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Short Selling: Unethical Blight on Retirement Investing

Pushing for Change on Capital Hill

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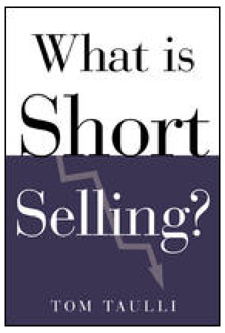

Some people believe that most everything in life has a price and can be purchased. This callous and cynical view lies behind the practice known as the "short selling" of equities and securities. In August of 2001, we wrote an article for the *Valentine Capital High Net Worth Newsletter* entitled, "Shorting Our Elderly Out of Retirement" which was also published in the *East Bay Business Times.* The piece was written in the early aftermath of the dotcom crash to define the then-lesser-known practice of short selling and to explain why we felt it was unfair and particularly damaging to the retirement portfolio. From that article:

> *"We argue that since its inception it (short selling) has been a growing malignancy in the markets; a mechanism that exploits bear markets and amplifies their negative impact upon the portfolios of traditional investors."*

Today, nearly ten years later, the same is true but the immense increase in the volume of short selling activity has brought the damage wrought to alarming levels. Just as during the bear market of 2000-2001, the pain of today's deteriorating economic climate is being amplified within retirement portfolios by the practice of short selling. In our 2001 article, we explained the unfair advantage short sellers held at the expense of retirement investors. Since IRA rollovers in a qualified plan are not eligible to short stocks, the typical retiree is not in a position to engage in this risky practice. The IRA in a qualified plan only allows for traditional investment into companies whereby rising values yield earnings and falling values yield losses. Yet, the actions of short sellers, betting on the possibility that the shorted stock will fall in value, add additional downward pressure on the stock. While the retiree hopes his positions will gain value, the short seller is banking on the probability that his positions will decline in value. The more stock sold (short or otherwise), the lower the value of the stock falls. The retiree loses value while the short seller gains.

What's most galling about this iniquity is the fact that the short seller is allowed to pursue this unfair strategy without even owning the stock he sells short! Yes, the short seller sells positions he does not own. The actual shares he sells are "loaned" to him by his brokerage with the explicit understanding that he will buy them back on the open market at a lower price once the share price has fallen and return them to the brokerage. In brief, the short seller sells 1000 shares of XYZ at $1.00 per share or $1000.00. If his strategy works and the value of the shares fall to $.50, he buys them back for $500. He keeps the $500 difference (less fees etc.) and then returns the shares to the brokerage. This is great for the short seller. But in a bear environment, where many company's stocks are losing value, the activity of short sellers increases the volume of overall sales further driving share prices downward. For the retiree whose portfolio is characteristically more conservative and tends to avoid this kind of risky, short-term investment strategy, the net effect is devastating.

We remain very concerned about the ethics of short selling. After all, if you owned a mint condition, 1968 Corvette or a painting by a French Renaissance master, how would you react if I were to arrange for its sale without conferring with you? Even though in the end the sold items were guaranteed to be replaced, is it truly fair for one to sell something one does not own? From early childhood, society instills the value of respecting the boundaries of others. I can think of no other example in life where it is socially acceptable to treat as one's own, items which clearly belong to another.

Beyond the obvious ethical quandary, there is a tangible, functional problem with short selling as it relates specifically to the retirement investor's portfolio. The act of short selling is enriching a very small group of investors at the expense of the vast majority of others. Consider the following by way of a simplified example.

Imagine that there are fifty thousand employees of fictitious company, ABC Telecommunications and they all own 100 shares of company stock which is valued at $10 per share. Each employee owns stock worth a total of one thousand dollars. Enter the short sellers, a small group of hedge fund managers for example; who begin to sell ABC Telecom stock, betting on their belief in the probability that ABC stock is poised to fall. If their predictions are correct and the shares of ABC begin to fall, these short sellers reap the benefits. The increased volume of short selling on ABC stock adds to the downward pressure on ABC stock price, prompting even more short selling activity in what can become a downward cycle. In the end, let's imagine that this process drives ABC Telecom stock to a price of $3.00 per share, rendering ABC Telecom employees' 100-share stakes worth only $300.00. The net result in this hypothetical example is that the 50,000 ABC telecom employees see their stock value decrease by 70% while the handful of short selling fund managers reaps outsized profits for their efforts. This has a significant impact on the velocity of money because those 50,000 ABC Telecom workers will likely rein in their spending as they feel less wealthy. The short sellers are likely to use their gains to enact even more short selling. Which group of consumers do you suppose would have a better overall effect on raising the velocity of money; 50,000 individuals putting money into the economy versus a dozen fund managers?

As we have explained many times in the past, velocity of money refers to the rate at which money is exchanged from one transaction to another. Simply, Joe buys an item from Bill for $10 and then Bill buys an item from Sue for $10. Sue then uses her $10 to purchase an item from Sally for $10. The same ten dollar bill has changed hands three times, but it has purchased $30 worth of goods. The more times money changes hands, the higher the velocity of money and the better it is for the economy. Also notable is the fact that government loses significant tax revenue as a result of short selling. The money exchanges of 50,000 ABC Telecom workers – even at the lower tax rate of 15% -- will far outweigh the money exchanges of the far fewer numbers of short sellers; even at the higher 30% tax rate.

We would urge our legislators to begin work on enacting what could be referred to as "The Reduction in Velocity of Money Act" in 2009 to legally prohibit short selling which is having a dangerously damaging effect on the portfolios of retirees and others who rely on their investments to replicate their paychecks. Any practice that artificially depresses the value of a retiree's investments is a practice that endangers their ability to maintain an income stream during retirement and must be stopped.

So today, in the autumn of 2008, markets are falling below levels they enjoyed ten years ago in the end of 1998 and early 1999. We contend that much of the pain can be blamed on the lack of regulation or the lack of regulation over certain types of investments that utilize a short selling strategy. New investments are being created, is allowing short selling to grow in practice and the few to profit on the misery of the many. This exponential growth in short selling activity is having a seriously damaging effect on the overall economy. It is contributing to the downward pressure on the markets and more capitulation. By allowing and even encouraging people to sell things that they do not own combined with the fact that the positions will eventually have to be repurchased, is making for the extreme movements going up and down. This fluctuation is very troubling for people retired or soon to retire. We strongly urge federal regulators to implement stringent restrictions on the practice of short selling. We have written to our elected representatives in Congress and are urging our clients and anyone, anywhere who plans to retire someday, to urge the Legislature to do the same.

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