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PREFACE

Word of Caution!

Short selling is not for the faint of heart. While fortunes have been made shorting, many have also been lost. Shorting stocks is for the financially experienced and sophisticated investors with a strong stomach for losses. It can be potentially very dangerous to your wealth, and while this book may be a helpful guide to finding successful short ideas, when it comes to actually shorting them, you are on your own. Please consult with your financial advisor before taking any action.

Who should read this book?

The book provides a research framework for individual and professional investors, finance students and professors, stock market reporters, and other stock enthusiasts to find uncommon short ideas and avoid common traps and hot stocks. Investors and professional analysts will find this book useful to uncover and pitch new short ideas.

Finance students seeking careers as professional analysts can benefit from this book. Finance professors can draw upon various examples and the shorting framework in the book to complement traditional textbooks on equity analysis. Market reporters, stock bloggers, and other stock market enthusiasts will find the book useful to watch for common themes behind short ideas that may have been overlooked by the stock market.

Why should you read this book?

There is a natural psychological bias toward buying stocks. The Dow Jones Industrial Average (DJIA) has continued rising from the 100 range in the 1920s to the 14,000 range in 2007, generating a compounded annual return of ~6 percent. Shorting stocks against this backdrop may seem like sailing against the tide. Rising tides often lift even the least sail-worthy boats.

Short sellers have profited from less worthy stocks since the 1600s when exchange-based trading began in Amsterdam; however, books on short selling are few and far between. Good investment books expound on downside risks in long ideas; however, risk analysis can always find one risk or another with any long idea.

Shorting stocks is not exactly the opposite of buying stocks, and risk

analysis of long ideas may not always detect clear signals to short. It takes more to uncover short ideas. I present a short selling framework in this book that uncovers the common themes behind falling stocks to find uncommon short ideas.

While shorting is inherently risky, investors can profit from well-researched short ideas. When a short thesis points out problems endemic to a specific industry, investors can short both stocks and sector funds in that industry to beat market returns. While investors may not always choose to act on short ideas, they can still avoid losses by using this framework to analyze weaknesses in their existing portfolio.

Structure of the book and content

I have divided the book into three parts: Part I lays out the framework to identify short opportunities. Chapter 1 explains the risks of shorting based only on high valuations and lays out a more comprehensive framework to identify shorts. Chapter 2 explains the inherent risks with leveraged businesses and the operating metrics that lead to a short idea. Chapter 3 describes issues with business models and turns in growth stories that can drive down stocks. Chapter 4 points out issues with key financial assumptions that can raise red flags about the business. Chapter 5 explains that history can be a good compass to navigate an ongoing crisis and that recession and crises can result in tightening credit cycles that expose vulnerabilities in certain business models.

Part II examines public recommendations by reputed investors as sources of short ideas. Chapter 6 illustrates examples of when it may be useful to bet with or against reputed investors and when to stay away. Chapter 7 contains an exclusive interview with Mark Roberts and samples of Off Wall Street research on short ideas.

Part III describes the risks and mechanics of shorting. Chapter 8 considers when to hold or fold your position and provides examples of traps and hot stocks to avoid. Chapter 9 describes the mechanics of short selling and how short selling is not the opposite of buying stocks.

I have used case studies throughout the book to illustrate the shorting framework in practice. I have drawn examples from my past research as well as research contributed by Off Wall Street, a short-focused research firm with a successful track record that spans two decades.