DAVID A. ROCKER

Managing General Partner, Rocker Partners, L.P.

Presentation to the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk"

May 22, 2003

My name is David Rocker and I am the managing general partner of Rocker Partners, L.P., a New Jersey based hedge fund[1]. I am honored to have this opportunity to address the House Subcommittee on Capital Markets to offer my views on hedge funds, short selling and the appropriateness of possible additional regulation.

Rocker Partners is an eighteen year old firm with a contrarian style. While we maintain both long and short positions, we have focused our research efforts more heavily in recent years on short selling because we have identified more stocks which we have felt were overvalued than those which we felt were attractive. We are generally viewed as a specialized manager and our investors, primarily wealthy families and institutions such as universities, hospitals and endowments, often use us as a risk-reducing hedge against their long biased investments.

Hedge funds have grown rapidly because they have served both of their constituencies, investors and managers, better than more conventional alternatives. Over the last six years, which encompassed both the expansion of the equity bubble and its subsequent deflation, an investment in an average-performing mutual fund would have remained essentially unchanged, but the same investment in an average performing hedge fund would have appreciated approximately 75%, and would have done so with lower volatility. Investors have also been attracted to hedge funds because of the greater identity of interests between the fund manager and the investor. Substantial personal assets of hedge fund managers and their families are typically co-invested alongside limited partners, and such investments typically represent a much higher percentage of the total assets under management than is the case in mutual

[1] Prior to founding Rocker Partners, L.P. in 1985, I was a general partner of Century Capital Associates, a registered investment adviser I joined in 1981. Prior to that, I was a general partner of Steinhardt, Fine, Berkowitz & Co., a hedge fund I joined in 1972. From 1969 to 1972, I was a research analyst and investment banker with Mitchell Hutchins, Inc., a registered broker-dealer. I was graduated from Harvard College magna cum laude in 1965 and received an M.B.A. with distinction from Harvard Business School in 1969.

funds. Hedge funds frequently provide a more attractive financial opportunity for successful managers. The broader investment flexibility available in a hedge fund structure has also proven appealing. Many former mutual fund managers have joined or started hedge funds in recent years.

While there is considerable discussion as to whether hedge funds require greater regulation, it is important to recognize that even unregulated funds are already subject to a substantial degree of oversight by their investors. Fund investors, especially in mature funds such as ours, impose tremendous demands on managers with whom they choose to invest, including, among many other things, that the fund has formal compliance policies, appropriate restrictions on employee trading, some amount of investment transparency, specific risk management techniques, operational proficiency, and a whole host of other protective requirements. The hundreds of billions of dollars invested in the hedge fund marketplace require, as a matter of fund Darwinism, best practices to be employed by hedge funds, and those managers that do not or can not provide these protections to the investor marketplace generally do not succeed or survive. Additionally, the co-investment of the hedge fund manager's personal and family assets helps serve as a self-governing mechanism.

The highly publicized hedge fund blow-ups in recent years must be placed in perspective. Such funds have represented fewer than ¼ of 1% of the industry and the superior investment results cited earlier include the losses from these entities. As the present structure has served investors well during both rising and falling markets, I believe additional regulation is neither necessary nor desirable. Existing regulations, effectively applied, coupled with the extensive due diligence and operational requirements of large investors, have proven sufficient to date. Anyone willing to commit fraud will not be deterred from doing so by a registration requirement. With few notable exceptions, hedge funds have proven less risky than conventional alternatives, so the present focus on them is somewhat puzzling.

The issue of retailization raised by Commissioner Donaldson, among others, merits careful consideration. On one hand, most present investors in hedge funds are large and sophisticated and have the capacity to analyze and endure the risk of investing in these funds, whereas the smaller public investor is less well-equipped to do so. On the other hand, one must question why the apparent advantages of hedge funds cited above should be denied the retail investor. As most of the blow-ups in hedge funds have come from the excessive use of leverage, it may be prudent to preclude retail investors from investing in highly leveraged funds.

I would now like to turn my attention to short selling and the important role I believe it plays in creating more liquid, balanced and fair markets. Short sellers already operate on a playing field tilted sharply against them, and considerable restrictions and risks relate specifically, and often uniquely, to this strategy. Unlike a long investor who can buy a stock at any price or repeatedly at ever higher prices intraday, the short seller must initiate his or her position only on an "uptick" – a price above the immediately preceding trading price. In contrast to a long position, in which only the initial investment can be lost, there is a risk of potentially unlimited loss on a short position. The short seller is obligated to pay dividends to the holder from whom stock was borrowed and, most especially, there is the potential loss of one's ability to determine when the short position is purchased or covered. If the supply of borrowable stock dries up, the short seller may be involuntarily "bought in" by his broker in what is generally known as a "short squeeze." The short seller has no control over when the stock is bought in or the price at which it is executed. This situation is clearly distinct from that of the long holder who cannot be forced into an involuntary sale.

The contribution of the short seller to more efficient markets can be best evaluated in the context of the stock market of the last six years. An equity bubble of extraordinary proportions developed in the late 1990's peaking in early 2000. The internet mania was just the most visible part of the general hysteria. Since the peak, the bubble has deflated, costing investors some $7 trillion dollars.

The goal of regulatory policy must be to establish fair and safe markets for investors. In considering what, if any, regulatory changes are appropriate, I believe it important to reflect on the forces that created the bubble as well as those which have led to its demise. In that connection, it is important to understand the structural bullish bias in the market. Shareholders, of course, want their stocks rising. Corporate officers desire higher prices, as the price of their stock serves both as their report card and, thanks to the liberal use of options, the key to enormous personal wealth. Higher stock prices also provide inexpensive acquisition currency for acquisitive issuers. Security analysts clearly want stocks higher to validate their recommendations. There must be a seller for every buyer or no trades would occur. Thus, it is interesting to note that while 50% of stock transactions are, by definition, sales, purchase recommendations by analysts are 10-20 times more numerous than sale recommendations. The recent Wall Street settlement has focused on the pressure placed on analysts from internal investment banking, but pressures from clients and corporate executives have received much less attention. Analysts who recommend the sale of a stock risk the ire of their clients who own it. These clients complain to research directors and can withhold favorable votes in reviews important to analysts' compensation. Similarly, corporate executives frequently react in a hostile manner toward any analyst who downgrades their stock, restricting his or her contact within the company, thereby making future analysis of the company more difficult. Collectively, these factors, coupled with a cheerleading media, created the bubble. Anyone challenging the valuation of a company or the integrity of its financial statements was most unwelcome in this environment. Analysts and market strategists who either warned of overvaluation or were insufficiently bullish were pushed aside, replaced by those who went along with the irrational exuberance.

Short sellers, through their research and public skepticism, provide a much needed counterpoint to the bullish bias described above. They are willing to ask tough questions of managements in meetings and on conference calls, thereby providing a more balanced view for listeners. Investors benefit by getting both sides of the story when the views of short sellers appear in the media.[2] Short sellers have helped uncover many frauds and accounting abuses in recent years at Enron, TYCO, Conseco, AOL, Boston Chicken, Network Associates and Lernout & Hauspie, among a host of others. Short sellers frequently serve as unpaid, but self interested, detectives and have willingly shared their findings with the SEC, which has acknowledged the usefulness of these inputs. Although there have been occasional instances in which short sellers have been accused of circulating misleading stories, these instances are dwarfed both in number and magnitude by the misleading stories circulated by long holders and the issuers themselves. Because of the greater risks in short selling, research done by short sellers has tended to be more careful and accurate than most. As Gretchen Morgenson of *The New York Times* recently reported:

> If you own shares in a company that declares war on short sellers, there is only one thing to do: sell your stake. That's the message in a new study by Owen A. Lamont, associate professor of finance at the University of Chicago's graduate school of business… The study, which covers 1977 to 2002, shows not only that the stocks of companies who try to thwart short sellers are generally overpriced, but also that short sellers are often dead right.[3]

The value of short selling as a means for creating greater liquidity and orderly markets is well understood. Specialists on the major exchanges sell short to help offset an imbalance of buy orders. Trading desks at brokerage firms do so as well to facilitate customer orders. It is important to note that over two-thirds of short selling is related to arbitrage activity.

Any effort to further restrict short selling should be rejected. While short sellers seem to attract a disproportionate amount of attention, usually from companies with questionable accounting or business models who do not welcome scrutiny, the number of short biased firms are few in number and are actually shrinking. Many short sellers were driven out of business during the bubble and, even today, they represent the only subcategory of hedge funds that has seen net redemptions in recent years. Of nearly 6,000 hedge funds, short biased funds

---

[2] I wrote articles for *Barron's* "Other Voices" column during the bubble. The first in 1999, "A Crowded Trade," warned of the dangers following the large mutual funds' loading up on richly priced, large capitalization stocks. In 2000, "The Fed Should Act Now" urged the Fed to adopt more stringent margin policy in a clearly overheated market; and in 2001 I wrote "Fantasy Accounting" which identified how the failure to treat options as expenses led to a vast overstatement of corporate earnings. (Copies are included.)

[3] "If Short Sellers Take Heat, Maybe It's Time to Bail Out," Gretchen Morgenson, *The New York Times,* January 26, 2003.

with asset bases of $100 million or more number fewer than 10, and the total assets managed by these entities are well under 1% of the total assets managed by all hedge funds. That few managers have chosen this strategy or have been able to survive suggests that there are easier ways to make a living.

The short interest in each stock is reported monthly, yet there are proposals circulating, most visibly from the Full Disclosure Coalition now in formation by the Washington law firm, Patton Boggs, which would seek to have individual short sellers detail their short positions in periodic Schedule 13D and Form 13F filings. The claim being made is that this would level the playing field, but as shown earlier, the playing field is already tilted sharply against the short sellers. Such disclosure requirements would serve only to make targets of individual short sellers and likely drive them out of business. Some publications are designed specifically for the purpose of creating short squeezes which can be exploited by other aggressive hedge funds and mutual funds who know that short sellers cannot defend themselves by selling on down ticks.[4] Most companies simply ignore short sellers, recognizing that there are differences of opinion in free markets, and go about their business. In light of Mr. Lamont's findings, it will be interesting to see which companies will become part of this coalition.

The Williams Act requires the filing of a Schedule 13D or Schedule 13G to alert a company that someone is accumulating more than 5% of their shares. No such threat exists from a short position. A short sale does not make the short seller the owner of the security (in fact, it is the opposite) and does not result in any voting authority for the short seller.

Given the positive contribution by short sellers and the evident shrinkage in their number, consideration should be given to truly leveling the playing field by modifying the uptick rule. This would contribute to greater market stability in today's electronically driven securities markets.

Short selling is an important part of the public capital markets. Any further bias in favor of long investors will further erode the important counterweight short sellers provide to the market. Short selling is an important investment tool as part of a proper risk-reduction investment strategy. The marketplace not only understands the benefits of short selling; it in fact requires it.

Thank you for your time and attention.

---

[4] The ShortBuster Club formed by Sky Capital LLC™ and the Erlanger Squeeze Play. Examples attached.

OTHER VOICES

VIEWS FROM BEYOND THE BARRON'S STAFF

A Crowded Trade

These big-cap investors are complacent now, but when they break ranks . . .

BY DAVID ROCKER • A trading position is said to become "crowded" when it is held by a vast preponderance of investors. Such positions develop when investors become so convinced of the logic of the position and its likely success that they become complacent. Crowded trades are dangerous because if anything occurs to shake the faith of these investors, efforts to bail out can be highly disruptive; few others are left willing to take the other side.

The convergence trades held by Long-Term Capital Management and the proprietary desks of many brokerage firms last fall, in which participants shorted Treasuries and purchased lesser-quality bonds in the expectation that spreads between the two would narrow, are examples of such trades and the violence that comes with unwinding them. Another recent example was the Japanese carry trade in 1994, when long U.S. bond positions were financed by banks and hedge funds borrowing cheaply in Japanese yen. The current investor infatuation with large-capitalization U.S. equities may be the most crowded trade ever.

The development of a two-tiered market in which investors focus on a relatively small number of high-capitalization stocks to the exclusion of most others has been amply discussed in the media. What has been less well discussed is how this has come to pass.

Nothing succeeds like success. The U.S. stock market has proven to be the eighth wonder of the world in the past decade as it has produced steady outsized financial returns. As a result, the market has risen to a level of unusual prominence in our culture, with tickers now scrolling in train stations, restaurants and even tennis clubs. The investing public, having been told endlessly that equities have far outperformed bonds and other more liquid investments, now assumes that such trends may be safely extended into the future. Indeed, there has become almost a sense of entitlement to 20% annual returns in an economy growing at 3%.

Investors have become reactive rather than anticipatory. Mutual-fund purchases accelerate after market advances and diminish or turn to liquidations after declines. The rise of momentum investing has reinforced this buy-high, sell-low mentality. A nation that reveres Warren Buffett has essentially disavowed his investment style to chase expensive stocks.

DAVID ROCKER is a general partner of the hedge fund Rocker Partners L.P.

The affection for large-capitalization stocks as a subset of the overall market stems from their recognizable names and products, the relative ease of trading them and their presence in the indexes against which money managers are compared. This last point is particularly important because of how the investment-management industry itself has changed in recent years.

No professional (I use this title loosely) is measured more than a portfolio manager. No one hires two lawyers or accountants, gives them the same problem, and then compares how each produces and bills for services. Yet this is commonplace among money managers. Net asset values are recorded daily in newspapers, and consultants regularly monitor results for nonpublic funds. These results are readily compared with the Dow Jones or Standard & Poor's 500 averages.

Because markets have risen so persistently in the past decade, evaluations have focused on relative, rather than absolute performance. Managers know that while investors usually talk about long-term results, they pick managers largely based on short-term relative performance. One must keep up with the averages or lose assets under management.

This point was publicly driven home by the experience of Jeff Vinik, the portfolio manager of **Fidelity Magellan**, the nation's largest mutual fund. In 1996, Vinik sold stocks to position his portfolio more conservatively. The market, however, continued to advance, and Magellan underperformed. Vinik was driven from Fidelity despite his attractive long-term record. Underperformance for even a short period couldn't be tolerated.

Other portfolio managers, strategists, consultants and plan sponsors got the message: "The standing nail gets hammered." Since then, they have chosen to be more fully invested and to more closely align their portfolios with major market averages. This, of course, has increased demand for the stocks within the averages over those not in the averages. But the action of investors trying to match the averages created an effect similar to a swimmer trying to grab a large beach ball in a pool. The more aggressively he swims toward the ball, the more surely it floats away.

By their efforts to emulate the indexes, managers have created a situation in which the indexes have outperformed more than 90% of active portfolio managers. This result has fostered increased preference among investors for index funds over active managers, further heightening demand for the large-cap stocks in the indexes. Witness how any stock added to a key index spikes sharply higher for that reason alone. The cycle is self-reinforcing.

This trend has produced some rather astonishingly high valuations. The 100 largest stocks on Nasdaq now sell for over 100 times their trailing 12-month earnings. Similarly, the price/earnings ratio of the Standard & Poor's 500 is at a record high. Normally, such elevated valuations would put off investors and encourage them to seek cheaper alternatives, but disregard for absolute price as an investment consideration has become a hallmark of the current market.

The talking heads seen regularly on television and in other media have justified their continued purchase of these expensive stocks by saying that if one buys good stocks and holds them a long time, they will grow into their valuations. This philosophy may sound familiar to those who remember the Nifty Fifty era of 1973-74.

Changes in the job function of securities analysts over the years have disabled another normally self-correcting mechanism. As commission rates have contracted, investment-banking revenue has become far more important to brokerage firms, and analysts' compensation packages have been altered accordingly. Analysts now are actively engaged in trying to bring investment-banking business to their firms. Recommending the sale of an overpriced stock is not the best way to gain the favor of chief executives. Analytical independence has been compromised as a result. Indeed, analysts generally have been more like cheerleaders, constantly "reiterating their buy recommendations" at ever higher prices to endear themselves to options-laden managements. In post-earnings conference calls, many questions are cloyingly prefaced by phrases like "Great quarter, John."

Corporate officers, in concert with their investment bankers and accountants, have encouraged acceptance of these large stocks' high valuations. With the blessing of the analytical community, they have persuaded investors to focus on "operating earnings" rather than "reported earnings," which are frequently encumbered by writeoffs and special charges. According to estimates by Goldman Sachs, reported earnings for the S&P 500 showed no growth at all from 1996-1998. Only by adding back unusual charges, which rose 170% during this period, was there any growth in "operating earnings."

The media have also played an important part in encouraging acceptance of high valuations. Money managers, analysts and corporate executives regularly appear on television to expound the virtues of their favorite stocks, but valuations are rarely discussed, and commentators rarely challenge their interviewees on this subject. This bias of the media is readily evident by the recent brouhaha at CNBC when James Cramer indicated he thought a stock overvalued and considered shorting it. The company involved threatened a lawsuit and Cramer, a frequent guest, was temporarily blocked from further appearances. Apparently, it is perfectly acceptable for dozens of portfolio managers and corporate officers to push their stocks, but contrary viewpoints seem less welcome.

The insensitivity to price has even spread to the public sector. When Alan Greenspan expressed his concern about "irrational exuberance" at 6300 on the Dow, he received so much criticism that even though prices have risen another 50% from those levels, he now speaks in highly subjective tones as to whether the market may be overvalued. While it may have been prudent for the Fed to help orchestrate the bailout of Long-Term Capital Management, which had leveraged itself 100 times, the action served to intensify the very speculative fervor that had apparently worried the Fed earlier. Investors, convinced that the Fed would support the market at all costs, developed a casino mentality that pushed Nasdaq up 70% from its October lows. Online trading exploded and Internet stocks soared to unimaginable levels without any cautionary comment or act of restraint from the Fed.

The dominance of the high-cap stocks has persisted for so long that skeptics have capitulated or been run over. Value managers have watched their assets drain away to large-cap managers. Even short sellers have largely given up. The short interest in **Dell** was 116 million shares in October when the stock sold at $25. Now, with the stock at $43 and with indications of a marked slowdown in growth, the short position is only 48 million.

Everyone is on the same side of the boat. The complacent response has been: "One could have made much the same argument last year, but the stocks are now much higher. What is going to change?" Such passionately held beliefs die hard, but every previous crowded trade has ultimately ended unhappily, usually for reasons that were unanticipated.

Crowded trades begin to unwind when some participants become concerned, break ranks and sell their positions, fearing that they must act before others do. The subsequent underperformance then challenges the confidence of others who have held the same positions only because the strategy was working. As more investors try to leave at the same time, things deteriorate quickly. Prices drop sharply because, in their hearts, everyone knows the positions to be overvalued. The collapse of Japanese long-bond prices as rates moved up sharply is a recent example. The daisy chain is only as strong as its weakest link.

The rise of momentum investing has reinforced a buy-high, sell-low mentality. A nation that reveres Warren Buffett has essentially disavowed his investment style to chase expensive stocks.

There are some challenges ahead for the new Nifty Fifty. The Securities and Exchange Commission finally seems to be getting serious about stopping accounting practices that artificially inflate or manage earnings. As these practices are eliminated, earnings surprises will become more numerous and the illusion of consistency that has led investors to pay big premiums for predictability will disappear. Additionally, the rise in long-term interest rates we have just experienced makes high multiples more vulnerable. Trade conflicts among nations are becoming more numerous, and these have triggered financial crises in the past. It would not be shocking to see the big-cap names trade substantially lower now that their invincibility has been so broadly accepted. After all, this is what happens in all crowded trades. ■

OTHER VOICES

VIEWS FROM BEYOND THE BARRON'S STAFF

The Fed Should Act Now

It has let market speculation get out of hand

BY DAVID ROCKER • The health and vitality of the U.S. economy have become dependent on a robust stock market. In an important speech at Jackson Hole, Wyoming, several months ago, Alan Greenspan indicated that the Fed is now sensitive to the potential for the stock market itself to cause an inflationary overheating of the economy. Based on the Fed's own model – even after last week's selloff – the market has never been as expensive as it is now. Not in 1929, not in 1987, never!

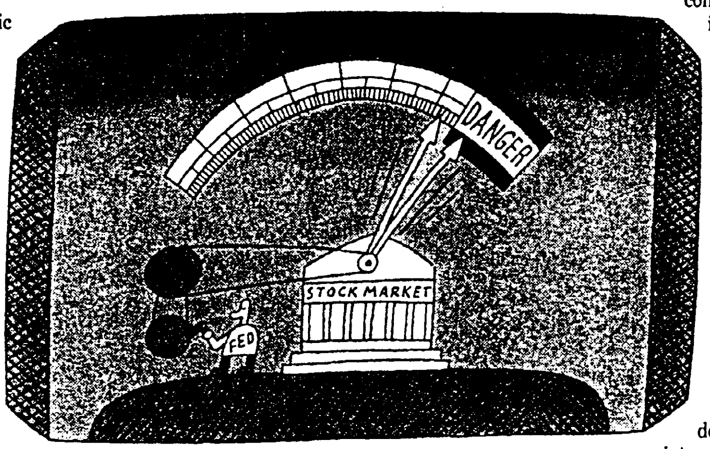
Much of the market's inexorable rise stems from the democratization of investing. CNBC, Bloomberg and CNN, among others, pour out a steady stream of stock-market information to homes, airports, bars and even the sides of buildings. The American people have gotten the message. Never before have so many invested so heavily, confident that the market cannot go down for any sustained period.

Investors have become increasingly complacent because there have been so few meaningful declines over the past two decades and markets have snapped back quickly from those setbacks. The assumption that past trends will persist, the essential analytical basis for the Dow 36,000 theorists, is a dangerous one. Long-Term Capital Management regularly earned nearly 40% a year. On that basis, one might have extrapolated a similar growth rate in 1998 with little volatility. They lost 90% of their capital in a month.

In the current feverish environment, it may be helpful to reflect on some traditional verities.

First, price matters in making an investment decision. While the Mercedes is a good car, it is probably not a sensible purchase at $500,000. While earnings of U.S. stocks have grown over the past decade, that growth rate has been unexceptional and P/Es have never been this high, even during periods of lower inflation and faster earnings growth.

Second, reported earnings are of sufficiently low quality that the Securities and Exchange Commission has become more vocal on this issue. Chief financial officers seem to have had at least as much to do with reported profit gains in recent years as chief operating officers. Corporations have been telling their shareholders a story far more optimistic than the one they're telling the tax collector. Federal corporate tax receipts were actually lower in 1999 than in 1998 and the Congressional Budget Office expects another decline this year. Investors have been piling into technology stocks to the exclusion of others because of their supposedly brighter earnings prospects, yet Dell, Intel, IBM, Hewlett-Packard, Lexmark and Xerox, among others, have recently had disappointing quarters.



Third, interest rates matter and they have been rising significantly around the world. Stocks have soared even though yields on long U.S. Treasury bonds have risen nearly 30% over the past year. Internet and other high-P/E stocks, which logically should have been the most adversely affected by rising rates because their multiples are high and their payouts more distant, have risen the fastest in this twilight zone of a stock market.

Fourth, as Long-Term Capital Management showed, leverage increases volatility. Investors have dramatically increased their leverage to maximize returns. Margin loans have risen vertically in the past several years to record levels. While it is not easily measured, it is also clear that large sums have been borrowed against homes and credit cards for stock purchases. Similarly, percentage cash reserves at mutual funds have been drawn down almost to all-time lows. Everyone owns the same small group of large-capitalization technology stocks. Investors are behaving like sheep on margin. The American public has committed the greatest percentage of its assets to the most expensive stock market in history at a time when the Federal Reserve is overtly tightening, our external deficit is swelling and cash reserves are low. This insensitivity to risk is dangerous.

The Federal Reserve and other government agencies have been significantly responsible for this euphoria because of the asymmetry of their policies. The Fed argues that markets should be free of government intervention; but it seems that such views are espoused only so long as markets are rising. When the market crashed in 1987, the Fed intervened. When banks and savings and loans were bankrolling wildly risky deals, the government looked on and did nothing. When this recklessness produced vast losses, the government stepped in to bail out the speculators – at enormous public expense. When LTCM overleveraged itself, regulators sat idly by. When its collapse in 1998 led to a market decline, the Fed stepped in again to coordinate the bailout, cut interest rates and pump in money. Once again, the government stopped natural corrective forces from punishing speculators, as always cloaking its actions in the mantle of the national interest. The message to the investing public has been clear: "The government will protect you from the downside but will not restrain your upside." Why not speculate?

As the "buy the dip" mentality is now so fully ingrained as to prevent all but a sudden steep decline, the risk has risen that this market will end violently, threatening our prosperity. The economy would clearly suffer after a sharp selloff because so many consumers are now so heavily invested. Real-estate values would fall. With U.S. equities out of favor, the demand for dollars would shrink, forcing the U.S. to pay higher interest rates to attract foreign capital to cover our rising trade deficit. The combination of a weaker economy and rising interest rates would further depress the stock market. In essence, the whole positive cycle we have enjoyed in the past decade would be thrown into reverse. Of course, the Federal Reserve would then be expected to again intervene.

Fed officials have periodically expressed concern about market valuations and speculation, but then the governors reverse themselves with "new paradigm" speeches and commitments not to raise margin requirements. Each reversal has brought forth a new burst of unbridled investor enthusiasm. The 100 largest Nasdaq stocks rose 102% last year and are selling at over 130 times earnings. The IPO market has been on steroids. In a testament to these times, one magazine implicitly criticized Warren Buffett, who has made nothing but money, while another lionized Jeff Bezos of Amazon.com, which has lost ever-increasing amounts of money.

If the Fed is serious, it should send an unambiguous message to investors that excessive speculation is unwelcome. It should raise margin requirements and interest rates immediately with a clear warning that more increases will come in the future if this speculation persists. It is better to accept moderate pain now and reintroduce a sense of risk to the marketplace than to wait until a massive blowoff and subsequent collapse occur that could severely damage this nation for years. ■

DAVID ROCKER is general partner of Rocker Partners.

OTHER VOICES

VIEWS FROM BEYOND THE BARRON'S STAFF

Fantasy Accounting

New financial reporting standards distort reality

BY DAVID ROCKER • As a portfolio manager, I need financial reports that accurately reflect the financial health and progress of the companies I seek to analyze. Unfortunately, recent decisions by the Financial Accounting Standards Board are not helpful and go so far as to defy common sense. These decisions have related to both employee stock options and goodwill. While the FASB doesn't consider options to employees to be compensation, everyone else does. Employees do and are willing to work for less cash than they would without them. Corporations recognize them as compensation as well. When share prices fall, some lower the prices of options previously granted, while others raise salaries to offset their employees' paper losses. As Warren Buffett put it, "If options aren't compensation, what are they?"

The IRS treats options as a compensation expense for tax purposes. When an employee exercises an option to buy shares at $20 when the stock's at $50, he must report taxable income of $30, and the IRS deems that the issuer incurred an equal expense. Such credits are frequently some of the largest items on corporate cash flow statements. For the five companies in the table, they represented an average 67% of earnings and 57% of the operating cash flow for the periods shown.

If the IRS allows these deductions because they are deemed legitimate business expenses, it is difficult to understand how the FASB can promulgate a reporting standard that disregards them.

The usual excuse given for not treating options as an expense relates to the indeterminancy of their use: What value do options have if they are never exercised? This is neither relevant nor insurmountable. Fischer Black and Myron Scholes received a Nobel Prize for developing a pricing model for options. Complex valuation issues may remain, but clearly options have significant measurable value. The charge to the income statement for an employee who receives $150,000 in dollars and $50,000 in British pounds is $200,000. However, as a result of the FASB position, if that same man is paid $150,000 in dollars and $50,000 worth of options, the income statement would be charged only $150,000.

Recently, the FASB has required footnotes in annual reports showing the financial impact of options. This leaves inflated earnings in the regular profit and loss statement compared with a more realistic standard that would include the cost of options. This, in turn, makes price/earnings ratios appear lower than they would be otherwise. As a result, heavy option-issuers appear cheaper to investors than those that pay their employees primarily in cash.

FASB's position on options makes life easier for investment bankers, who raise enormous sums for heavy option issuers. Could so much money have been raised for Internet startups and roll-up acquisition companies if analysts at investment banks had been required to include options expense in their financial models supporting the public offerings? This overstatement of earnings has contributed to a significant misallocation of resources within the economy, and to the losses suffered by investors.

The FASB has also been concerned about the distortive effects of "dirty pooling" and recently issued an exposure draft which would lead to its elimination. Unfortunately, the proposed cure is worse than the disease. Acquiring companies would have to use purchase accounting, which has historically required an annual amortization expense that gradually writes down goodwill, the premium paid over book value. The FASB's new purchase accounting proposal would eliminate all amortization expense. Goodwill would be shown as an asset but would never be amortized unless the company itself found it to be "impaired." This is like putting the fox in charge of the chicken coop.

Companies are frequently valued in the stock market at greater than their stated net worth because their research and development spending is expected to produce products of value, or because of valuable brands created through advertising. Research and development costs and advertising budgets are expensed annually. When companies with these attributes are acquired, the value of these prior expenditures is capitalized to goodwill, which, unlike plant and equipment, would not be depreciated.

The FASB proposal will aid managements inclined to inflate reported earnings. A public company could boost reported profits by transferring scientists to a new private company and then acquiring it after their research led to development of new products. Research thus wouldn't show up as an expense on the public company's books. Similar arrangements could enhance revenues.

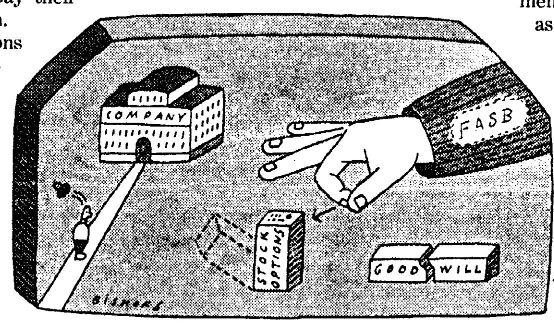
As was the case with options, the FASB seems to have taken the position that, because there is difficulty deciding the appropriate amount of expense to be taken, no expense whatsoever should be recorded. Today companies are acquired because of their talent, technology and market positions, among other reasons. The value of these intangible assets change over time. Good people leave, products become obsolete, and competitors gain market share. If anything, accelerating technological change demands shortening amortization periods rather than eliminating them.

Most of the tests to be used in determining when impairment occurs are backward-looking, such as when the share price has fallen below book value. Such a declaration of impairment won't assist investors. It will be as useless as an analyst downgrading a stock at $5 that he recommended for purchase at $50, and it will be as common. Impairments will be run through the income statement in large lump sums, encouraging analysts to ignore them as both extraordinary events and non-cash charges. Analysts who like to talk about cash earnings somehow never seem to consider the initial outlay for an acquisition to be a cash charge.

It's bad enough that the FASB allows corporations to tout customized "pro forma" earnings. For example, Amazon.com excludes amortization of goodwill and intangibles, its share of losses in partially owned companies, merger and acquisition costs, and stock-based compensation. Others choose their own menu. Thanks to FASB's tolerance of such shenanigans, companies are being evaluated by different self-defined earnings standards. If the goodwill proposal is adopted, there will be a huge increase in acquisitions, and even more unexplained variance among corporate reports.

The final positions on both options and goodwill accounting are vastly different than the FASB's initial proposals. The FASB has simply caved in to extensive and persistent lobbying by corporations and investment bankers that would benefit from such weakened standards.

The U.S. has held up its accounting as a model for the rest of the world, claiming that accuracy and rigorous regulation have made our markets the safest, broadest and most efficient in the world. If the FASB has come to stand for Fantasy Accounting Serving Business, our accounting will be unworthy of emulation. ■



Maris Bishofs for Barron's

Profit Boosters

▶*The tax benefits that flow to companies from employee stock plans have had a powerful effect in improving the reported earnings of some top high-tech companies.*

	Sun Microsys (3 mos. Oct)	Microsoft (3 mos. Sept)	Intel (9 mos. Sept)	Cisco (3 mos. Sept)	Dell (9 mos. Oct)
Tax Benefit from Employee Stock Plan* (Most Recent Operating period)	$472	$1,215	$852	$985	$739
Earnings*	$510	$2,191	$8,342	$798	$1,802
Tax Benefit as Percentage of Earnings	108%	55%	10%	123%	41%
Operating Cash Flow*	$701	$2,857	$1,107	$1,363	$2,993
Tax Benefit as Percentage of Operating Cash Flow	67%	43%	77%	72%	25%

*In $millions

Source: Company reports

DAVID ROCKER is a partner in Rocker Partners, an investment management firm in New York.

Barron's welcomes submissions to "Other Voices". Essays should be about 1,200 words in length, and sent by e-mail to the Editorial Page editor at tg.donlan@barrons.com.

SHORTBUSTER CLUB

SKY CAPITAL LLC™

The "ShortBuster Club"

The "ShortBuster Club" ™ presents a monthly table listing 100 heavily shorted NYSE and ASE stocks. Some of these stocks appear to have substantial upside potential based upon the fundamentals as reported by the individual companies and the possibility that short covering could accelerate an upward movement in the stocks' prices.

At least 10% of the shares outstanding have been shorted in 80 of these stocks, and in 93 of them the number of shares short equals more than 10 days of average daily trading volume for the month ended April 15, 2003. (Source- Bloomberg, Reuters).

The table for each company lists the Price/Earnings Ratio based on earnings estimated for 2003, an estimated three-year growth rate, the recent market capitalization, and the percentage of shares outstanding held by institutions.

A guide to the intensity of the short interest in each stock is provided in the columns on the right under the headings DTC (Days to Cover), SSH (Shares Short as a Percentage of the Shares Outstanding), and SX (Spark Index), which is the sum of DTC and SSH. For the ShortBuster Club, SX provides a guide to the intensity of the short interest.

Sky Capital LLC currently has a Strong Buy rating on Fremont General (FMT) and Vector Group (VGR). Please contact Ray Dirks for information on these 2 stocks including copies of research reports written by Theodore Kovaleff and Stevens Monte respectively.

In a few days, The Shortbuster Club will provide a similar table for heavily shorted stocks listed on NASDAQ.

The ShortBuster Club will provide this table once a month before the end of the month. Additional information is available on an interim basis by contacting Ray Dirks at: (212) 709-1939, or toll-free at: (866) 991-9918, or by fax at: (212) 709-1950, or by e-mail to tkovaleff@skycapitalllc.com.

Table 1: Heavily Shorted Stocks

SYM	NAME	Price 5/2/03	P/E est. 2003	Price/ Book	Gth (3 yr)	MKT cap ($000,000)	Institutional % Ownership	DTC (Days to Cover) Nov	Dec	Jan	Feb	Mar	Apr	SSH (% Outs)	SX Spark (ndex)
PPD	Pre-Paid Legal	24	12	15	10	422	81	28	16	15	23	29	53	53	106
SWS	SWS Group	17	20	1.1	10	284	70	87	101	44	55	39	66	21	87
USG	USG	7	3	0.5	10	317	47	59	42	36	39	27	59	22	81
SRZ	Sunrise Assisted Living	28	10	1.2	13	618	83	38	33	24	35	54	26	25	80
IFC	Irwin Financial	24	11	1.8	14	657	42	37	69	41	58	75	56	14	70
SFP	Salton	13	6	0.5	8	145	42	42	52	35	35	64	56	14	70
TRN	Trinity Industries	17	17	0.8	10	780	94	36	54	48	71	80	46	22	68
ATN	Action Performance	19	10	1.4	16	334	39	8	11	24	18	31	28	39	67
ASF	Administaff	7	21	1.7	25	193	83	17	22	26	31	28	40	24	64
MSV	Manufacturers Services	4	21	1.3	19	144	93	32	24	33	48	60	56	7	63
AGM	Federal Agricultural Mortgage	23	11	1.8	20	261	77	36	70	25	17	45	44	18	62
TRR	TRC Cos.	12	10	1.2	30	156	41	11	14	20	31	41	19	60	60
IDN	Intelli-Check	7	Loss	17	10	66	4	38	14	33	45	76	46	14	60
PLB	American Italian Pasta	43	17	3	15	753	124	13	24	32	21	27	27	31	58
COA	Coachmen Industries	13	16	1	10	203	80	57	53	29	19	48	49	8	57
PQE	ProQuest	24	13	5	17	673	105	6	15	11	16	18	32	24	56
FLE	Fleetwood Enterprises	6	LOSS	1.3	10	217	133	57	37	46	21	33	27	28	55
AND	Andrea Electronics	0.2	LOSS	0.3	10	5	11	27	8	24	43	49	49	6	55
RHB	Rehab Care Group	17	10	1.5	19	293	110	21	32	35	24	42	36	18	54
ION	Ionics	19	40	0.8	13	340	84	13	23	34	33	32	23	30	53
COO	Cooper Cos.	28	13	3	21	864	114	13	27	12	18	18	21	31	52
MSS	Measurement Specialties	4	5	2	20	48	29	20	23	43	47	40	40	11	51
XLA	Xcelera	0.9	Loss	0.8	10	106	1	8	12	16	19	38	50	1	51
BFT	Bally Total Fitness	6	4	0.4	13	215	87	22	30	17	24	20	23	27	50
DRD	Duane Reade	14	11	1	20	326	130	14	27	19	9	15	28	21	49
ALD	Allied Capital	21	12	1.5	7	2,397	42	41	35	43	37	28	32	17	49
SEN	SEMCO Energy	5	10	0.9	3	101	18	26	25	26	17	27	36	12	48
CRY	CryoLife	8	LOSS	2	20	162	40	9	11	13	14	7	22	26	48
NOR	Northwestern Corp.	2	4	0.2	10	91	53	20	31	14	24	21	18	28	46
AIR	AAR Corp	4	Loss	0.4	10	130	93	11	31	16	26	20	42	4	46
OCA	Orthodontic Centers of America	6	5	0.7	12	304	90	14	17	26	29	44	13	32	45
VGR	Vector Group	12	10	20	25	431	39	20	31	51	42	53	34	11	45
CHS	Chico's FAS	24	24	8	24	2,054	94	15	18	18	17	14	18	26	44
FTS	Footstar	10	5	0.7	14	195	119	18	13	21	11	24	19	25	44
COB	Columbia Laboratories	5	LOSS	NEG	10	189	33	11	27	21	31	38	38	5	43
NLS	Nautilus Group	13	8	2	16	434	41	8	24	24	17	33	12	30	42
MWY	Midway Games	3	15	0.9	20	150	54	12	9	10	22	28	28	13	41
GAP	The Great Atlantic & Pacific Tea Co.	6	LOSS	0.5	10	240	-	8	9	13	11	23	33	8	41
MFC	Manulife Financial	26	11	1	14	12,155	27	29	31	40	49	58	39	2	41
FS	Four Seasons Hotels	32	45	1	10	1,119	53	9	15	14	13	20	17	22	39
MMS	Maximus	24	14	1.7	13	506	105	21	23	26	28	30	20	19	39
AM	American Greetings	15	11	0.9	8	971	144	26	23	29	18	22	20	19	39
PII	Polaris Industries	57	13	5	14	1,255	76	7	12	9	9	12	15	23	38
KKD	Krispy Kreme	32	41	7	30	1,846	53	19	12	14	12	15	16	22	38
SKO	Shopko Stores	12	8	0.6	13	357	107	16	9	20	20	18	20	20	38
UVN	Univision	30	60	4	26	6,845	74	14	24	25	33	31	9	28	37
MXT	Metris Companies	3	LOSS	0.3	16	197	95	16	17	12	6	23	9	28	37
NFI	NovaStar Financial	45	6	2	15	441	67	12	29	6	7	12	14	22	36
ELY	Callaway Golf	14	15	1.6	10	1,079	83	19	22	16	17	29	22	14	36
CPN	Calpine	5	12	0.5	10	1,974	59	8	10	14	14	17	12	23	35

**Statistical source of information above- Bloomberg, Reuters.

PXP	Plains Exploration	9	5	1.2	10	207	57	-	-	1	7	14	27	8	35
BHE	Benchmark Electronics	26	14	1.3	19	644	108	13	11	12	12	13	11	23	34
CUM	Cummins Inc	28	34	1.4	8	1,090	83	8	11	15	12	16	11	22	34
GMT	GATX	18	14	1.1	12	905	94	21	17	19	12	17	18	16	34
MCL	Moore Corp.	11	14	3	12	1,263	72	1	0	2	9	19	21	13	34
HAE	Haemonetic	18	16	2	14	428	105	14	16	18	22	31	25	9	34
MPH	Championship Auto	4	Loss	0.5	10	53	47	5	10	5	13	24	24	9	33
GEG	Global Power Equipment	6	17	2	15	263	60	17	16	29	48	65	29	4	33
JAH	Jarden Corp.	30	11	5	11	426	76	3	5	10	13	14	17	15	32
FMT	Fremont General	10	6	1.7	25	754	-	24	35	41	59	16	19	13	32
CHB	Champion Enterprises	2	LOSS	3	15	135	87	28	21	34	57	63	20	12	32
FWC	Foster Wheeler	3	5	NEG	13	110	27	51	30	29	30	45	21	11	32
SM	St. Mary's Land & Exploration	27	11	2	10	840	68	15	16	15	21	22	25	7	32
MNS	MSC. Software	6	13	0.8	20	188	71	13	13	18	24	23	26	6	32
AMR	AMR Corporation	5	LOSS	0.9	7	855	75	5	4	6	6	11	3	28	31
ACV	Alberto Culver	49	19	3	11	2,843	38	18	18	20	17	26	21	10	31
WGO	Winnebago Industries	39	13	4	17	706	68	7	11	9	11	13	8	22	30
GT	Goodyear Tire & Rubber	6	LOSS	2	5	1,113	59	10	10	12	7	17	13	17	30
TSS	Total System Services	19	27	6	15	3,740	7	27	37	36	40	31	27	3	30
ACF	AmeriCredit	7	13	0.6	17	1,060	116	14	15	16	4	8	9	20	29
MRX	Medicis Pharmaceutical	59	26	4	17	1,587	-	12	16	16	10	15	12	17	29
CVC	Cablevision Systems	22	LOSS	NEG	13	6,304	69	10	14	16	13	17	16	13	29
ORB	Orbital Sciences	6	17	1.9	13	262	59	9	12	20	10	14	16	13	29
PNX	Phoenix Companies	8	14	0.4	15	752	-	2	5	3	13	26	22	7	29
STN	Station Casinos	22	20	5	15	1,234	79	13	19	23	18	17	14	14	28
FCN	FTI Consulting	47	18	3	21	1,279	89	12	13	20	12	17	14	14	28
AMT	American Tower	7	LOSS	0.8	22	1,439	74	14	9	25	11	18	16	12	28
GPI	Group 1 Automotive	29	9	1.5	17	652	64	4	6	8	11	10	18	10	28
WIN	Winn - Dixie Stores	13	9	1.8	12	1,797	33	14	17	12	16	23	19	9	28
SOV	Sovereign Bancorporation	15	11	1.4	11	4,052	70	13	22	17	13	17	21	7	28
TE	TECO Energy	11	9	0.7	5	1,911	44	3	11	12	10	11	11	16	27
WMS	WMS Industries	14	60	1.8	18	435	62	14	15	11	12	15	20	7	27
HCR	Manor Care	20	14	1.8	13	1,786	94	7	13	19	11	18	16	10	26
MSO	Martha Stewart Living	8	70	1.7	17	450	19	14	8	19	14	14	21	5	26
NAV	NaviStar	28	LOSS	7	9	1,913	106	6	8	9	15	12	10	15	25
PCS	Sprint (PCS Group)	4	LOSS	12	22	3,702	-	13	11	14	13	22	15	10	25
LRW	Labor Ready	6	20	2	30	258	78	22	27	17	20	22	17	8	25
XRX	Xerox	10	18	4	9	7,416	-	17	18	20	13	17	17	8	25
UAG	United Auto Group	17	9	1	16	700	81	8	12	11	12	15	18	7	25
SIE	Sterra Health Services	17	8	3	15	473	71	1	1	2	2	5	11	13	24
MTG	MGIC	47	8	1.3	12	4,642	104	5	6	9	12	11	12	24	24
GGP	General Growth Properties	56	17	3	10	3,533	92	19	18	12	16	24	15	8	23
OMI	Owens & Minor	19	13	2	13	630	94	26	27	22	24	21	15	8	23
TEX	Terex	18	11	1.1	13	860	81	4	7	8	9	17	15	8	23
GY	Gencorp	8	17	0.9	10	331	85	12	8	13	12	12	16	7	23
SFN	Spherion	5	LOSS	0.7	12	284	91	16	20	13	17	20	19	4	23
CMO	Capstead Mortgage	11	5	1.3	10	157	15	10	1	4	6	19	9	13	22
ENZ	EnzoBiochem	16	45	4	20	450	27	14	19	18	18	24	16	5	21
RMD	ResMed	38	29	5	21	1,240	41	10	17	19	11	13	12	9	21
NDC	NDC Health	20	15	2	14	697	101	8	17	13	16	26	6	13	19

**Statistical source of information above- Bloomberg, Reuters.

[i]

[i]Sky Capital LLC prepared the information in this report and all opinions are those of Sky Capital LLC.

This report is based upon information available to the public. The information herein is believed by Sky Capital LLC to be reliable and has been obtained from sources believed to be reliable, but Sky Capital LLC makes no representation as to the accuracy or completeness of such information.

Opinions, estimates and projections in this report constitute the current judgment of the author as of the date of this report. They are subject to change without notice. Sky Capital LLC has no obligation to update, modify or amend this report or to otherwise notify a reader thereof in the event that any matter stated herein, or any opinion, projection, forecast or estimate set forth herein, changes or subsequently becomes inaccurate or misleading. This report is provided for information purposes only. In is not to be construed as an offer to buy or sell or a solicitation of an offer to buy or sell any financial instruments or to participate in any particular trading strategy in any jurisdiction in which such an offer or solicitation would violate applicable laws or regulations.

Sky Capital LLC may be market makers or specialists in, act as advisers or lenders to, have positions in and effect transactions in securities of companies mentioned herein a principal or agency basis and also may provide, may have provided, or may seek to provide investment banking services for those companies.

Member NASD, SIPC

LOCATIONS

- **Sky Capital LLC**
  110 Wall Street, 8th fl
  New York, NY 10005
  Office 212•709•1900
  Facsimile 212•709•1950
  Toll Free 866•991•9918

- **Internet Address**
  www.skycapitalholdings.com

erlanger squeeze play

MONTHLY NEWSLETTER

#022, April, 2003

DAILY SQUEEZEOMETER UPDATES

May 20, 2003

SQUEEZE ALERTS

#090, May 14, 2003

SPECIAL REPORTS

Welcome To *Erlanger Squeeze Play*

Phil Erlanger

Erlanger Squeeze Play is a unique service that provides a disciplined way to capitalize on recurring market phenomena. Through quantitative monitoring of price action and sentiment, we identify short-term trading opportunities in both long and short squeeze plays. At the same time, our analysis allows us to recognize the strength of an existing market trend and accurately classify any given stock as Buy, Sell, Hold or Sell Short.

WHAT IS A SQUEEZEOMETER
click here to find out

This is the first time the investing public has had direct access to the Erlanger Factor. This indicator uncovers the individual issues, industry groups and sectors that put the odds in favor of individual investors and delivers incredible investment opportunities month after month.

We are committed to providing tremendous value through our research. It is with great pleasure that I invite you to become a charter subscriber.