Short Selling Tutorial

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Have you ever been absolutely positive that a stock is going to decline and wanted to profit from its demise? Don't you wish there was a way to see your portfolio increase in value during a bear market? Both situations are possible. Many investors make money on a decline in an individual stock or during a bear market, thanks to an advanced investing technique called “short selling.”

Short selling isn't a difficult thing to do, but it is a concept that many investors have trouble understanding. In general, people think of investing as buying an asset, holding it while it appreciates in value, and then eventually selling to make a profit. Shorting is the opposite; an investor makes money only when a shorted security falls in value.

Short selling isn't quite that simple though, it has many unique risks and pitfalls that you need to watch out for. The mechanics of a short sale are somewhat complicated and the investor's risks are high. It's important that you understand how the whole process works before getting into it.

If you aren't familiar with the concept of margin, we'd advise that you read our margin tutorial because many of the risks in short selling arise because margin is used.

What is Short Selling?

The Basics

Going long on an investment means that an investor has bought a stock believing that it's price will rise in the future. The opposite is going short, which is when an investor anticipates a decrease in share price.

Selling short is the sale of a stock that you don't own. More specifically, a short sale is the sale of a security that isn't owned by the seller, but that is promised to be delivered. That may sound a little confusing, but it's actually a simple concept.

Here's the skinny, when you sell short a stock your broker will lend you the security. The stock will either come from the brokerage's own inventory, another one of the firm's customers, or from another brokerage firm. The shares are then sold and the proceeds are credited to your account. Sooner or later you must "close" the short buy buying back the same number of shares (called covering) and returning them to your broker. If the price drops, you can buy back the stock at the lower price and make a profit on the difference. If the price of the stock rises, you have to buy it back at the higher price, and you lose money.

Most of the time, you can hold a short for as long as you want. You can, however, be forced to cover if the lender wants back the stock you borrowed. They can't sell what they don't have, and so your brokerage will have to either come up with new shares to borrow or you'll have to cover. This is known as being "called away." It doesn't happen often, but is possible if many investors are selling a particular security short.

As you don't own the stock (you borrowed and then sold it) you must pay the lender of the stock any dividends or rights declared during the course of the loan. If the stock splits during the course of your short you'll owe twice the number of shares at half the price.

Also, because you are being loaned the stock, you are buying on margin. In fact, you'll have to open a margin account to short stocks. Your broker will charge you interest on the loan and you are subject to rules of margin trading.

Why Short?

There are two main motivations to short:

1. To speculate
The most obvious reason to short is to profit from an overpriced stock or market. Probably the most famous example of this was when George Soros "broke the Bank of England" in 1992. He risked $10 billion that the British pound would fall and he was right. The following night Soros made $1 billion from the trade with his profit eventually reaching almost $2 billion.

2. To hedge
Very few sophisticated money managers short as an active investing strategy like Soros (for reasons we'll discuss later). The majority of investors use shorts to hedge. This means that they are protecting other long positions with offsetting short positions.

Restrictions
Shorting is subject to many restrictions on the size, price, and types of stocks you are able to short. For example, you may not short sell penny stocks and most short sales need to be done in round lots.

In addition, the SEC, NYSE, and NASD have rules preventing short selling unless the last trade of the stock is at the same or higher price (known as an uptick or zero plus tick). These rules exist so that investors can't sell short in a declining market, as continuous short selling will make a falling stock keep falling.

The Transaction

Suppose that after hours of research and analysis you believe that company XYZ is a real stinker. The stock is trading at $65 currently, but you see it trading much lower in the coming months. You decide to take the plunge and short 100 shares. The transaction is straightforward, most online brokerages will have a check box that says "short sale" and "buy to cover."

One of two things can happen in the coming months:

The Stock Price Sinks
(stock goes to $40)

Borrowed 100 shares of XYZ at $65	**$6,500**
Bought Back 100 shares of XYZ at $40	**-$4,000**
Your Profit	**$2,500**

The Stock Price Rises
(stock goes to $90)

Borrowed 100 shares of XYZ at $65	**$6,500**
Bought Back 100 shares of XYZ at $90	**-$9,000**
Your Profit	**-$2,500**

Clearly, short selling can be profitable. But just as with buying long, there is no guarantee that the price of a stock will go the way you want.

Shorters use an endless number of metrics and ratios to find shortable candidates. Some use similar stock picking methodology to the longs, but just short the stocks that come out worst. Others look for insider trading, changes in accounting policy, or bubbles waiting to pop.

One indicator specific to shorts worth mentioning is short interest. This tells us how many shares have already been sold short. It's a dangerous sign if too much stock is sold short before initiating new short positions. We talk about this in detail in our article: "Short Interest: What Does It Tell Us?"

The Risks

Now that we've introduced short selling, let's get one thing clear - shorting is risky. Actually, rephrase that - shorting is very, very, risky. Though you can think of the outcome of a short sale as basically the opposite of a regular buy transaction, the mechanics behind a short result in some unique risks.

1. History shows us that in general, stocks have an upward drift and over the long run most stocks appreciate in price. For that matter, even if a company barely improves over the years, inflation should somewhat drive its stock price up. What this means is that shorting is betting against the overall direction of the market.

2. When you short sell, your losses are infinite. A short sale loses when the stock price rises, and a stock is (theoretically at least) not limited on how high it can go. On the other hand, a stock can't go below 0, so your upside is limited. In other words, this means that you can lose more than you initially invest, but the best you can earn is a 100% gain if a company goes out of business.

3. Shorting stocks involves using borrowed money, otherwise known as margin trading. Just as when you go long on margin, it's easy for losses to get out of hand because you must meet the minimum maintenance requirement of 25%. If your account slips below this you'll be subject to a margin call and will either have to put in more cash or liquidate your position. (As mentioned, we're not going to cover margin details here because we have an entire tutorial devoted to it).

4. If a stock starts to rise and a large number of short sellers try to cover their positions at the same time, it can quickly drive up the price even further. This phenomenon is known as a "short squeeze." Usually, news in the market will trigger a short squeeze, but sometimes traders who notice a large number of shorts in a stock will attempt to induce one. This is the reason it's advisable to not short a stock with high short interest. A short squeeze is one way to lose a lot of money extremely fast.

5. The final, and most important problem, is being right too soon. Even though a company is overvalued, it may take a long time for it to come back down. In the meantime you are vulnerable to interest, margin calls, and being called away. Academics and traders alike have tried for years to come up with explanations as to why a stock's market price varies from its intrinsic value. We've never come up with a model that works all the time, and probably never will.

Take the dot-com bubble for example. Sure, you could have made a lot of money if you shorted at the market top in the beginning of 2000. But, many believed that stocks were grossly overvalued even a year beforehand. You'd be in the poorhouse now if you shorted the Nasdaq in 1999! This is despite the popular belief that pre-1999 valuations more accurately reflected the Nasdaq. However, it wasn't until 3 years later in 2002, that the Nasdaq returned to 1999 levels.

Momentum is a funny thing. Whether it be in physics or the stock market, it's something you don't want to try and stop. All it takes is one big shorting mistake to kill you. Just as you wouldn't jump in front of a speeding train, don't fight against the trend of a hot stock.

Ethics and the Role of Short Selling

It's safe to say that short sellers aren't the most popular people on Wall Street. Many investors see short selling as "un-American" and "betting against the home team." Some hold short sales as a major cause of market downturns, such as the crash in 1987. There isn't a whole lot of evidence to support this, as other factors such as derivatives and program trading also played a big part. Still, regulators have introduced rules that make it more difficult for short sales to push a market downward. We already mentioned one of these regulations, the uptick rule, where a short is prevented unless a stock is trading up.

On the other hand, it's tough to deny that short selling makes an important contribution to the market. It provides liquidity, drives down overpriced securities, and generally increases the efficiency of the markets. Short sellers are often the first line of defense against financial fraud. While the conflicts of interest from investment banking keeps some analysts from giving completely unbiased research, work from short sellers is often regarded as being some of the most detailed and highest quality research in the market. Some even go as far as saying that short sellers actually prevent crashes because they provide a voice of reason during raging bull markets.

However, short selling also has a dark side, courtesy of a small number of traders who are not above using unethical tactics to make a profit. Sometimes referred to as the "short and distort," this technique takes place when traders manipulate stock prices in a bear market by taking short positions and then using a smear campaign to drive down the target stocks. This is the mirror version of the "pump and dump," where crooks buy stock (take a long position) and issue false information that causes the target stock's price to increase. Short selling abuse like this has grown with the advent of the Internet and the growing trend of small investors and online trading. For more information on this, check out our article entitled: "The Short and Distort, Stock Manipulation in a Bear Market."

Conclusion

Short selling is yet another technique you can add to your trading toolbox. That is, if it fits with your risk tolerance and investing style. Short selling brings both opportunities and risks. We hope this tutorial has enabled you to understand whether it's something you would like to pursue. Let's recap:

- In a short sale an investor borrows shares, sells them, and must eventually return the same shares (cover). Profit (or loss) is made on the difference between the price when the shares are borrowed compared to when they are returned.

- An investor makes money only when a shorted security falls in value.
- Short selling is done on margin, and so you must pay interest and are subject to the rules of margin trading.
- The shorter must pay the lender any dividends or rights declared during the course of the loan.
- The two reasons for shorting are to speculate and to hedge.
- There are restrictions as to what stocks can be shorted, and when a short can be carried out (uptick rule).
- Short interest tells us the number of shares that have already been sold short in a security.
- Short selling is very risky. You can lose more money than you invest but are limited on the upside.
- A short squeeze is when a large number of short sellers try to cover their positions at the same time and thus, drive up the price of a stock.
- Even though a company is overvalued, it may take a long time for it to come back down. Fighting the trend almost always ends up with trouble.
- There are some that see short selling as unethical and bad for the market.
- Short selling contributes to the market by providing liquidity, efficiency, and acting as a voice of reason in bull markets.
- Some unethical traders spread false information in an attempt to drive the price of a stock down and make a profit by selling short.

Quiz Yourself
Finally, if you think you know this stuff now we challenge you to take the quiz and **Test Your Short Selling Knowledge**.

Also:
1. If you think we missed something and have a question, tell us about it.
2. If you enjoyed this tutorial, make sure to Tell a Friend!
3. If you still aren't on our newsletter, why not?

Related Tutorials
This link has been included a few times already, but if you don't understand margin, learn the details in our **Margin Trading Tutorial**.

If you like the idea of leverage, then you'll be interested in options and futures. These are a special type of security called a "derivative" that has some very interesting features for sophisticated investors. See the **Options Tutorial** and the **Futures Tutorial**.

Finally, even a more advanced tutorial is **Electronic Trading and Market Makers**. Here you will learn about the advanced systems that professionals and full-time traders use.