

Savvy Speculators Sell Short, But They're Not Always Right

Three of the key factors that influence people's decisions when trading stock are fundamental analysis, technical analysis and psychology. Fundamental analysis is mainly concerned with *why* a stock may move; it measures sales figures, price/earnings ratios, cash flow and dividends. Short-term traders may find the fundamental information interesting, but on a stand-alone basis, trading on fundamental analysis rarely equates to profitable trades. In fact, following fundamental analysis often is an obstacle when trading because traders tend to form an opinion of what the stock "should do," and many times that opinion gets in the way of objectively analyzing what the stock actually does.

Think of how many times you may have bought a "good company," but it turned out to be a bad stock. Technical analysis, on the other hand, attempts to determine *when* a stock may move and how long that move may last. I have never met anyone who has consistently made money trading that does not use some form of technical analysis. Technical analysis allows the trader to objectively look at price action to determine what is a good or bad trade, without any understanding of what the company may do or what the fundamentals may be.

The final, and probably hardest factor to measure, is psychology. Understanding the psychology of stock movements

often is measured through technical indicators and attempts to answer *who* would be a buyer, and *who* would be a seller under certain circumstances. Big money can be made in a stock's movement when there is a favorable combination of the three factors listed above to uncover profitable upside opportunities.

Short Interest Can Help Identify a Short Squeeze

In this article, we will take a look at a specific technical indicator, short interest, in an attempt to uncover situations where a short squeeze may develop in a stock. We'll then review a stock that has the characteristics of what may offer good upside potential based on these three factors.

Short selling is a strategy that attempts to capitalize on a decline in share value by selling stock at a high level and later repurchasing the stock at a lower price. The short seller benefits by selling high and buying back lower. It should be noted that once a stock has been sold short, those sellers represent future demand because they must buy the stock back at some future date.

The appeal of selling short is easy to understand, as we've seen in this bear market; stocks usually fall faster than it takes to move higher in an uptrending market. Of course, as with

Learn to Identify Potential Short Squeeze Candidates



By Brian Shannon

any strategy that is a straight directional bet, there are risks. The biggest risk to a short seller is that instead of share price dropping, the stock price rises. Later we'll see that a rising share price in a stock that is heavily shorted can often lead to dramatic upward movement as losses mount in the accounts of those who are short, and these traders attempt to minimize

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their losses by buying the stock back. The motivation by the short seller to buy back the stock is often the fear of unlimited losses. When you buy a stock at \$20/ share, the most you can lose is your entire investment, \$20/ share. When you sell a stock short at \$20, the potential for losses, in theory, is unlimited. The stock may rise to \$40, which would result in a 100-percent loss of capital, but what prevents that stock from rising to \$50, \$60 or even \$100? It is the fear of such an advance that can make for an explosive upside in a heavily shorted stock. The phenomenon of a rapidly rising stock with a large short interest is known as a "short squeeze," and we will now explore the dynamics of how a short squeeze develops.

The Basics

Before we continue, first let us cover some terminology. Short interest is defined as the total number of shares of a stock that have been sold short and are not yet covered. When a person sells a stock short, exchange rules mandate that the order must be identified as a short sale, with statistics on the total number of shares sold short kept by the exchange and released to the public once each month. Short interest for Nasdaq stocks is tallied up by the exchange on the 15th of each month, and that information is disseminated to the public eight business days later. For example, if the short interest is 1,500,000 shares as of August 15, that information is released to the public on August 27.

Essentially, the potential short squeeze candidate is a stock in an uptrend that has attracted a large short interest and has strong fundamentals.

Any change to this number is released one month later. The short interest ratio (S.I.R.) is the number of shares sold short (short interest) divided by the average daily volume for the previous month for the particular stock. This number is interpreted as the number of days it would take to cover (buy back) the shares sold short based on the average daily volume. The higher the ratio, the longer it would take to buy back the borrowed shares. This often leads to upward momentum for the stock if the sellers become motivated to

buy back their short positions. If the stock had a short position of 1,500,000 shares and an average daily volume of 500,000, the S.I.R. would be 3.0, meaning it would take three full days of average daily volume for the short sellers to cover their bearish bet. If the stock had average daily volume of just 250,000 shares, the S.I.R. would then be 6.0, meaning it would take six days of buying to cover their position. From a contrarian standpoint, a higher S.I.R is desirable because it means it is more difficult to cover the position, and the resulting buys have the potential to create significant short-term trading profits.

Why Short Squeezes Occur

With the basic understanding of short interest and the short interest ratio in hand, let's now learn how to identify stocks that could be vulnerable to a short squeeze. A short squeeze develops when those who sold short the stock, expecting it to decline in price, change their minds about the trade (often because of rising prices) and attempt to cover their positions before the market advances and losses accumulate. Short squeezes often occur because of a news event that changes investors' perception as to the worth of a particular company. A short squeeze also can be created by long holders of the stock attempting to push the price higher, in an attempt to tap into the emotional buying that a trapped short seller can provide. Obviously, if you are short a stock that is advancing, there is a point where you will become fearful of holding a position. With that said, in order to eliminate the mounting losses and the emotional trauma of holding a big loser, the once-pessimistic seller will become a panicky buyer. It is this buying that makes the stock advance at a rapid pace.

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There are numerous sources for finding information about the number of shares that are short for any individual stock as well as the corresponding ratio to average daily volume. The site I use most often is www.viwes.com, because this website not only lists the information for individual stocks, but also has some unique screening features. Below is an example of one such screen. This is often a good place to start your search for stocks that may be vulnerable to a short squeeze, because it shows there are fresh shorts in the stock. Professional money managers (usually hedge funds) that establish large short positions are typically very disciplined about taking losses, and their discipline can often work in the longs' favor. When the stock starts rising, fund managers often will act quickly to cover their shorts, and they tend to become aggressive buyers in their attempt to minimize losses.

It is this pick-up in demand that can benefit long positions as shares can rapidly move higher.

In **Table 1**, we can see the stock with the highest S.I.R. is Odyssey Healthcare Inc. (ODSY), with a S.I.R. of 22.28. Typically any number more than 5.0 (days to cover) is considered high. ODSY shows an S.I.R. four times higher than this relatively high number, which indicates the short sellers may have a difficult time covering their positions without moving the stock higher. This information is a good starting point for finding potential short squeeze candidates because it gives us the answer as to *who* would buy the stock. By recognizing the large short position, we can understand the potential urgency buyers may have in ODSY, and this urgency could be a key psychological development behind a buying frenzy in the stock.

In order to whittle the list down further, the charts of each company should be studied to see if there is any technical confirmation that it might be the proper time for a low-risk entry into the stock. As a general rule, any stock in a downtrend can be immediately eliminated because short sellers are more confident in a position that is moving in their favor. Eliminating situations that are not high-probability candidates frees our time to focus on the strong stocks where the short sellers may be in trouble. In order to make this a quick process, I like to look at where the stock is trading in relation to its 50-day moving average (50 DMA). If the stock is below the declining 50 DMA, I will eliminate it from the list and then focus on stocks that are trading above the rising 50 DMA. A stock that is above a rising 50 DMA is in an uptrend and should be studied further on different timeframes to find where there may be potential for resistance to halt its upward progress.

If a stock is at a new high, it indicates to me the only source of supply will come from profit takers, rather than people selling to get even on a position they may have been holding in their portfolios at a loss. A stock trading at a new high also

Table 1 – Short Position Increasing > 10% for Four Consecutive Months

Ticker Symbol	Company Name	Short Position	Avg Daily Volume	Ratio*
1 ABRX	Able Laboratories Inc.	296,604	410,948	0.72
2 ARTI	Artisan Components Inc.	2,538,746	192,323	13.20
3 ASKJ	Ask Jeeves Inc.	3,424,425	1,269,375	2.70
4 AVID	Avid Technology Inc.	5,901,222	754,171	7.82
5 BCGI	Boston Communications Group Inc.	2,778,165	451,874	6.15
6 CGPI	Colla Genex Pharmaceuticals Inc.	353,608	61,781	5.72
7 DAKT	Daktronics Inc.	785,515	111,908	7.02
8 DIGE	Digene Corporation	2,177,211	462,612	4.71
9 DPII	Discovery Partners International Inc.	302,112	59,303	5.09
10 FSII	FSI International Inc.	271,037	100,430	2.70
11 GRMN	Garmin Ltd.	1,906,236	705,207	2.70
12 IRIC	Information Resources Inc.	327,881	138,006	2.38
13 NTESE	Netease.com Inc.	3,227,303	1,070,849	3.01
14 ODFL	Old Dominion Freight Line Inc.	284,956	96,702	2.95
15 ODSY	Odyssey Healthcare Inc.	6,795,939	305,050	22.28
16 PHCC	Priority Healthcare Corporation	3,743,436	823,584	4.55
17 PKTR	Packeteer Inc.	897,330	303,339	2.96
18 SOHU	Sohu.com Inc.	704,684	838,039	0.84
19 TDS	Telephone and Data Systems Inc.	1,927,888	227,014	8.49
20 TSIC	Tropical Sportswear Int'l Corporation	547,498	71,075	7.70
21 UCOMA	UnitedGlobalCom Inc.	12,203,191	1,274,779	9.57
22 URBN	Urban Outfitters Inc.	1,998,618	473,885	4.22
23 ZBRA	Zebra Technologies Corporation	1,984,426	447,200	4.44

*Ratio = Shares Short/Avg Daily Volume; it may be used as a rough measure of days to cover.

Note: Each of the stocks in the above table has shown an increase in short position of at least 10 percent for each of the last four months.

Table courtesy of www.vivres.com

Table 2 – ODSY-Current Short Position

Ticker Symbol	Company Name	Month	Shares Short	Avg Daily Volume	Ratio*
ODSY	Odyssey Healthcare Inc.	04/03	6,795,939	305,050	22.28
		03/03	6,032,673	460,396	13.10
		02/03	4,734,503	243,086	19.48
		01/03	3,475,353	311,681	11.15
		12/02	2,770,905	391,379	7.08
		11/02	1,799,601	372,275	4.83
		10/02	1,532,313	210,338	7.29
		09/02	1,285,973	190,421	6.75
		08/02	1,207,293	560,831	2.15
		07/02	1,670,558	262,124	6.37
		06/02	1,112,744	123,863	8.98
		05/02	881,825	224,187	3.93

*Ratio=Shares Short Avg daily volume

Table courtesy of www.vivres.com

indicates it is unlikely that the short sellers are in a profitable position and that may make them more motivated to cover their short positions. A chart of ODSY shows the stock trading above its rising 50 DMA, and this upward momentum is further confirmed by the fact that as of this writing, May 6, the stock is trading at an all-time high. After I find a stock that has both a large short position and is at new highs, I want to know the approximate price at which the short position was initiated. By understanding how much the short sellers are losing, I can monitor the stock for signs they may become urgent in their buying.

In order to find the information on where the short position was initiated we can look deeper into the short interest tables. By clicking on the symbol "ODSY," we get a new table, seen in **Table 2**, that shows the current short position as well as any changes made to that number over the last year. Looking at the information on ODSY, we can see that on May 15, 2002, the outstanding short position was just 881,825 shares. As of April 15, 2003, that number was up to 6,795,939 shares sold short and not yet covered. This means that between May 15, 2002, and April 15, 2003, nearly six million shares were added to the short position in ODSY.

Chart 1 for ODSY shows when the short position changed, and this allows us to understand from where sellers may be short. For ODSY, from September 15, 2002, when the stock was trading near \$19 to April 15, 2003, the short position grew by 5.2 million shares. All of these shares were sold short below \$26, meaning the potential for a short squeeze is high because the short sellers are in a losing position, and they have to buy back stock to prevent those losses from growing. This puts the short sellers in a very uncomfortable position

because they are damned if they don't do anything. They are further damned if they buy back shares because this will add to the upward momentum they were trying to avoid in the first place. This makes conditions ripe for a short squeeze.

Look for a Downtrend

It is important to know that a large short interest ratio by itself is not a reason for buying a stock in anticipation of a short squeeze. As with any other indicator, the short interest ratio should not be used on a stand-alone basis.

It is important not to make a decision about the company, but only what others may think about the stock.

The informed trader will find an edge when there is a preponderance of indicators leading to a price advance. Short sellers who take large positions are typically sophisticated speculators who have done extensive research on their targeted company and often are right. Many times those who sell short have the right idea fundamentally (examples include names such as Qualcomm, Rambus, Iomega, Presstek, Amazon.com and Krispy Kreme), but their timing could be off. The correct time to sell a stock short is when it is either in, or entering, a downtrend. When a short position is initiated in a stock that is trending higher, there is real potential for big trouble. As the stock continues higher in an uptrend, it often becomes tempting to sell short because "it is up too much," or "the P/E is too high;" however, avoiding that temptation and going long is usually the right thing to do until the stock rolls over and shows weakness. Essentially, the potential short squeeze candidate is a stock in an uptrend that has attracted a large short interest and has strong fundamentals.

Finally, and probably the least important factor re: a short squeeze candidate, is the fundamentals of the company. Although poor fundamentals would not preclude a stock from being a potential short squeeze target, a company with strong fundamentals would add to the source of demand that would move prices higher. When looking at fundamentals on a momentum play, it is important not to look too deep. I usually look at the company's news headlines for sales and earnings information, as well as new product developments and analyst ratings changes. In the case of ODSY, a glance at the headlines shows news reported on May 5, 2003, that read, "Odyssey Healthcare Reports First Quarter 2003 Results; Revenue Increases 50 Percent, Net Income Increases 79 percent, Company Increases Guidance." Just reading this headline tells me the company is growing their business by selling more (revenue increase); they are more profitable than they were last year (net income up 79 percent); and the business remains strong (increases guidance). On the day this fundamental news was reported, the stock advanced \$0.56 on heavy

Chart 1 – ODSY-Short Position Changes



From September 15, 2002, to April 15, 2003, 5.2 million shares of ODSY were sold short. By looking at this information on a chart, we can see that when the stock broke out to new, all-time highs in early May, all of those shares sold short were in a losing position, leaving them vulnerable to a short squeeze.

volume—clearly the reaction from Wall Street was a positive one. This news gets me thinking, “This is *why* people will buy this stock.”

When reviewing fundamentals, traders should be more interested in why others would buy or sell. It is important not to make a decision about the company, but only what others may think about the stock. There are many people who buy and sell stocks based on what the prospects for the company are, and we cannot ignore them in making our decisions due to their potential large impact on price.

In Short...

By walking you through my thinking on ODSY, you now should have an example of how to quickly analyze fundamental, technical and psychological influences that could be involved in a trader’s decision-making process. When we have all three of these factors telling us the same conclusion (buy) like we do in ODSY, it makes sense to be long (which is why as of this writing I am long ODSY.) By the time this article is printed, I will likely have exited this long position, hopefully with a profit. The one thing I know for certain, barring an unforeseen event, is that I will not take a large loss on the trade. As much as I think it is a good idea to be long

ODSY, I realize that the market does not always agree with my analysis, and my ego will heal a lot quicker than my equity after a large loss.

It’s important to remember that short sellers are usually very savvy speculators; however, like any group of market participants, they aren’t always right. When shorts are wrong about the direction of a stock, the move higher can be dramatic, leading to some excellent short-term profits for traders who see a short-squeeze situation developing. Like any indicator, short interest should not be used on a stand-alone basis, but it should become part of a trader’s arsenal. Because technical analysis is largely about measuring supply and demand, short sellers can become an excellent source of demand for a stock at higher prices when the stock is in an uptrend.

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