happening! - too many times...

In contrast, I've had quite a bit of success shorting stocks that are valued on a multiple of earnings - and the earnings collapse. "Well, duh," you might be thinking, but sticking to this simple approach would have kept me (and countless other short sellers) out of stocks that crushed us like Salesforce.com, Tesla (my worst short ever, from $35 to $205) and Netflix (which doubled against me in 2010 before I covered and later went long it - very profitably - in 2012-13).
BEING TOO SMART CAN BE PAINFUL

• Let’s say you’ve done your homework and correctly identified a company whose earnings are sure to collapse. Short it immediately, right? Not so fast...

• It’s also critical to have some sense of when earnings might start to decline because being early can lead to years of painful losses, as the many examples in previous slides show

• The lesson here is often a cruel one: being too smart can work against you

• The goal of investing is to develop insights before everyone else in the market – but if you do so too far in advance, it can be a long and painful wait for your investment thesis to play out, so you need to be clever and patient on the timing
STOCKS USUALLY FOLLOW EARNINGS

• Even the most well-publicized, airtight case that a company is, for example, committing blatant accounting fraud, bilking its customers, is dangerously under-reserved and over-levered, etc. is usually not enough to cause the stock to decline materially.

• As long as a company continues to report growing earnings, it’s generally safe to assume that its stock will continue to rise as well.

• Historical Examples: Allied Capital (David Einhorn) and MBIA (Bill Ackman)
  – Bill Ackman published a devastating 66-page report on 12/9/02 entitled *Is MBIA Triple A?* and in subsequent years he continued to warn investors, ratings agencies and regulators about the company and the danger it was causing to the financial system.
  – But nobody cared as long as the company continued to report strong earnings, so the stock doubled – until the financial system collapsed, as did MBIA’s earnings and stock price.
CASE STUDY: LUMBER LIQUIDATORS

Operating Income

![Graph of Operating Income](image-url)

![Graph of Stock Price](image-url)
CASE STUDY: 3D SYSTEMS
CASE STUDY: BED BATH & BEYOND
CASE STUDY: VALEANT
CASE STUDY: CROCS
HOW TO FIND COLLAPSING EARNINGS

There are many reasons why a company's earnings might collapse – the primary ones I tend to look for are:

1) Unsustainable or illegal business practices (e.g., Lumber Liquidators buying Chinese-made formaldehyde-tainting flooring; Valeant making endless acquisitions and jacking up prices of acquired drugs);
2) A business model made obsolete by technology (e.g., numerous retailers such as Bed Bath & Beyond, Staples and Barnes & Noble getting crushed by Amazon; Netflix's DVD-by-mail business; Blockbuster video; newspapers);
3) Accounting fraud (e.g., Enron; WorldCom);
4) Legal/regulatory scrutiny (e.g., Lumber Liquidators; Valeant; Insys Therapeutics);
5) A wave of new competition (e.g., 3D Systems; will this happen to Tesla in the near future?);
6) The aftermath of one-time events (e.g., Hurricane Sandy (Oct. 2012) juiced Lumber Liquidators' earnings);
7) Cyclical companies over-earning at the peak of a cycle or due to random industry events (e.g., Cooper Tire & Rubber today I believe); and
8) Fads coming to an end (e.g., Crocs).
LOOK FOR OBVIOUS BUBBLES (1)

3D PRINTING

3D Systems

Organovo

Stratasys

voxeljet

Exone
LOOK FOR OBVIOUS BUBBLES (2)
ALTERNATIVE POWER PROMOTIONS

Ballard Power

Plug Power

FuelCell

Capstone Turbine
Avoid Valuation Shorts

- My experience is that if a company’s revenues and earnings are rising rapidly, the stock will rise as well, irrespective of how highly valued it is.
NEVER SHORT ACCELERATING GROWTH: NETFLIX

Netflix’s Year-Over-Year Revenue Growth
NEVER SHORT ACCELERATING GROWTH: AMAZON
NEVER SHORT ACCELERATING GROWTH: ALPHABET
DON’T SHORT COMPANIES WITH INSANELY HAPPY AND LOYAL CUSTOMERS

• It’s been my experience and observation that the stocks of companies with insanely happy and loyal customers are almost always bad shorts – think Apple, Netflix, Starbucks, Green Mountain Coffee, Lululemon, Costco and Southwest Airlines
• Such strong customer loyalty gives companies so many advantages: pricing power, free word-of-mouth advertising, etc.
• The most vivid example I can give in recent years is Tesla
  – It has so many things short sellers look for: a highly promotional CEO as well as declining free cash flow and rising debt
  – But everyone I know who owns a Tesla loves it with a burning passion
  – It was dumb of me to bet against this loyalty
  – I foolishly shorted this in 2013 and paid a steep price as it rose 5x against me before I finally realized my mistake and covered
DON’T SHORT STOCKS OWNED BY IRRATIONAL INVESTORS

• It is very dangerous shorting story/faith stocks owned by irrational investors
• Case study: Tesla
  – I suppose there is a value-oriented case that can be made for Tesla’s stock: project a certain market share 5-10 years in the future, which leads to a certain number of cars sold, estimate the sales price and margin of each car to arrive at profits, and then put a multiple on those profits to (presumably) conclude that the stock is trading at a discount today
  – But let’s be serious: the vast majority of Tesla shareholders in my opinion own it based on a belief that Elon Musk is a genius (he is!) and that Tesla is going to revolutionize the global auto industry (it is!) and change the world for the better (we’ll see)
  – These investors don’t care that Tesla is losing ever-increasing amounts of money, debt is piling up, and the Model 3 continues to be plagued by production delays and quality issues
  – So my question to those short the stock is: what, exactly, do you think is going to cause these investors to give up on the story, which is what’s necessary for the stock to decline?
BE CAREFUL OF IRRATIONAL ACQUIRERS

- be extra careful shorting stocks in industries like tech and phama in which there is substantial M&A activity and a lot of big, dumb, deep-pocketed buyers
- It was really irritating (and costly) being short Palm years ago when Hewlett-Packard bought them, and when Mallinckrodt bought Questcor, which was a total scam
Many investors think they’re mitigating risk by buying put options on a stock rather than shorting it because it reverses the math: gains are theoretically unlimited, while losses are capped at 100%. While this is true, you now have to be right on both the stock and the timing. It’s hard enough to be right on one, much less both, which is why most options expire worthless. Owning something that is likely to go to zero isn’t my idea of mitigating risk. A wise friend once said to me: “Options are like heroin. They feel soooooo good...but they’ll kill you!”
DON’T BE AFRAID OF SMART INVESTORS OR MANAGEMENT

• I have trouble thinking of a successful short in my career in which there wasn’t at least one smart investor who was long the stock
  – Though I never had a position, think of all the brilliant investors who were long Valeant as it declined by 97%

• Depending on who the investor is, it’s worth taking the time to fully understand what that investor’s long thesis is, but it shouldn’t deter you from putting on the short position if you’re convinced you’re right
TRY TO MATCH LONG AND SHORT POSITIONS

- If you’re going to run a big short book (50%+ exposure), try to match long and short positions.
- There’s a serious mismatch between a long book focused on large-cap blue-chips like Berkshire Hathaway, AIG, Procter & Gamble, Microsoft, and ExxonMobil, and a short book focused on smaller, more volatile, heavily shorted and/or battleground stocks.
- These stocks tend to be the most overvalued and have the potential to fall the furthest – often 100% – but they can also rise the most during periods of excess liquidity and complacency (like today).
- Owning riskier/volatile/heavily shorted stocks like Netflix, Sodastream and Deckers can balance the pain on the short side.
- If you have a large-cap, low-beta long book, look for large-cap, low-beta shorts (e.g., IBM).
SOURCES OF GOOD SHORT IDEAS

• Other short sellers
  • Build relationships/networks, and swap ideas
• Investing conferences
  • The Art, Pain and Opportunity of Short Selling (5/3/18)
  • Robin Hood Investors Conference (every fall)
  • Ira Sohn Conference (every May)
  • Value Investing Seminar (in Italy every July)
• Value Investor Insight
  • Go to www.valueinvestorinsight.com/freetrial for a free trial
• Valu InvestorsClub.com
  • Can access ideas as a guest with a 30-day delay
• Activist Shorts Research (www.activistshorts.com)
• Seeking Alpha
• SumZero
• Citronresearch.com
• Stock screens
• Newspapers, magazines, business television
CONCLUSIONS

• Shorting is really difficult
• Size positions small and aggressively manage risk
• Focus on stocks valued based on earnings – and then earnings collapse
• Look for multiple ways to win
  – Companies/industries in secular decline
  – A fad coming to an end
  – Leverage/financial distress
  – Market under-reacts to an earnings miss/guide down, etc.
  – Impact of new competitors
  – Regulatory problems
  – Very high valuation – far above historical and peer averages
  – Very high margins – far above historical and peer averages, and what common sense says is possible
• Be patient
  – Stocks tend to follow earnings not analysis or headlines
  – Often there is time to get into a short after the writing is on the wall
  – Short stock rather than use options
• Balance long and short book