by Rick Wayman (Contact Author | Biography)

A less-publicized and more-sinister version of short selling can take place on Wall Street. It's called "short and distort" (S&D).

Nothing is inherently wrong with short selling, which is permissible under the regulations of the Securities and Exchange Commission (SEC). However, the S&D type of short seller uses misinformation and a bear market to manipulate stocks. S&D is as illegal as the pump and dump, but is mainly used in a bear market. It is important for investors to be aware of the dangers and to know how to protect themselves.

Shorters' Actions Can Promote a Healthy Market

Short selling is the practice of selling borrowed stock in the hope that the stock price will soon fall, allowing the short seller to buy it back for a profit. The SEC has made it a legal activity for several good reasons. First, it provides the markets with more information. Shorters (traders who practice selling short for a living) often complete extensive and legitimate due diligence to discover facts and flaws that support their suspicion that the target company is overvalued. Because most shorters are scrupulous and ethical, their actions are conducive to the health of the market. Finally, short selling also provides investors who own the stock (with "long" positions) with the ability to generate extra income by lending their shares to the shorts. (For background reading, see the *Short Selling* tutorial.)

S&D Traders Manipulate Stock Prices With Smear Campaigns

On the other hand, S&D traders manipulate stock prices in a bear market by taking short positions and then using a smear campaign to drive down the price of the targeted stock. This is the inverse version of the "pump and dump" tactic, whereby crooks buy stock (take a long position) and issue false information that causes the target stock's price to increase.

Generally, it is easier to manipulate stocks to go down in a bear market and up in a bull market. The pump and dump is better known than the S&D because of the long bull market and the media. For example, the stock market had been in a general uptrend in the early to mid 1980s, which provided ample fodder for "pumpers". Movies like "Wall Street" (1987) and "The Boiler Room"(2000) helped educate investors about the risk of this type of stock manipulation. (To read more about stock market movies, see *Financial Careers According To Hollywood*.)

The S&D shysters try to profit by stimulating fear, but this only works if they have credibility. As such, when working online they will often use screen names and email addresses that imply that they are associated with the SEC or the Financial Industry Regulatory Authority (FINRA) (formerly the National Association of Securities Dealers), or that they can regularly spot worthless stocks. Their goal is to convince investors that every proponent of the stock has ties to the company and that the SEC is watching and will halt the stock. S&Ds also intimate that they are looking out for investors' interests.

S&D players clutter message boards, so optimistic information cannot easily be found. "Get out before it all comes crashing down" and "Investors who wish to enter a class action lawsuit can contact..." are typical posts, as are their projections of $0 stock prices and 100% losses. If their strategy is suspected by "longs", they attack the person who has caught them. In other words, the market manipulator will do everything in his or her power to keep buyers out of the stock and keep the price heading south.

The Net Effect

When the short and distort maneuver succeeds, investors who initially bought stock at higher prices sell at low prices because of their mistaken belief that the stock is worthless, caused by an effective distortion campaign. At the same time, the S&Ds cover at low prices and lock in their gains.

Right after prominent bankruptcies such as Enron in 2001 or Nortel in 2009, investors could be more susceptible to this type of manipulation than during prosperous periods such as the 1990s in the U.S. During downturns, the first appearance of impropriety could cause investors to run for the hills much easier. As a result, many innocent, legitimate and growing companies could get burned, and investors along with them. (To learn about how you can profit when everyone else is heading for cover, read *Profit From Panic Selling*.)

How to Identify and Prevent S&D

1. Do not believe everything you read - verify the facts.
2. Do your own due diligence and discuss it with your broker.
3. Hypothecate your stock - take it out of its street name to prevent the short sellers from borrowing and selling it. (Learn more about doing your own due diligence in our related article, *Due Diligence In 10 Easy Steps*)

The best way to protect yourself is to do your own research. Many stocks with great potential are ignored by Wall Street. By doing your own homework you should feel much more secure in your decisions. And, even if the S&Ds attack your stock, you will be better able to detect their distortions and be less likely to fall prey to them by selling the stock at a loss.

How To Identify Good Research

Ask yourself these questions to spot the key characteristics of a good research report:

1. Is There a Disclaimer?

The SEC requires that everyone providing investment information or advice fully disclose the nature of the relationship between the information provider (the research analyst) and the company that is the subject of the report. If there is no disclaimer, investors should disregard the report. (For related reading on disclosures, see *Disclosures: The Good, The Bad, And The Ugly*.)

2. What Is the Nature of the Relationship?
Investors can get good information from pieces published by investor relations firms, brokerage houses and independent research companies. Using all of these sources will provide information and perspectives that can help you make better investing decisions. However, you need to evaluate their conclusions in light of the compensation (if any) that the information provider received for the report.

Can a Wall Street analyst who is even partially compensated by trading generated by the report be more objective than a fee-based research firm that is paid a flat monthly rate with no "performance" bonus? The answer to this question is left for each investor to decide, but both reports are available to use for evaluating a potential investment. The nature of the compensation will provide information to help you evaluate a report's objectivity.

3. Is the Author Identified and Contact Information Provided?
Generally speaking, if the author's name and contact information are on the report, it is a good sign because it shows that the author is proud of the report, and provides investors with a way to contact the author for additional information.

Research reports from legitimate brokerage firms post the author's name and contact information near the top of the front page. If the author's name is not given, investors should be very skeptical of the report's contents.

4. What Are the Author's Credentials?
Letters after a name do not necessarily mean that the author of the report is a better analyst, but they do indicate that the analyst has undertaken additional studies to expand his or her knowledge of finance and investing. (For more insight, see *The Alphabet Soup Of Financial Certifications*.)

5. How Does the Report Read?
If the report contains grandiose words and exclamation points, beware. This not to say that good analysts are boring, but good reports don't read like the *National Enquirer*. A reputable analyst would never use exaggerations like "sure things" or "rockets", and would never suggest that you mortgage your home to buy a stock.

Objective research reports provide reasoned arguments to buy or sell a stock. Key factors such as management expertise, competitive advantages and cash flows are cited as evidence to support the recommendation. (For more insight, read *Research Report Red Flags*.)

6. Is There an Earnings Model and Target Price With Reasonable Assumptions?
The bottom line for any recommendation is the earnings model and target price. The assumptions upon which the earnings model is based should be clearly stated so the reader can evaluate whether the assumptions are reasonable. The target price should be based on valuation metrics - such as the price-to-earnings (P/E) or price-to-book (P/B) ratio - that are also based on reasonable assumptions. If a report lacks these details, it is generally safe to assume that the report

lacks a sound basis, and should be ignored.(For more details about analyzing ratios, see the *Financial Ratio Tutorial*.)

7. Is There Ongoing Research Coverage?
A commitment to providing ongoing research coverage (at least one report per quarter for at least one year) indicates that there is a solid belief in the company's fundamental strengths. It takes a lot of resources to provide this type of coverage, so a firm providing ongoing coverage is a sign that it legitimately believes in the long-term potential of a stock.

This contrasts with one-time reports that are used to manipulate stocks. In these cases, supposed research firms will suddenly issue "reports" on stocks they have never reported on before. Generally, these reports can be identified as an attempt at stock manipulation because they will not contain the attributes of a legitimate research report (discussed above).

The Bottom Line
Unscrupulous short and distort tactics can leave investors holding the bag. Fortunately, high-quality stock reports are relatively easy to spot, and needn't be confused with stock manipulators' dramatic claims. Keep your cool when analyzing a stock, and avoid getting caught up in online hype. By analyzing potential investments carefully and objectively, you can protect yourself from falling prey to S&D players - and make better stock picks overall.

***by Rick Wayman**, (Contact Author | Biography)*

**** This article and more are available at Investopedia.com - Your Source for Investing Education ****