Introduction

Have you ever been absolutely sure that a stock was going to decline and wanted to profit from its regrettable demise? Wouldn't it be nice to see your portfolio increase in value during a bear market? Both scenarios 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 is neither terribly complex nor entirely simple. In other words, it's 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 involves many unique risks and pitfalls to be wary of. The mechanics of a short sale are relatively complicated compared to a normal transaction. And, as always, the investor faces high risks for potentially high returns. It's essential that you understand how the whole process works before you get involved.
What is Short Selling?

The Basics
When an investor goes long on an investment, it means she has bought a stock believing its price will rise in the future. Conversely, when an investor goes short, he is anticipating a decrease in share price.

Short selling is the selling of a stock that the seller doesn'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 confusing, but it's actually a simple concept.

Still with us? Here's the skinny: when you short sell a stock, your broker will lend it to you. The stock will come from the brokerage's own inventory, from another one of the firm's customers, or from another brokerage firm. The shares are sold and the proceeds are credited to your account. Sooner or later you must "close" the short by 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. However, you can be forced to cover if the lender wants back the stock you borrowed. Brokerages can't sell what they don't have, and so yours will either have to 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.

Since 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 have to open a margin account to short stocks.

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. His profit eventually reached almost $2 billion.
2. To hedge
For reasons we’ll discuss later, very few sophisticated money managers short as an active investing strategy (unlike Soros). The majority of investors use shorts to hedge. This means they are protecting other long positions with offsetting short positions.

Restrictions
There are many restrictions on the size, price and types of stocks you are able to short sell. For example, you can't short sell penny stocks and most short sales need to be done in round lots.

In July of 2007, the Securities and Exchange Commission eliminated the uptick or zero plus tick rule. This rule required that every short sale transaction be entered at a higher price than that of the previous trade and kept short sellers from adding to the downward momentum of an asset when it was already experiencing sharp declines.

The Transaction
Suppose that, after hours of painstaking research and analysis, you decide that company XYZ is dead in the water. The stock is currently trading at $65, but you predict it will trade 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:

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<th>The Stock Price Sinks</th>
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<td>(stock goes to $40)</td>
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<tr>
<td>Borrowed 100 shares of XYZ at $65</td>
<td>$6,500</td>
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<tr>
<td>Bought Back 100 shares of XYZ at $40</td>
<td>-$4,000</td>
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<td>Your Profit</td>
<td>$2,500</td>
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<table>
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<th>The Stock Price Rises</th>
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<td>(stock goes to $90)</td>
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<tr>
<td>Borrowed 100 shares of XYZ at $65</td>
<td>$6,500</td>
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<tr>
<td>Bought Back 100 shares of XYZ at $90</td>
<td>-$9,000</td>
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<td>Your Profit</td>
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Clearly, short selling can be profitable. But then, there's no guarantee that the price of a stock will go the way you want (just as with buying long).

Shorters use an endless number of metrics and ratios to find shortable candidates. Some use a 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 that is worth mentioning is short interest. This reveals how many shares have already been sold short. It's a dangerous sign if too much stock is sold short before you initiate a new short position.

The Risks

Now that we've introduced short selling, let's make one thing clear: shorting is risky. Actually, we'll rephrase that. Shorting is very, very risky ... not unlike running with the bulls in Spain. You can have a great time, or you can get trampled.

You can think of the outcome of a short sale as basically the opposite of a regular buy transaction, but the mechanics behind a short result in some unique risks.

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

2. When you short sell, your losses can be 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. Bottom line: 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 - you'll be forced to put in more cash or liquidate your position. (As mentioned earlier, we won't 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 why it's not a good idea to short a stock with high short interest. A short squeeze is a great way to lose a lot of money extremely fast.

5. The final and largest complication is being right too soon. Even though a company is overvalued, it could conceivably take a while 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. They have yet to 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 killing if you shorted at the market top in the beginning of 2000. But many believed that stocks were grossly overvalued even a year earlier. You'd be in the poorhouse now if you shorted the Nasdaq in 1999! This is contrary to the popular belief that pre-1999 valuations more accurately reflected the Nasdaq. However, it wasn't until three years later, in 2002, that the Nasdaq returned to 1999 levels.

Momentum is a funny thing. Whether in physics or the stock market, it's something you don't want to stand in front of. All it takes is one big shorting mistake to kill you. Just as you wouldn't jump in front of a pack of stampeding bulls, 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 massive role. Still, regulators have introduced rules that make it more difficult for short sales to push a market downward.

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. It's been said 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.

**Conclusion**

Short selling is another technique you can add to your trading toolbox. That is, if it fits with your risk tolerance and investing style. Short selling provides a sizable opportunity with a hefty monkey of risk on its back. 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 is 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.