RealMoney Silver - The Edge

Scott Rothbort, founder and president of LakeView Asset Management, LLC, is filling in for Doug Kass today. Email Rothbort at scott.rothbort@thestreet.com. Doug will return on Thursday.

Not Your Average Year
Scott Rothbort
7/22/08 7:25 AM EDT

I always like to find some interesting statistical data to present at the beginning of the day when I sit in for Doug Kass on The Edge. On March 24, I presented
a table that explained volatility as a function of the excessive quantity of up and down days in excess of 1%, as measured by the **S&P 500** from the beginning of 2008 through March 20.

For that period, there were 55 trading days, of which 29 were up or down by at least 1%. That period of time was significantly more volatile than the historical average.

Now, we fast forward to just over a quarter into the future. As of last Friday's close, the S&P 500 was up or down 1% on 55 occasions or 40% of the time in 2008. This is less frequent that the earlier part of the year but is far more frequent that the historical average of about 19% of the time.

Bottom line: We still have too much day-to-day volatility in the markets.

Here is another interesting look at the action in 2008. The S&P has fallen roughly 14% so far this year. On a simple basis by the days of the week, the S&P has performed on daily average as follows:

> Monday -- up 0.06%;
> Tuesday -- up 0.11%;
> Wednesday -- down 0.22%;
> Thursday -- up 0.15%; and
> Friday -- down 0.61%.

In fact, if you add up all of the Friday trading results for the S&P 500 this year, the total return is **-16.53%**.

Since 1950, by days of the week on an average daily basis, the S&P has performed as follows:

> Monday -- down 0.07%;
> Tuesday -- up 0.03%;
> Wednesday -- up 0.09%;
> Thursday -- up 0.04%; and
> Friday -- up 0.08%.

Clearly, 2008 is anything but an average year for the markets. The data presented above also explain the more volatile day-to-day action we have endured this year. More stable Wednesday and Friday trading sessions will likely be the precursor to more constructive markets.

There are 23 full weeks left until the year is over.

Position: *Long SSO*

Energy and Materials Still Safe Havens
Scott Rothbort
7/22/08 9:10 AM EDT

Pre-market futures are firming a little bit as we approach the open. Weakness from **Wachovia** (WB), **American Express** (AXP) and **Apple** (AAPL) are all setting the tone for a weak open. Apple is just another Groundhog Day.

If we learned anything from the spate of earnings reports from last Thursday through this morning, it is that the best place to reside in stocks continues to be the energy and materials names. After getting killed for a few days last week, expect those sectors to resume their bull markets.

Doug Kass beat me to the punch as I agree with his prognostication. I think there is a good chance we open on the lows and move our way higher over the course of the day.

Position: *Long AAPL*

Time to Reinforce the Uptick Rule?
Scott Rothbort
7/22/08 9:37 AM EDT

Last evening, I was a guest on "Nightly Business Report" on *PBS*. Paul Kangas interviewed me on the subject of abusive short selling and the uptick rule. My opinion on short selling is very clear: Short selling is a necessary component of the financial markets, but we need to curb abusive practices. I told Kangas that I believe that the uptick rule would be reinstituted in some form in the future.

Should we reinstitute the uptick rule and curb abusive short-selling practices? What do you think? The Finance Professor is looking for more than just a "yes" or "no" answer. Express your knowledge. Send me an email or post your thoughts on The Study Hall Forum on *TheFinanceProfessor.com*, and I will have your responses posted on The Edge at the end of the day.

FCX Nearing the End of the Golden Age?
Scott Rothbort
7/22/08 10:24 AM EDT

Crude oil is slumping once again, which is putting a bid into the rest of the market that has not reported earnings in the last 24 hours.

Energy and materials stocks reversed hard on the crude trade and the **Freeport McMoRan Copper & Gold** (FCX) earnings report, which sent that stock lower. Despite average realizations increasing, volume outputs declined dramatically for gold at Freeport McMoRan. The company raised its dividend and share buyback.

I am going to jump onto the Freeport McMoRan call now.

Position: *Long FCX*

Natural Gas Stocks Deflating
Scott Rothbort
7/22/08 11:20 AM EDT

Natural gas stocks are taking huge hits across the board. This is creating compelling valuations but at the price of some significant pain. **Southwestern Energy** (SWN) and **Chesapeake Energy** (CHK) seem to go down more and more every day.

The **S&P 500** and **DJIA** are now in the green. The **Russell 2000** is once again the upside leader, adding on nearly 1%. Tech stocks continue to put a dent in the **Nasdaq**.

The response to my question on short selling has been great. Keep them coming.

Position: *Long SSO and UWM*

Stay Away From Semis
Scott Rothbort
7/22/08 12:53 PM EDT

I went into **Staples**
(SPLS) with my wife the other day to grab a few items. I noticed the proliferation of USB flash memory sticks and other memory devices. As is usual with commoditized technology, you get more memory or power for less money than in the past.

Is it any surprise that flash memory maker **SanDisk** (SNDK) is getting slaughtered? I would also not touch a semiconductor stock, another manmade commodity, with counterfeit money. If you are going to play commodities, play those with limited natural supply, not those with manmade supply.

So, the drop in **Freeport McMoRan Copper & Gold** (FCX) is much more tolerable than the drop in SanDisk or

Advanced Micro Devices (AMD).

Position: *Long FCX*

Let's Talk Lunch -- Restaurants
Scott Rothbort
7/22/08 2:07 PM EDT

I am back from lunch, so how about some restaurant talk? There are some developments in the restaurant sector today worth noting. **CKE Restaurants**
(CKR) reported combined same-store sales for its Carl's Jr. and Hardee's units increased 5.2% in the past four weeks.

Domino's Pizza
(DPZ) reported an OK quarter, missing EPS estimates by 1 cent but bettering revenue estimates by about $2 million. International same-store sales rose 7% in the quarter while domestic same-store sales slumped 5.4%.

The company mentioned higher commodity costs and the need to pass those on with higher consumer pricing. DPZ is surging around 15% in reaction to the earnings report and earning call commentary.

Buffalo Wild Wings
(BWLD) is moving higher as well. Recall I bought this stock around $24 and sold half around $32, $33. BWLD has great growth potential. McDonald's (MCD) reports tomorrow. I previewed McDonald's here. I have been waiting to buy **Yum Brands**
(YUM). I may have missed the bottom and am close to pulling the trigger on an investment position.

Position: *Long MCD.*

Reader Responses
Scott Rothbort
7/22/08 3:37 PM EDT

Below are the responses from The Finance Professor/Edge Forum question of the day. Your responses were many and varied. Thanks again for taking the time to express your knowledge.

G.G.:

> I think that the practice of naked shorting would be a better place to start. Why should "short people" be discriminated against? As much as I like the upside, an institutional bias to that end seems counter to free markets. There is no denying there are some very smart shorts out there.

P.C.:

> We should reinstitute the uptick rule and affirm that the practice of short now, locate later, is eliminated.

P.W.:

> I might be slightly bias here with my response (I am a trader at a hedge fund), but reinforcing the uptick rule will only create a short-term short squeeze and actually increase market volatility (as the shorts scramble to cover, sending stock prices up massively). Simply, put, no financially sound institution will be driven out of business solely from "the shorts." Even if the uptick rule is reinforced, shorts and traders can get around these rules. Let's not forget that management can always buy back stock. Heck, that is what Lehman did in the $30s because the company felt it was undervalued. Looks like that investment/trade paid off, right?

C.P.:

> The uptick rule should definitely be reinstated, and they should enforce the rules that are already on the books, like *no*
> naked short selling. If you can't borrow the shares, then you can't sell it short. That rule has been on the books for decades, but it gets enforced only selectively. The hedge funds get a free pass to beat on their short positions with impunity. *Enforce* the rules that are already there!

W.G.:

I think the stock market is different from commodity markets in that it serves both a price discovery and a financing function. The financing function ought to have a different set of regulations surrounding it -- somewhat akin to the legal protections afforded to property rights.

I am not against shorting by any means, but right now the shorts can operate with impunity while companies that seek financing are gagged and prevented from commenting, and the restrictions on companies buying their own stock can be gamed, as you and Cramer have written.

I am also under the impression that so-called naked shorting is supposed to be illegal, but, apparently, that is not ever enforced? Is that your understanding? On the surface, it seems to me that naked shorting is a particularly dumb risk, so I wonder why anyone would engage in it unless they know something I don't.

R.G.:

Yes, I believe we should reinstitute the uptick rule. Since it has been eliminated on July 6, 2007, the market has gone straight down. I agree that there are other major forces causing the market to go down, but abusive short selling cannot be discounted.

If the uptick rule were in place, it would prevent some of the abusive short selling and give companies a fighting chance not to have their stock pushed down by collusion. On the other hand, there is nothing wrong with traditional short selling, and it is actually a force that is needed to keep the bulls in check when something just does not seem right with a company -- for instance, **Fannie Mae** (FNM) and **Freddie Mac** (FRE). Here is the **DJIA** chart from July 6, 2007, to today. The Dow is down almost 16% during this time period. I wonder what it would look like if the uptick rule was still in place?

D.B.:

What other reason do you need? They practice and collaborate to manipulate stocks! An investigation by unbiased people would show they led the demise of **Bear Stearns**. Without them, it would have never happened. What a shame.

Have you never noticed weakness or strength in a stock on Friday, and, lo and behold, there is a hatchet job on said company in *Barron's* on Saturday. Fraud is everywhere in this industry.

B.B.:

You are about to witness a hanging. Of course, the uptick rule should be reinstated. We are about capital formation, and anyone with a lot of money can destroy stocks. They like this due to its profitable nature, and they grew up on video games. Some of these guys never worked but were very good at video games where the timeline is like the silly TV shows -- you know, everything is solved in a half hour, even with commercials.

But the *real crooks*
are the naked short sellers. They create (by not properly borrowing) counterfeit shares. They lied, or never even tried to borrow, but took queues from market makers who ultimately helped their best clients.

They all have a tidy packet of reasons why they did this, *but then* a great thing came to happen. The greedy nakeds developed an appetite for the previous friends they were in cahoots with -- namely **Lehman Brothers** (LEH), **Citigroup** (C), **Bear Stearns**, etc. They were turned on, and now we will find "the rest of the story," including why the **SEC** never enforced the rules on the books.

Was it payola, greed, stupidity, being understaffed?

As someone who has spent seven years on this fraud, the answer will ultimately take the U.S. down a few more notches. We are a disgrace to the world. Instead of being the leader, Chairman Cox will lead us out. Our job is to build and not to tear down. Legitimate shorts like Chanos are good for the market, but why he defends some of his *[expletive deleted]* friends. I'll never know.

J.R.:

I say no. I'm tired of the shorts getting blamed when there is no evidence other than hearsay. Let's obtain some evidence first, and, if it shows manipulative shorting, then I would certainly change my mind. In this supposedly high-tech era, it's high time that data on shorting be improved.

Time and sales data (real-time) should indicate whether a sale is short and whether a buy is a cover.

By having this flow of data, it would be easy for traders to see if a downward spike in price is due to a surge of short selling. It would also show whether an alleged short squeeze is really due to shorts covering or due to long side traders gunning the stock, thinking they are forcing a squeeze.

Also, reporting of short interest data should be weekly instead of monthly. And why not institute an **SEC** filing requirement for those whose short position in a stock exceeds some threshold percentage of outstanding shares.

W.F.:

Reinstate the plus-tick rule!!

One way in which stock returns demonstrate asymmetric behavior is that they tend to go down faster than they go up. One reason for this is that while position closure is often mandated and urgent, position initiation is generally more discretionary. Given that, on the whole, more investors own stocks on a pretty-much-permanent bias rather than short-them holdings, more forced closings are stock sales than buys-to-cover, hence the asymmetry.

Exacerbating this tendency is the fact that, as stocks go down, a given absolute unit move -- say, a dollar -- in the price per share becomes a larger part of the value overall of the position; that is, the absolute value percentage return for that unit move increases relative to that of the return for that unit move when the stock had a higher price per share. This is just math, but it matters because of its effect on the shares' liquidity.

Transaction and other market impact costs are generally not only fixed or not highly correlated to the share price change but also are mostly fixed per share rather than per transaction. As a proportion of a given position size, they actually increase as share prices decrease, and the number of shares required for a given position size increases. This tends to put upward pressure on market impact costs, attenuating liquidity, increasing volatility and, therefore, lowering the likelihood that the marginal long-term holder will continue to be willing to stay in the stock and so adding to potential selling pressure. Share ownership becomes redistributed to more speculative, or potentially "weaker,"hands, and so on.

The plus-tick rule was a reasonable single-factor counterbalance to these effects.

B.D.:

My biz mix rarely involves shorting a stock, other than through derivatives.

My understanding has always been that shorting a stock involves a number of steps.

- The very first was to contact legal and/or stock loan to be sure that stock could be borrowed.
- Second, you sell (and, as you point out, for most of my career, that involved an uptick).
- Third, you fight over who keeps the interest earned on the credit that the short sell creates...lol.

It has been my understanding that Regulation SHO spelled out the rules and was there to prevent 'naked' shorting via 'phantom' stock sales.

I have had deep suspicions about many hedge funds and prominent media members being in cahoots to manipulate stock prices on the short side. (I am convinced that David Rocker and Herb Greenberg, along with a reporter named Dave Evans, conspired to disseminate negative info on specific companies that had "naked short" positions established by their hedge funds.). I know of one company in particular.

Still, one incident did not excite me, and it took some time and research to understand the ease with which naked shorting could be facilitated.

Certainly, after reading some SHO info, Chairman Cox has made some efforts over the past few years to curb abuses. The media should not be critical of him to the extent I read. They should applaud him for making some efforts.

The truth remains that naked shorting and phantom stock selling need to be stopped and confidence restored to our markets.

The so-called financial professionals and media folk doth protest too much!! I wonder why??

They are the criminals and the culprits, simply trying to divert our attention from the real problem -- they have met the enemy and, perhaps, and it is them!!

Scott, I would start by data-mining the last 10 years of trading from the DTCC. Let's look for who still has 'phantom' stock that has yet to covered, for how long, for what dollar value, etc.

It can be done if someone has the backbone and the guts to do it.

Flipped Out of SSO Into UYG
Scott Rothbort
7/22/08 4:02 PM EDT

I have been a busy beaver this afternoon. When I returned from lunch, I flipped out of most of my **Ultra S&P 500 ProShares** (SSO) into the **Ultra Financials ProShares** (UYG), although I have a tiny SSO residual position mostly in custodial accounts.

I will get back to you after the close.

Position: *Long SSO and UYG*

An Impressive Session
Scott Rothbort
7/22/08 4:37 PM EDT

We had a very impressive session today.

The loss in **Apple** (AAPL) was rather insignificant and well within the stock's typical daily gain-and-loss profile.

The buy financials/sell commodities trade is in on full force. Enjoy it while it lasts.

After hours, **Intuitive Surgical** (ISRG) beat by a dime and is rising about 8%.

Washington Mutual
(WM) is a convoluted mess as the company posted a big loss. I would wait until reading the full text of the earnings release and listen to the conference call before rushing to make a trade or pass judgment. Right now WaMu is trading up 5.5% after hours as management commented that it has sufficient capital. If it holds, this should help the financials tomorrow.

Finally, **Yahoo!**
(YHOO) comes up light for the quarter, but the stock still catches a bid. Again, let's wait for the Yahoo! conference call to draw any conclusions.

Thanks for reading the Edge and have a good evening. I am going for a swim.

Position: *Long AAPL*
