Interview With a Short Seller
Part 1

By Zeke Ashton & Whitney Tilson
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Last week's historic market closedown has focused the attention of many nervous investors and the financial media on the topic of short selling. With last week's attacks, the debate rages over whether selling short is right or wrong in this uncertain economic and political climate. Emotions run high as rumors circulate that the alleged terrorists may even have profited from short sales of insurance companies before the attacks.

Manuel Asensio is perhaps the most famous short-seller in the market, thanks to his adversarial style and very public profile. The author of *Sold Short: Uncovering Deception in the Markets*, Asensio has produced perhaps the best public record of stock calls in the business: on his website, www.asensio.com, Asensio & Co. has initiated "strong sell" coverage on 26 different companies since January of 1996, and the market has proven him correct on 24 of those calls (the 25th company is Network Solutions, and the 26th is **VeriSign** (Nasdaq: VRSN), which acquired Network Solutions in 2000; this is still an open position but so far very profitable.) Of the 26 stocks, 14 have declined in value by more than 90%, 8 of the 14 have been de-listed, and 3 of the 8 have gone bankrupt.

Practiced by Asensio, short selling isn't about betting that good companies will fail or about trying to profit from the misery of others. He argues passionately that short sellers play an important and necessary role in the market by correcting mis-allocations of capital that disrupt the economy. Selling short requires a belief that free markets will encourage enterprises that create value and discourage those that don't -- and the choice to concentrate on the second factor rather than the first. According to a company press release last week, Asensio argues that short sellers challenge "not the system, but those who abuse the system."

Back in May, Fool writers Zeke Ashton and Whitney Tilson talked at length with Mr. Asensio about how he targets companies ripe for shorting, why he specializes on the short side, and why he believes that he and other short sellers represent "the knuckles of the invisible hand" of an efficient market. Whether you short stocks or not, we think you'll find the following interview to be a fascinating glimpse inside the mind of a short-seller.

For more information on shorting, see our special, "Is Shorting Stocks Foolish?"

TMF: Thanks for talking with us today. In looking at your website, where you publish your strong sell/short sell opinions, your track record is pretty much perfect. We counted 24 out of 25, or 95%, where things pretty much turned out as you described in your reports.

Manuel Asensio: It depends on whether you consider Network Solutions and VeriSign to be one play or two plays [VeriSign acquired Network Solutions in 2000]. Because with our first call on

Network Solutions, we didn't lose money, and now we've issued a strong sell on VeriSign, and we're still in the game there. So it depends on how you count it.

TMF: There are 10,000 or so publicly traded companies -- and you target publicly maybe three or four per year. How do you narrow down your selections?

Asensio: We have two very different universes that we look at. The first is the universe of companies that we publish, where our track record is nearly 100%. What draws us into the markets in those cases is that we have factual evidence, undeniable, with no uncertainty, that proves what the company is saying is not complete, not correct, or in fact, in many cases, diametrically opposed to the facts.

TMF: In other words, they are fraudulent.

Asensio: Let's not use the word "fraudulent," let's not use the word "false," because it doesn't matter. The only thing that is important is that we discover some companies that are disseminating information that is, to describe it in the most gentlemanly way possible, of questionable validity. Those questionable disclosures, which might include complete falsehoods or might simply be the failure to disclose negative material information that investors need to make a judgment about the stock. If the stock price is a result of the market believing what the company is saying, that we know to be incorrect, then we look at it. So we focus on questionable companies, but then we look for price action and volatility.

You then have to make a judgment -- this stock is trading at this much, based upon assumptions that we know to be incorrect. If those things come together, when we have factual, third party, unquestionable information that shows that the company is disseminating information that is both positive for the company and false, then those conditions make up the premise for our decision to initiate coverage with a strong sell report on our site and to short the company. Once we have initiated coverage, we also commit to the coverage and report on it continuously.

TMF: Why do you take such a public, adversarial position relative to these companies? If you know that the stock price is based upon assumptions that aren't true, why not wait for the market to recognize that?

Asensio: Being public with our research speeds the process along. The fact that we are an advocate of our position and we strongly word our research, act quickly, and are accusatory in our language helps the stock correct itself, and helps the market correct itself. That is also what has created the controversy.

TMF: So you make everybody put their cards on the table?

Asensio: If we relied upon giving that factual information -- which is hard to discover, sometimes hard to understand or to apply -- to a media outlet like *The Wall Street Journal*, which is institutional in nature and biased towards the status quo, that information would never be treated the way that we treat it when we issue our hostile adversarial short-selling research. People find it offensive, and of course most of those that are offended are involved in the battle and are also involved in the promotion of the company. This has led to some of these companies pursuing litigation at times, none of which has ever been successful.

Our record, I feel, is a tribute to the efficient market, not a record in the face of an efficient market. In our thinking, the fact that we are rewarded and generated better profit in the bull market relative to other short sellers or even long players, comes from being very close to the knuckles of the invisible hand that sets prices. Society is willing to provide us with a profit in return for the benefit to society that we provide of eliminating obvious misallocations of capital, which is always damaging to capitalist society and free enterprise.

If the invisible hand is being hampered because there are no short sellers, no adversary to the promotion of the company, then you are going to get prices that are just too high. You have to put in valuable information in a manner that advocates the short side, and you will be paid to the degree of credibility you have and the correctness of your research and your information that you provide to the market that strives to be efficient. We are fundamentalists, and we are respecting of the efficient market and efficient capital asset pricing.

TMF: With all the companies out there, you can't read every 10-K and press release. How do you find the ones that are disseminating false information that you then decide to short?

Asensio: First of all, you have to concentrate on questionable companies and questionable management to begin with. The stock must also have a price and volume, and there has to be volatility, to make it worth our time to look at. For example, one company that we shorted, **Zonagen** (Nasdaq: ZONA), was a very questionable company that was picked up by some underwriters to do a secondary offering, and all of a sudden it was a respectable company.

TMF: But how did you know that Zonagen was questionable? How do you find the companies?

Asensio: We have a database of fraudulent stock promoters, and a database of companies that those promoters use to do Ref-Fs, Reg-Ds, 504s, private placements, and the like.

TMF: So you follow the stock promoters and the underwriters?

Asensio: Exactly. We tend to be very active on the American Stock Exchange. The AMEX is a hotbed of fraudulent activity.

TMF: To what do you attribute that?

Asensio: There is a widely held perception among investors that a listed company is more stable and better than a company that trades over-the-counter. This may come from the quality and size of the NYSE listing but the AMEX is very, very different, and worse so. Investors don't know this, and the AMEX insiders and penny-stock promoters use it to their advantage.

Hemispherx (AMEX: HEB) is certainly the most exposed stock fraud in America, and the AMEX refuses to de-list it. There were three high ranking officers in the American Stock Exchange involved in Hemispherx. One was a prominent specialist who has since been permanently barred -- another was on the board of governors, and the third was president. The American Stock Exchange has a deep institutional and fundamental problem with their listing requirements and with their business in general.

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Zeke Ashton (TMF Centaur) wouldn't be caught dead owning any of the stocks mentioned in this article, though he owns others you can see in his profile. He heartily recommends Manuel Asensio's book -- it's a fun read.

Guest writer Whitney Tilson is Managing Partner of Tilson Capital Partners, LLC, a New York City-based money management firm. He owns no shares of companies mentioned in this interview. He writes Tuesday's Fool on the Hill column for The Motley Fool.

The opinions expressed by Mr. Asensio are his only and do not represent those of The Motley Fool, Inc.

Interview With a Short Seller
Part 2

TMF: What about the positions that you don't publish on your website?

Asensio: We short stocks other than those we put strong sells on. When we go public, we have to respond to every press release the company issues. Our track record is good on the positions that we don't publish, though not as good as our public record.

TMF: We have all heard about the theoretically unlimited risk that taking a short position exposes one to. How do you manage the risk of being short stocks?

Asensio: It is an entirely different process to be short a stock and have it go against you than to be long a stock and have it go against you. There are only two real ways to protect yourself. You can diversify. The second is to have both the conviction and the capital to survive a run-up. We don't want to be martyrs, and we haven't ever been martyrs. We've never suffered a big run-up.

TMF: Do you also invest in companies on the long side?

Asensio: Right now, in this market, we are not long any stocks.

TMF: It strikes me that Network Solutions/**VeriSign** (Nasdaq: VRSN) is a completely different case than what you normally target.

Asensio: We knew that Network Solutions and VeriSign were different than the typical companies we usually target. In this case, VeriSign's illegitimacy is endorsed by Congress. We knew going in that we were involved in a chasing the windmill, Don Quixote type of activity. But we initiated our actions because there was so little discounting by the market of the potential risks involved with that business.

Not that we don't believe that there isn't some illegitimacy both in the trading of that company's stock and in the company itself. It's just that the company is so powerful politically and has such strong institutional backing. There are 24 Wall Street analysts recommending the stock. The company has a $10 billion market cap and a billion dollars in the bank, and the amount of political contributions that they give to both Democrats and Republicans to make sure that their illegitimate business remains in place is huge.

The first time we went against them, it took about four months for the company to successfully secure its monopoly when all signs were against that happening. All outward signs would have led any non-biased, non-skeptical observer to say that Network Solutions should not have been given the contract they were given by Clinton, so during that period of uncertainty, the stock capitulated. Of course, when they later got everything they wanted and more, the market rejoiced and the stock ran up.

This time around, the amount of uncertainty is less, and the timing of that uncertainty is less. This time around our position is much larger than it was the first time around. There would be no barriers to VeriSign's business if the politicians didn't take care of them. And if the politicians didn't take care of them, the world would be a better place, because the consumer would benefit from the competition.

On a fundamental basis, the balance sheet and income statement at the company are already starting to reflect the little amount of competition the company is starting to face. The company denies it, but it's there. High sales to related parties, rapidly increasing accounts receivables, those are classic warning signs. We think that there will be material negative developments in that business to come. So now it's more a fundamental issue than a political one. Hopefully, that gives you a flavor of why that stock is different.

TMF: As you look at the almost celebrity status of some of the big Internet stock analysts like Mary Meeker and Henry Blodget that have an abysmal record of investment calls, and here you are 25 out of 26 in your calls... Investors would have been much better off in following your recommendations than virtually any other analyst out there. Yet you are often portrayed in a sinister light. You ever wonder why you haven't gotten your due?

Asensio: Let's just go over that. That's a very important point. These celebrity analysts were created out of necessity, and it all started with the money that came into the mutual funds. Once there, it had no place to go because there wasn't sufficient earnings capacity existing to justify the amount of money sitting in mutual funds that had to be invested. Once the money was there, but the legitimate investment potential wasn't there, you had a scenario that created the incentive for investment bankers to create blatantly fraudulent and misleading and outright bullish statements about the new economy and to create the celebrity status of the analysts to push that view. They had to market to Middle America. Middle America was buying mutual funds that specialized in Internet investing much faster than the fundamentals merited. There wasn't enough value there to justify the amount of investment that was sold to American consumers.

So it all had to be huge. There had to have been a Mary Meeker or a Henry Blodget or whoever to drive it. Their individual talents and skills are meaningless, they were just people who reacted to a set of circumstances so that they could get paid a certain amount -- they didn't have any idea what they were participating in on a larger scale. Wall Street convinced middle America that regardless of what you pay for them, stocks will always be the best performing asset class. That money has now been dissipated -- it's gone into the pockets of insiders, venture capitalists, bankers, brokers, and the analysts, and Middle America, by and large, has no recourse.

Now let's compare the massive amount of money, influence, and power these celebrity analysts have to the resources the shorts have. The short specialist typically has very little capital, very little in the way of support personnel, and is harassed by libel and securities laws, by the SEC, by shareholders, by the promoters, and by the media. If this weren't the case, I would guess that the market would have never reached the peak that it did, and the celebrity analysts wouldn't have ever really existed. But because there was really nobody to oppose the promotional machine on Wall Street, they drove prices up to ridiculous levels. Anybody who stood up and said this was madness was simply driven under by the powerful forces at work.

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