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Selling Short the Short-Seller

by Gregory Bresiger

It happens every financial crash. Or in every prolonged bear market.

Or almost any time things go bad in the financial markets. An evil person must be found. Oftentimes, the scapegoat is the short-seller.

Today the short-seller is like Shylock in *The Merchant of Venice*. It's all his fault that Venetians are spendthrifts. They despise him even as they borrow money from him. They brand him and all like him — moneylenders — as evil.

It's the same in these difficult times. It is the fault of the evil men and women, economic populists and regulations say, who have been betting against markets, and especially certain stocks. They ignore that such stocks have been artificially pumped up by the government's reckless fiscal and monetary policies.

Last fall the Securities and Exchange Commission was feverishly studying new short-selling regulations, regulations that some in the securities industry feared might be unilaterally put into effect on an emergency basis without debate or public comment.

Regulators, in effect, have blamed the short-sellers for some of the nation's financial woes. In September and October the SEC actually placed short-selling bans on hundreds of financial stocks, using its emergency powers. These short-selling bans included the two most conspicuous government enterprises, Fannie Mae and Freddie Mac.

Yet Congress's and the Federal Reserve's foolhardy "everybody must get a house whether he can afford it or not" policies have spooked the market and they have not allowed market corrections to take place over years of bubble-building.

"What did those emergency orders do for Fannie Mae and Freddie Mac? They went bankrupt," says one institutional clearing-firm executive whom I recently interviewed for *CQ&D*, a quarterly financial magazine.

Short-selling, instead of being blamed, should be understood. It should be supported by everyone as a necessary investment tool. It should no more be scorned or regulated to death

simply because most of us invest long — that is, bet that our stocks and funds will go up — than we should scorn someone who subscribes to a minority religion or has a different point of view.

Short-selling is a risky yet necessary practice whereby an investor borrows a stock at a certain price, betting that it is about to head south. The investor has no guarantees. Indeed, he is often playing a dicey game, since historically stocks over the long term tend to go up more often than down. If the short-seller is right, he can make a bundle. If not, he can be wiped out.

When the market heads down fast, many investors complain about volatility and some actually demand a Securities and Exchange Commission investigation. Yet what about the opposite? “No one,” a money manager acquaintance of mine once told me in the late 1990s as the markets were being pumped up by the Fed’s cheap money, “ever complains about upside volatility.”

The principle is the same with respect to short-selling. People complain about it only when the market goes down, not up.

Volatile markets are inevitable and short-selling is one technique that some investors use to survive them. But short-selling also benefits those who don’t use it. Indeed, short-selling is a necessary practice. It contributes to the liquidity and efficiency of markets.

Efficiency?

Indeed. Thousands of short-sellers nailed the corrupt, government-connected so-called energy company Enron. Back in the last days of Enron, when its leaders were well known on both sides of Congress and in the White House (President Bush referred to Enron chairman Kenneth Lay as “Kenny Boy”) short-sellers weren’t fooled.

The short-sellers weren’t writing letters to the SEC or members of Congress. What good would that have done? Many members of Congress were in love with Enron. Instead the short-sellers effectively exposed the fraud of Enron: They bet their own money on the stock’s going down. Keeping the market honest

In a tribute to Adam Smith’s rule in *The Wealth of Nations* that people pursuing their private ends benefit the common good, short-sellers shorted the egregious Enron in the pursuit of profit. In doing so, they provided us with a more efficient market.

Yet, in the popular press and in the SEC’s recent short-selling bans, there have been stern warnings against spreading false “rumors” and the values of plunging stocks.

That raises a question: Where were these economic populists and regulators’ “warnings” back in the late 1990s when chat rooms and other places egged on stocks to newer and newer highs? When regulators and the central banks rushed to prop up badly run or venal businesses when the market tried to correct itself?

Those market highs became so unrealistic that the late great investor Sir John Templeton, a man of universally applauded high principle, made a famous short bet on the Nasdaq index in 2000. He made tens of millions of dollars on the bet. Templeton was once again acclaimed as the

brilliant man that he was. He placed one of the greatest short-selling bets ever made. Was he evil for lifting up the curtain behind the Nasdaq Wizard of Oz?

Don't blame the short-sellers as this market continues to burn up trillions of dollars of equity. Still, many regulators and politicians, looking for a scapegoat, will look for excuses instead of looking in the mirror.

The continued bear market is "sinister." It is caused by "systematic bear raids, vicious pools ... pounding down security prices." Short-sellers are "deliberately making a profit from the losses of other people." Although those all sound like comments from today's politicians, they are not. Rather, they are all comments from Herbert Hoover.

Hoover railed against short-sellers as his counter-cyclical policies exacerbated the economic problems of the early 1930s. Those problems were made even worse by his successor, Franklin Roosevelt, who was also unable to restore prosperity by expanding the Hoover inflationary policies. All of this is detailed in Murray Rothbard's book *America's Great Depression*.

Let us not repeat history. The best way for the market to recover is not to restrain or abolish short-selling. Regulators, lawmakers, and presidents made the mess in which our assets are burning up. Now they want us to blame others. Blame them instead.

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