



IN DEFENCE OF STOCK LENDING – PART 2

Here we are in the middle of the greatest crisis the world has seen since World War 2 and instead of writing an opinion piece about the crisis I find myself completely bereft of any original ideas relating to it. I am just unable to think of anything to write that hasn't been said a thousand times by other commentators. I even delayed writing an opinion piece thinking that I would have that moment of inspiration when I would think of something original to say. I have now given up and accepted defeat. The only comment I'll make in relation to the crisis is that I'm just sticking to my plan of owning good companies through thick and thin even though I know the pandemic will have a severe impact.

As unimportant as it might seem compared to a pandemic, I have had further thoughts on the issue of stock lending and therefore I have decided to put those thoughts down on paper.

In my last opinion piece, I wrote about Hiro Mizuno and the decision of the GPIF to stop the practice of stock lending. Since I wrote that piece, Hiro has retired from the GPIF and has taken on the role of non-executive director at Tesla. This is an interesting development because the founder of Tesla, Elon Musk, has been one of the harshest critics of stock lending. Elon has had a continuous battle with short sellers including well-known names like David Einhorn. He feels that short sellers are too short term and do not allow people with a long-term vision the time to bring their dreams to fruition. In an interview with Rolling Stone magazine over two years ago Elon said the following about short sellers *"They're jerks who want us to die, They're constantly trying to make up false rumors and amplify any negative rumors. It's a really big incentive to lie and attack my integrity. It's really awful."*

When Hiro Mizuno stopped stock lending at the GPIF, Elon tweeted the following: *"Bravo, right thing to do! Short selling should be illegal,"*

Given Elon's stated views it didn't come as a surprise to me when he announced the appointment of Hiro to the Tesla board. The Tesla press release specifically mentioned Hiro's decision at the GPIF: *He also challenged many established market practices, including short-selling,*

There is no way that I want to defend short sellers that start false rumours or amplify negative rumours. Anyone that starts a false rumour is a criminal, full stop, and I don't think I need to say anything further on that subject. All I'll say in relation to David Einhorn is that I would be surprised if he started a false rumour.

I know I'm only repeating what I wrote in my last opinion piece but I would love to know what Elon thinks about the way short sellers continue to catch criminal behaviour and fraudsters at other companies.

Since that last opinion piece, we have had the case of NMC, the FTSE100 health care company. We have Carson Block and Muddy Waters to thank for this particular piece of excellent detective work. This is what they said at the start of their first report on NMC: *We are short NMC Health plc. We have serious doubts about the company's financial statements, including its asset values, cash balance, reported profits, and reported debt levels. At the worst of times, the company has invested in large assets at costs that we find too high to be plausible – including from parties we believe are de facto under common control. This behavior gives rise to concerns about fraudulent asset values and theft of company assets.*

Thanks to Muddy Waters we can start to sort out who was behind this particular fraud.

Once again, I have to ask the question as to whether anyone would have discovered this fraud beside a short seller? There are only so many investigative journalists in the world prepared to take on that type of project and there is little to suggest that the auditors were close to discovering the hundreds of millions of hidden borrowings at NMC.

Since my last opinion piece, we have also had interesting developments at the German company, Wirecard. Whistle-blowers alleged a number of things about them and KPMG were hired to investigate the allegations. In their recently published report KPMG stated that they have been prevented from doing their job properly.

Hedge fund manager Chris Hohn of “The Children’s Investment Fund” (TCIF) wrote a letter to the board of Wirecard stating the following:

If KPMG was unable to obtain standard information that it requested from Wirecard such as bank statements, customer names and contracts as well as transaction data [p. 13 KPMG Report] after a lengthy forensic investigation, then in our view this raises questions as to how investors, lenders and regulators can be confident that Wirecard's current and historic accounting is accurate.

Chris Hohn has stated that he is short Wirecard shares and therefore I have to once again point out that without stock lending he might not go to all this trouble.

It is clear to me that we need to get to the bottom of what has gone on at Wirecard. If there has been fraud, we will be better off knowing about it and we need to keep the pressure on in order to make sure that we get answers to these questions.

Besides recent developments I also want to talk about an historic case that I forgot to write about last month. This particular case of fraud was one of the worst I’ve come across because it involved a company that was putting the health of people in danger. It was uncovered by someone I have never met but I feel that I have got to know quite well over the years because of his reasonably high profile in the investment world. The person I’m referring to is Whitney Tilson and he was involved in stopping the fraud at Lumber Liquidators. I’ll let him describe the situation in his own words: *A few months after I went public with my questions about Lumber Liquidators, an industry insider came to me with exactly the information I was looking for. He had run a laminate flooring factory in China and told me that he tried to sell to Lumber Liquidators. But the company would only buy from him if he matched the prices of his competitors, which were 10% lower. He knew such prices were only possible by cutting corners and selling illegal – and dangerous – formaldehyde-drenched flooring.*

To test his story, I went out and paid a laboratory \$5,000 to test three samples of the Chinese-made laminate flooring that Lumber Liquidators was selling. Sure enough, it was loaded with formaldehyde... two to six times higher than what was legally permitted.

Once I confirmed that the company was breaking laws and poisoning its customers, I had to decide how to share my findings broadly. I could have written an article or made another presentation at an investment conference. But that wouldn't have reached a broad, national audience.

Then, I had a brilliant idea: "This is the perfect story for 60 Minutes," I thought. It's not only one of the most-watched television shows in America, it also has fantastic credibility, especially for exposing wrongdoers.

Better still, 60 Minutes had the resources I didn't. It hired a team that smuggled hidden cameras into a number of Chinese factories supplying Lumber Liquidators. Posing as buyers, they caught the managers on camera admitting they were selling Lumber Liquidators toxic product!

If stock lending was banned, I wonder whether Lumber Liquidators would still be selling toxic product to this day? Stock lending enabled Whitney Tilson to earn enough profit to give his investors a decent return. I think we owe him and his investors a debt of gratitude.



In conclusion I'm just going to say that I hope all the fraudsters out there will sleep a little less easy tonight thinking about the possibility that Muddy Waters might be on to them!