SHORT-SELLING WITH THE O’NEIL DISCIPLES
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SHORT-SELLING WITH THE O’NEIL DISCIPLES

Turn to the Dark Side of Trading

Gil Morales
Chris Kacher

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As the old aphorism says, “When life gives you lemons, make lemonade.”
When the stock market gives you lemons, one should make lemonade by selling short. This book is dedicated to all those who seek to improve and transform themselves by taking the lemons that life throws at them and turning them into lemonade.
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This book is intended as a follow-up and updated “second edition” of the book I originally ghost-wrote in 2004, *How to Make Money Selling Stocks Short* by William J. O’Neil with Gil Morales (John Wiley & Sons, October 2004). While that book has been a strong seller and does a reasonable job of outlining the basic concepts behind the art of short-selling, it is woefully inadequate in terms of its coverage of the basic mechanics of short-selling at the granular level. In that book, we relied entirely on weekly charts, and while weekly charts most certainly have their purpose in helping to identify the macro-patterns that develop in short-sale candidate stocks, it is on the daily chart that we determine the precise point within a stock’s pattern at which to sell it short. Thus, the fact that the 2004 short-selling book did not contain any daily charts meant that it essentially ignored the most important aspects of short-selling. What is radically different about this book is that it relies mostly on daily charts and gives readers a much more detailed and realistic view of just how the short-selling process can play out. This is the essential difference between this book and the last, and one which I believe makes a huge difference in terms of conveying a true sense and understanding of how short-selling works at the point of impact (e.g., the precise point or points at which the short-sale trade can be executed). This can only be seen on the daily chart.

In this book, we update and modify what I see as a fluid, evolving set of short-selling principles rather than a static, dogmatic one. In the process, some of the old short-selling “golden rules” described in both *How to Make Money Selling Stocks Short* and Chapter 6 of the first book that I wrote with my friend and colleague Chris Kacher, *Trade Like an O’Neil Disciple: How We Made 18,000% in the Stock Market* (John Wiley & Sons, 2010), have been exposed as myths. One major myth about short-selling is that one can only short stocks during a bear market. That is simply
not true, and the objective material in this book more than blows that premise out of the water. So it is that as I continue to trade on the short side of the market and gain more experience, my objective research and post-analysis of my own short-sale trading as a matter of course reveals more sides to the multifaceted diamond that short-selling, when done right, can be.

One of the major new developments in my work and research on the short side is the use of “fractal” short-selling patterns. My colleague Chris Kacher has frequently brought up the idea of the stock market’s technical action as being of a highly fractal nature, with each observable pattern breaking down into and containing within its structure smaller patterns and sub-patterns. I must give credit to Chris in helping to inspire my clarification of what I was seeing on my charts, and his concept of a fractal market is shown to be quite valid on the short side. Fractal technicals can be thought of in simple terms by taking a basic cup-with-handle base formation on a weekly chart and then seeing that the handle of this pattern in turn consists of another, smaller or fractal cup-with-handle formation. If we then look at a 60-minute chart of the same pattern, we might notice that the handle of the fractal cup-with-handle in turn consists of an even smaller cup-with-handle formation. This is a basic illustration of what we mean when we talk about fractal chart patterns.

Sometimes, however, the fractal nature of a pattern can also be observed on a single time-frame, such as the example of a smaller head-and-shoulders formation forming within the head of a larger head-and-shoulders formation. In this case, the fractal components can all be seen in one time-frame on the weekly chart. In any case, the use of fractal chart formations can be very useful in helping one exploit a top in a stock long before the large head-and-shoulders formation becomes obvious on the weekly chart. This also underscores why the sole use of weekly charts in short-selling, and in particular in trying to teach short-selling, is highly deficient. This book corrects all of that.

The short-selling model book section in Chapter 10 of this book is also vastly different from the one in the 2004 book. This new model book section shows both weekly and daily charts, and both time-frames are annotated in detail. Each short-selling example also includes relevant notes, as well as space for readers to make their own notes as they engage in more detailed study. I highly recommend HGS Investor Software (www.highgrowthstock.com) as an excellent analytic and charting tool for use in studying the short side of the market. The great advantage of this particular product is that it allows one to easily scroll backward in time and therefore facilitates the study of a stock’s historical price/volume action. This particular feature is also useful for studying the historical long side of the market as well.

The final difference between this book and the 2004 short-selling book is that this time around I have the luxury of being backed up by Chris Kacher with respect to the research that went into this book. Because I am the only one between the two of us who actually sells short, I was the only one who could write and produce
this book. That is why the book is written in first person by me, while the research backup and editing assistance of Chris Kacher keeps things tight.

Finally, I think the material in this book is not only quite useful for would-be short-sellers, but also for investors and traders who stick to the long side of the market. The truth is that understanding short-selling is also all about understanding how leading stocks top. That sort of understanding not only helps short-sellers make money when “good stocks go bad,” but also helps those playing a leading stock on the upside and milking a strong uptrend optimize their long-only process by being able to recognize when their good stock has gone bad and the time to sell has finally arrived. When considering whether this book is right for you, this is an important factor to take into account.

To me, short-selling encompasses all of the common sense methodology and wisdom that runs through the works of William J. O’Neil, Richard D. Wyckoff, and Jesse Livermore, or the OWL, as we refer to them. While the roots of my investment methodologies and philosophy lie in my tenure at William O’Neil + Company, Inc. from 1997–2005 as a vice president, internal portfolio manager, and head of O’Neil’s institutional advisory business, my current work as a short-seller (and as a buyer of stocks on the long side) makes me more of an “OWL Disciple” than an O’Neil Disciple. Short-selling is a complicated game to play, and as I already noted, is much like a diamond with many, many facets. Thus it becomes a fascinating process that most certainly contributes to the element of self-discovery that every trader and investor experiences over time as they expand and refine their skills.

As Chris Kacher and I wrote in our first book:

Like athletes and thrill-seekers who engage in activities that seem extremely dangerous, almost to the point of the unthinkable, to those who live more normal lives, we as traders seek the “rush” that comes not from a successful trade, but from the experience of being entirely in the present as we operate “in the zone,” and a certain fluidity and calmness pervades our actions as we engage the markets in real-time. Ocean wave surfers experience this as the intensity of riding a powerful wave-form that forces them to focus on the matter at hand as a matter of sheer survival. Focusing on the matter at hand forces one to operate entirely in the present—there is no worrying about yesterday’s problems, or tomorrow’s challenges, there is only the “now.”

Nowhere does this concept hold true more than when one is selling short and doing it well. Given the inherent risk and danger of short-selling, it might be considered the stock market equivalent of big-wave surfing. Certainly, as a trader,
there is no greater satisfaction to be had than being “in the zone” on the short side and making big money during a period where the vast majority of investors on the long side of the market are losing their shirts. Good luck!

Gil Morales
Playa del Rey, California
November 2014
The term “O’Neil Disciple” was first coined by our colleague Kevin Marder, who co-founded MarketWatch.com in the 1990s. In the book *The Best: Conversations with Top Traders* by Marc Dupee and Kevin N. Marder (M. Gordon Publishing Group, September 15, 2000), we are both interviewed in Chapter 1, titled “The Disciples.” When we wrote our first book in 2010, the use of the term “disciples” came up as something of an inside joke, and we eventually settled on calling ourselves “The O’Neil Disciples.” Ultimately, it is a very succinct and accurate description of what we are. Our methods are steeped in the literature and methods of Jesse Livermore, Richard D. Wyckoff, and William J. O’Neil, and it was O’Neil who was our real-life, real-time mentor back in the days when we worked for his organization as internal portfolio managers. As disciples, we have taken what we have learned from these masters and synthesized it into what we believe are far more concrete and precise methods on both the long and short sides of the market. We teach and discuss these methods in our books, media and tradeshow appearances, and our website, www.virtueofselfishinvesting.com. Thus, we feel that this is the right time to acknowledge the fact that Kevin Marder was the originator of the “disciple” moniker, and we thank him for providing this seed for what we later expanded to The O’Neil Disciples.

We should also acknowledge that this work, as with all our works, was produced without the aid, cooperation, approval, or endorsement of the O’Neil organization.

We gratefully acknowledge the role that our followers and subscribers have played with their questions and feedback in helping us to improve how we teach our methods as disciples of O’Neil, Wyckoff, and Livermore (the OWL). This book is no different in this regard.
We would also like to acknowledge the help and support we have received from HGSI Investment Software, LLC (www.highgrowthstock.com) and its three main principals, George Roberts, Ron Brown, and the Big Kahuna himself, Ian Woodward. HGS Investment Software has become our “weapon of choice” when it comes to an equity analytics, screening, and charting software program, and the product includes many templates, screens, and chart views that are directly based on and related to our work and methods as discussed in our books and on our website. Their enthusiastic support in providing us the full use of their charts throughout our books, including this one, is a welcome endorsement of the validity and effectiveness of our methods and techniques, and for this we are deeply grateful.

Finally, we would like to send a shout-out to the great staff at John Wiley & Sons who helped us with this project: Judy Howarth, Tula Batanchiev, Evan Burton, Kumudhavalli Narasimhan, Darice Moore, and Pamela Van Giessen. When you are working with the top publisher of financial books in the world, not much needs to be said. These individuals set the standard for the rest of the industry!

Dr. Chris Kacher
Gil Morales
Playa del Rey, California
November 2014
Introduction to Short-Selling

Reduced to its mechanics, short-selling is simply the act of identifying a change of trend in a stock from up to down and then seeking to profit from that change of trend as one rides the stock to the downside. To do this, the investor or trader sells the stock in question while not actually owning it, e.g., being “short” the stock, and pockets the proceeds of the sale with the idea of buying the stock back later at a lower price as the downtrend takes hold and extends to the downside. To go short, the seller must first borrow the stock from her broker and may have to pay a very small fee to do so. If and when the stock drops in price, the seller then repurchases the shares, “covering” her short position for less than she sold them, returning the borrowed securities and pocketing the difference. This is, of course, not a risk-free proposition, as the short-seller may also end up owing the difference if the stock rises in price and the cost of buying back those shares exceeds the proceeds they pocketed at the time of the initial short-sale. Because stocks can theoretically rise to infinity, while their decline is finite given that a stock price cannot go below zero, or 100 percent of its current value, then the potential losses a short-seller faces are unlimited. Of course, this assumes that a short-seller is operating without a stop-loss that provides a clear point at which the short-sale would be covered and the trade closed out at a loss, hopefully a small one.

To some, short-selling represents the “dark side” of the market, and history has often characterized the art of selling short as an evil enterprise, embodying a conspiratorial or pessimistic frame of mind that fixates on the negative. Consider that during the Great Crash of 1929, Jesse Livermore made $100 million in 1929 dollars, an astronomical sum at that time, by short-selling stocks during this severe
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market downturn. When this was later disclosed to the public, Livermore was the subject of extreme public outrage, even to the point where his short-selling activities were blamed as part of the cause of the great crash. In reality, Livermore merely observed and acted upon the market facts as they became apparent. The true cause of the Crash of 1929 was the fact that everyone had piled into the market and there was nobody left to buy stocks at that point. As well, paltry 10 percent margin requirements allowed investors to buy $100 worth of stock with only $10 in their pocket, creating a massive asset bubble and the optimal conditions for a rapid and destructive popping of that bubble.

Thus stocks find their value given the circumstances, and short-sellers can act as a catalyst to help stocks reach their true value faster than they might without any short-sellers. Supply–demand mechanics have shown time and time again that even when short-sellers pile onto stocks as they did the dot.coms, such as Amazon.com (AMZN) in the early 2000s, their short-selling has no long-term effect on depressing price if the perceived value of the stock continues to be higher than where the stock is currently trading.

Nevertheless, during the earlier existence of the United States, short-selling was in fact banned because of the inherent instability of the then very young country’s fragile markets, mostly thanks to speculation surrounding the outcome of the War of 1812. It was not until 1850 that the short-selling ban was repealed. More recently, in 2008, government officials banned the short-selling of certain financial stocks that had come under pressure as a result of severe, even deadly, liquidity issues related to having swarms of bad mortgages held on their books. Excesses in the mortgage industry, fostered by government subsidies and policies that forced and/or allowed banks to lower their lending standards in order make home loans to low-income consumer borrowers who had no means of paying back the loans, created a housing bubble as demand for homes was artificially spiked, sending real estate prices soaring. These low-quality mortgages were in turn repackaged into bundles known as mortgage-backed securities (MBS), and the structure of these MBSs magically enabled them to be rated Triple-A by the credit-rating agencies such as Standard & Poor’s and Moody’s. With Triple-A ratings, such mortgage-backed securities were eagerly purchased by investors, ending up en masse on the books of a large number of financial institutions as well as in the portfolios of many institutional and retail investors. When the real estate bubble finally popped in 2008, these loans went bad, sending the institutions that had many of these mortgages on their books into insolvency.

In keeping with the fact that history often rhymes with the present, government officials attempted to deflect part of the blame for the financial crisis of 2008 onto short-sellers who were accused of the predatory practice of “naked” short-selling as they swarmed vulnerable financial stocks on the short side and helped to drive their
prices lower. Forget the fact that short-sellers were doing little more than what smart speculators do in the first place, which is to identify a potential or emerging trend and to then capitalize on it by investing in the direction of that trend. The excesses of the mortgage and housing industries by 2008 deserved to be exposed for the frauds that they were, and short-sellers were simply part of that process of exposure and “cleansing.” As well, investors who were foolish enough to buy the stocks of financial companies on the way down did not heed what the trend was telling them. Obviously, anyone who understood what was going on knew that the only logical endpoint for the excesses of the housing and mortgage industry and the resulting insolvencies that it produced once the bubble popped was bankruptcy. And that is precisely what happened to venerable financial institutions like Lehman Brothers, Merrill Lynch, and Bear Stearns, which went belly-up or were absorbed by other financial companies.

Aggressive short-selling was alleged by regulators to have played a role in the demise of both Lehman Brothers and Bear Stearns, but the fact is that the insolvency of the financial system in 2008 was real, and true insolvency leads to bankruptcy, whether the stock is a favorite target of short-sellers or not. Without the Fed stepping in to flood the system with unprecedented amounts of liquidity using unprecedented systemic schemes collectively known as quantitative easing, or QE for short, more such financial institutions would have suffered the same fate as Lehman Brothers and Bear Stearns. Ultimately, the Financial Accounting Standards Board (FASB) would also step in to aid the Fed’s QE propping by changing Rule 157, otherwise known as the “mark-to-market rule,” which required financial institutions to value their assets at fair market value. By allowing banks and other financial institutions to value their bad mortgages at whatever they wanted to rather than what they were in fact worth, further insolvencies in the system were avoided, at least temporarily and on paper.

What is interesting to observe is that the government’s creation of an entirely artificial force to prop up and stimulate a reversal in the deleterious downtrend of the financial sector stocks is accepted as a legitimate way to influence stock prices, but the actions of short-sellers are seen as an unnatural and evil influence. We would argue that short-selling is a natural part of the process that defines the life-cycles of all stocks as they benefit from growth and the ensuing speculative excess on the upside, but at some point must go through a process of correction and downside price movement that clears the decks, so to speak, and either helps to build a foundation for a new uptrend and cycle of growth or results in a final and complete demise of a company that is no longer able to compete in its core industry. In a sense, the demise of older companies also helps to foster new growth cycles in that the way is cleared for newer, more innovative companies to supplant the older, slower, and larger companies that have lost their innovative and, hence, competitive
edge. Short-selling, at its core, is nothing less than the investment manifestation of the virtuous cycle of creation and destruction, as well as the periodic need to cleanse excesses from the system that is the hallmark of an entrepreneurial economy.

As a very instructive and current example, one need look no further than the financial crisis of 2008 and the market events that led up to it. The reality is that the financial crisis of 2008 and the severe bear market that accompanied it actually began well before it reached full-blown crisis proportions between September 2008 and April 2009. It began quietly with the topping of home-building stocks in July of 2005. Recall that the financial crisis was a function of a mortgage crisis based on the promotion and writing of ridiculously risky home loans by banks and other home-lending institutions. The lowering of lending standards in turn fueled what was really a ballooning artificial demand for houses, and this heroin-induced rush of home buying drove home prices higher, spurring a homebuilding boom that manifested in the stock market as a strong uptrend in the prices of homebuilding and building-related stocks from 2000–2005. While the demand for housing reached a crescendo in 2006–2007, homebuilding stocks had already begun to top, as the charts of two separate homebuilding stocks, Toll Brothers (TOL) and Pulte Group (PHM) (Figures 1.1 and 1.2) show.

**FIGURE 1.1** Toll Brothers (TOL) weekly chart, 2003–2006. Luxury homebuilder TOL topped in July of 2005 with the rest of the homebuilding stocks, presaging the coming housing and mortgage crisis that would shake the financial market three years later.

Homebuilding stocks to a large extent represented the point at which the rubber meets the road for the financial crisis as the consumer “end-product” of the housing stimulus, provided by an extremely low interest rate environment and lax lending standards both mandated and promoted by government policies that were readily embraced by the home-loan industry. As more and more consumers purchased homes they could not afford, eventually the chickens began to come home to roost as the reality of making loan payments took hold. The stock market, in its inimitable ability to foresee and begin discounting the future, saw this coming, and when the homebuilding stocks topped, they represented the first warning shot across the bow for the homebuilding industry at large, including the financiers and suppliers that both fed it and fed off of it. In this manner, the top in homebuilding stocks represented stage one of the impending financial crisis.

The great bear market of 2007–2009 officially started when the major market indexes topped in October 2007. Figure 1.3 shows the NASDAQ Composite Index topping in late October 2007 and then moving sideways for six weeks before breaking down further in January of 2008. The observant reader might also note that around this time the NASDAQ Composite had formed something of a “head and shoulders” top formation, a pattern that we will examine in detail later on in this book.
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While the general market did not top until October of 2007, we have already observed that the homebuilding stocks topped in July of 2005, more than two years prior to the general market top in 2007. That was the first warning shot across the bow, but the second warning shot took place in the financial stocks themselves when they began to top in May of 2007, preceding the general market top by exactly five months. The chart of the Financial Select Sector SPDR (XLF), shown on a weekly chart in Figure 1.4, shows a classic head and shoulders topping formation around the peak in May 2007.

The breakdown in the peak off the top in the financial sector constituting the first down leg in the XLF took place from May to August, at which point the XLF rallied twice back up to its 40-week moving average. As financials led the downturn off the peak in May 2007, the period from August to October produced volatile reaction rallies and bounces in the group as a number of other leading groups, including solar energy stocks like First Solar (FSLR), shown in Figure 1.5, and Sunpower Corp. (SPWR), and technology stocks like Apple (AAPL), shown in Figure 1.6, and Baidu (BIDU) continued to rally well past the general market top in October 2007 and into late December 2007 and early January 2008.

So as the general market was continuing to move higher from May to October, the financials were trying to bounce and rally with the market, but this action only served to create a right shoulder in an overall head and shoulders top in the XLF, which then broke down in synchrony with the actual general market top in

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**FIGURE 1.3** NASDAQ Composite Index, weekly chart 2006–2009. The general stock market, as represented by the NASDAQ Composite Index, tops in late October 2007.

**FIGURE 1.4** The financial sector, as measured by the Financial Select Sector SPDR (XLF) ETF, tops in May of 2007, well before the general market indexes and long before the actual financial crisis took hold in the fall of 2008.

*Source: Chart courtesy of HGSI Investment Software, LLC (www.highgrowthstock.com), ©2014.*

**FIGURE 1.5** First Solar (FSLR) weekly chart, 2007–2008. Notice that FSLR initially tops out in late December 2007, and is then able to rally back to new highs when the general market stages a reaction rally and puts in a final top later in 2008, as the third and final leg of the 2008–2009 bear market takes hold.

*Source: Chart courtesy of HGSI Investment Software, LLC (www.highgrowthstock.com), ©2014.*
October 2007, as illustrated by the weekly chart of the XLF in Figure 1.4. Once the general market topped in October 2007, the other areas of leadership during the bull phase started to top over the next few months as a final wave of topping leaders took hold in early 2008, resulting in the second leg down off the peak in the NASDAQ Composite Index in January 2008, as can be seen in Figure 1.3.

The lesson here is that bear markets and the short-selling opportunities they present are thematic, unfolding events that reflect what is going on in the general economy—essentially, the “underlying conditions” that the great trader Jesse Livermore described as the backdrop of any market trend, whether bull or bear. Before the bear market becomes obvious to everyone, including government officials, stocks are already starting to top in waves, as money that had moved in during the uptrend now seeks to exit the market and leading stocks. This is a natural process and is in no way, shape, or form something that is artificially created by short-sellers.

Very real excesses build up in any bull market phase, which is often propelled by underlying growth in specific areas of the economy. In the early- to mid-1990s we saw a strong bull phase that was generated by strong growth in the technology area, specifically semiconductors and related computer technology, as the PC boom took root. In the late 1990s it was growth in the potential and profitability of the Internet that drove the wild dot.com boom, which in turn drove a parabolic bull market. In the mid-2000s, the bull market that ended in October 2007 was helped along by...
a housing bubble that resulted from excesses in easy money policies. Easy money policies by the Fed also served to sharply devalue the U.S. dollar, leading to huge growth in the prices of “stuff” stocks—companies that mined or produced basic materials such as steel, precious metals, fertilizers, coal, and building materials.

The ensuing bear markets are nothing more than the natural clearing out of excesses that were built up in the prior bull phases as winners and losers are sorted out and the foundation is laid for the next growth phase. Short-sellers are merely smart investors who can recognize a change in trend in the general market and leading stocks and profit thereby. If the stock market is accepted by all as a way to build wealth, why shouldn’t investors also be able to take action to protect that wealth during a bear market, and even seek to further build that wealth by profiting on the short side? In our view, short-selling is as American as baseball, Mom, and apple pie.

How Not to Sell Stocks Short

This book will explain in detail how we sell stocks short, and before we get started, it might be worthwhile to discuss how we DO NOT sell stocks short.

Often times we hear of a prominent hedge fund manager who goes on financial cable TV and declares a certain high-flying stock to be the beneficiary of nothing more than irrational, speculative fever on the part of mindless, lemming-like investors. Generally this hedge fund manager is a graduate of what we like to refer to as the University of “I-Am-Smarter-than-the-Market.” As such, he or she is one who is “smarter” than the mass of investors who get carried away with the “hype” surrounding a given “hot stock” and thereby sees fit to declare that the fundamentals of the company in question “do not justify” its often-high and going-higher stock price.

High-flying stocks that have attracted more than their fair share of naysayers who consider the stocks’ ever-rising prices as representative of a sort of moral infirmity among investors have in recent years included great companies like Netflix (NFLX), Tesla Motors (TSLA), and 3D Systems (DDD), for example. Getting up on financial cable TV and declaring investors in such stocks to be misguided doesn’t win one a lot of fans, and because most of these hedge fund managers try to short these stocks on the way up, they generally end up looking stupid before they start looking smart, as the basic axiom of investing, essentially that the trend is your friend, often persists, even when it comes to allegedly overvalued stocks. Trying to short a stock based on the fact that it is overvalued ignores basic stock market reality when it comes to P/E ratios in leading stocks and seems to stand in the way of the dominant upside technical trend. Countless numbers of high-flying stocks over the years have been downgraded by analysts on the basis of being overvalued. This was especially true in the late 1990s with so many dot.com stocks reaching dizzying heights in price despite being downgraded a number of times by analysts.
Netflix (NFLX) is a more recent example of such a phenomenon, as it endured the wrath of a couple of very vocal “valuation” short-sellers all the way up during the incredible price run it had from early 2009 to mid-2011. Valuation short-sellers are those who believe a stock’s price is going to go down because its price-to-earnings ratio, or P/E, is far too high. In December of 2010, a hedge fund manager we will simply refer to as “W” wrote an article in a prominent investment blog discussing the reasons why he was selling NFLX short. The day that article appeared, NFLX closed at a price of $181.65 a share. Within seven months the stock price hit an all-time high of $304.79, not too long after “W” had revealed that his fund had covered its short-sale position, unable to withstand the pain of the losses its NFLX short position generated as the stock ground its way higher, as can be seen in Figure 1.7.

W’s primary reason, his only reason in fact, for shorting NFLX was that its P/E was “too high” and that the company’s business model could not possibly generate the revenues and profits such a valuation implies. This, of course, ignores the fact that a P/E ratio is less a measure of static value and more a measure of the marketplace’s current assessment of a company’s forward earnings stream. If one objectively studies the price/volume action of leading stocks that have huge price moves, one quickly realizes that during these massive upside price runs the P/Es

![Netflix (NFLX) Weekly Chart 2009–2011](image)

**FIGURE 1.7** Netflix (NFLX) weekly chart, 2009–2011. There was a time to be long NFLX and a time to be short NFLX. Self-proclaimed graduates of the University of “I-Am-Smarter-than-the-Market” had trouble identifying either.

*Source: Chart courtesy of HGSI Investment Software, LLC (www.highgrowthstock.com), ©2014.*
of these stocks actually expand, often to 100 or more times the current earnings. Price strength often begets further price strength, thus stocks and even markets themselves often go far higher than most analysts expect.

Individuals like these are seen as “negative nellies” who fail to understand the dynamic nature of the U.S. stock market and the essential direction of money flows into and out of leading stocks during their life cycles. It’s one thing to walk into a clothing store and declare a pair of jeans with holes in the knees to be grossly defective and hence not worth the price tag; it’s quite another to recognize the contextual fact that sometimes jeans with holes in them represent the hottest, cutting-edge fashion statement that every style-minded consumer must make at any price. And so it is with stocks.

In our view, these valuation short-sellers give short-selling a bad name. They want to think negatively about a situation that is being viewed positively by investors who see the stock market as a realm of opportunity and possibilities. As well, valuation short-sellers ignore the psychological nature of the markets, and the inherently dynamic potential, often unknowable in precise terms before the fact, of an emerging-industry business model that can only be sorted out in advance by the “mass mind” of the stock market, e.g., millions of investors making real-time decisions with real money based on their best real-time knowledge and forward assessments.

To illustrate this idea, take the example of Apple (AAPL) in 2004 after it had come out with the iPod, ostensibly, as some argued at the time, an mp3 player “in drag” and nothing more. But the iPod product, fathered along by the genius of one Steve Jobs, would provide the platform for even more massive-selling products like the iPhone, which truly revolutionized the smartphone, and the iPad, which turned the PC on its head, over the next several years. The point is that stock market opportunities are dynamic and evolve as more and more investors begin to see the potential of a company’s product platform and its role within a potentially huge emerging market for those products. Such was the case with Apple.

Eventually, however, there came a time to sell Apple short, but only when the stock’s strong uptrend had finally reversed itself as everybody who was going to be in the stock eventually was. This left only one direction for money flows in the stock to begin moving, and that was out. “Pile in, pile out” was a critical phenomenon that was readily observed in the institutional fund ownership data for Apple as it finally topped and rolled over.

Another entirely underestimated company and investment opportunity that serves as an added example is the highly innovative electric car maker Tesla Motors (TSLA), shown on a weekly chart in Figure 1.8. In May of 2012, we notified our subscribers of a “buyable gap-up” in the stock in the mid-60 price range at what was roughly the start of a robust upside price run that eventually carried above 290 by the summer of 2014. At the time we also saw Tesla Motors as being similar to General Motors (GM) in 1915 when the stock of that future “big three” U.S. automaker began its
own significant post-IPO price move. In the same manner that Tesla was bringing style and power to the otherwise mundane and utilitarian-oriented electric vehicle market in 2013, General Motors had introduced a mass-produced V-8 combustion engine that enabled the fledgling auto concern to bring style and power to the mainstream and help to accelerate the popularization of the automobile. Like Tesla in 2013, General Motors in 1915 was a recent IPO, having come public in 1911. Also like Tesla in 2013, General Motors in 1915 had been moving in a big, sideways consolidation for about 2.5 years before breaking out and initiating a massive upside price move. Thus we saw a historical “precedent” for what was going on with Tesla Motors based on the theme of a new company pushing the envelope of an emerging industry, in this case electric vehicles in 2013 as compared to what General Motors was doing with the combustion engine as it was pushing the envelope of the auto industry in 1915.

Despite the fact that Tesla was selling at 100 times forward earnings estimates at the time, it was still able to generate a huge upside price move that began at the point where we first bought the stock, essentially in the mid-60 price area, in early May of 2013. Considering that it is not uncommon for such a “ridiculously high P/E” to attract short-sellers who consider themselves to be smarter than the market, Tesla quickly became a popular target of short-sellers hell-bent on seeing “foolish” buyers of the stock punished. In the end it was the short-sellers who
were foolish and who suffered a brutal but still self-inflicted punishment. After all, a basic reality of the stock market is that a young, new, dynamic company with game-changing technology and a cutting-edge approach can often sell at 100 times forward estimates or more at the very point where it begins a huge upside price run. This has been seen time and time again with stocks like eBay (EBAY) and Amazon.com (AMZN) in 1998, Salesforce.com (CRM) from 2009–2010, or even Taser International (TASR) in 2003 when it had no earnings to speak of and hence an “infinite” P/E yet still was at the cusp of a nearly twenty-seven-fold price move over the next nine months! Such was the case with Tesla Motors in 2013. As we wrote in an article for Forbes.com in early June 2013, “What the GM example tells us is that maybe there will be more to this price move in TSLA than currently meets the eye, and investors should remain open to whatever the stock’s future price/volume action tells us and not rely on simple-minded valuation analysis that can often cause investors to miss huge stock market opportunities.”

One reader commented in the article’s blog section (remember that TSLA stock was around $90 at the time), “What about us who are short above $100? How dare you compare TSLA to GM in 1915!!! Now I know the longs are like cult members.” This sort of comment is typical of valuation short-sellers who, as a result of their graduate degrees from the University of “I-Am-Smarter-Than-the-Market,” believe they possess superior abilities and knowledge that they express by denigrating those who buy and profit from strongly trending stocks as “cult members.”

The mind-set of short-sellers like these is fraught with emotion, and at times it appears that their investment methodology in such a situation is born more of indignation than of any intelligent assessment of the trend and the stock’s potential. Tesla Motors (TSLA) eventually moved higher than $290 a share as of the time of this writing, and so our answer to the individual who commented “What about us who are short above $100?” is that we hope they were smart enough to cover their positions once the stock rallied well past the $100 price level. In our experience, however, such individuals simply become even more indignant and continue to short the stock on the way up as they go bust.

When you argue against stocks like Apple, Netflix, Tesla, or 3-D Systems, you are arguing against the virtuous system of entrepreneurial capitalism that embraces the freedom, nobility, humanity, and shining promise of new ideas, new ways of thinking, positive change, and new products and services that enable people of all socioeconomic stages to improve their productivity, their leisure enjoyment, and ultimately their standard of living, and that is, well, downright un-American! Thus one facet of the dark side of short-selling is revealed, but in fact we see it more as the dumb side of short-selling by those who consider themselves as graduates of the University of “I-Am-Smarter-Than-the-Market.”

In our view, short-selling is nothing more than a method of investing and trading that recognizes the life-cycle paradigm arising from an economic system that thrives
on creative destruction. A major component of that creative destruction is the process of cleaning out prior excesses and forcing the redeployment of capital to more productive areas of the economy. The quicker that process is able to cycle through the system, the better. Stocks, like people, have life spans. Unlike people, however, they can have more than one life span, providing opportunities on both the long and short sides depending on which side of the creation/destruction cycle they are in. Great companies like Apple can experience periods of tremendous growth that fuel a higher stock price, followed by periods of contraction as they become obsolescent and lose their competitive edge. During such a period, the price of the company’s stock shares declines as it should. But great companies like Apple also adapt and respond by coming up with new ideas and new products to regain that edge and generate a new cycle of tremendous sales and earnings growth, which in turn fuels a higher stock price once again. In such a manner, a strong, adaptive, and innovative company can be born and reborn many times.

Investing and trading is about making money by profiting on the price movement of stocks and other securities. Short-selling is simply one component of smart investment and money management. Preserving gains is crucial in optimizing the performance of one’s investments over the long term, and short-selling serves as a way to either profit outright or to help offset declines in other stocks that make up the positions in a portfolio with more of an intermediate- to long-term investment horizon during a bear market. The study and practice of short-selling not only provides investors with a useful arrow to keep in their quiver of investment skills, but it also aids in developing one’s skill and understanding with respect to when to sell long positions in leading stocks when they have finally reached the end of their upside life cycle.