Understanding Short Selling

Short selling can be challenging to understand. It is relatively simple to understand when buying-low and selling-high. However, selling-high and buying-low is harder to figure out. To help understand short-selling, it is good to first understand long and short.

Understanding Long and Short

There are two types of transactions that can take place in the stock market:

1. Buy
2. Sell

Each day, billions of shares trade back and forth in the stock market. There are transactions to buy and to sell. As obvious as this may seem, powerful dynamics occur under the surface that can be challenging to see, analyze, and use to make decisions.

Long and Short

Long: If an investor wants to “buy low and sell high,” then that investor is Long. Most investors participate in the markets this way. The idea is to buy a stock now with the expectation that it will increase in value. The stock can be sold for a profit at a future point (days, weeks, months, or years from now).

Short: If an investor wants to “sell high and buy low,” that investor is Short. This can be confusing and seem illogical, but it does happen. The hope is to sell a stock now and then buy it when the price is lower in the future. We get the cliché “Don’t sell yourself short” from this method of “investing.”

Putting a Long Together

When you are long a stock (buy low, sell high), you enter the investment by paying the current Ask Price.

At some point in the future, you may decide to sell that stock.

When you sell, the price you will receive is the current Bid Price.

Example:

Buy: $10 per share on January 1, 2016. (**Ask 10.00** Bid 9.95).

- At the time the stock was bought, the price to buy was $10 per share. The price to sell was $9.95 per share. Since this was a purchase, the transaction took place at the Ask Price ($10 per share).

Sell: $20 per share on January 1, 2020. (Ask 20.05 **Bid 20.00**).

- At the time the stock was sold, the price to sell was $20 per share. The price to buy was $20.05 per share. Since this would be a sale, the transaction took place at the Bid Price ($20 per share).

Please click here for a deeper explanation of Bid/Ask Prices.

Understanding Short Selling

Short selling can be confusing and may require an “Aha Moment.” The concept can be perplexing because of the terms used, such as “buy” and “sell.” You may find it easier to think of this in terms or parts of a transaction rather than using the literal meaning.

“Buy” and “Sell” are two parts of a process that must be performed for a transaction to be complete. Sometimes “the buy part” takes place first, and sometimes “the sell part” takes place first. To complete the transaction, the opposite process is done. If “the buy part” was done first, “the sell part” must be done last for the transaction to be complete. If “the sell part” was done first, “the buy part” must be done last for the

transaction to be complete. As crazy as this may sound, this does occur in real life and might be easier to understand when using a different type of example.

Example:

Goal: You want to make a profit. It does not matter to you if you make money if prices go up or down. You only wish to have extra money left when both sides of the transaction are finished.

You have an idea. You think you can make some money by selling Superbowl tickets to a friend. This example will demonstrate how it is possible to make money by going long or short. You just need to do the right thing at the right time.

<u>Long example:</u>

You can buy Superbowl tickets for $800 each using your own cash. Nothing is borrowed. Also, you have a friend who has agreed to buy the tickets from you for $1,000 each. If everything goes according to plan, you have made a profit of $200 on each ticket.

In this example, you bought first and then sold last to complete the transaction.

<u>Short example:</u>

You have a friend who has agreed to buy Superbowl tickets from you for $1,000 each. Your friend gives you the $1,000 first. The only problem is that you don't have the tickets. In essence, you sold something that you don't own. However, that money can be used to buy the tickets for $800 each. You buy the tickets and deliver them to your friend. When everything is completed, you have made a profit of $200 on each ticket.

In this example, you sold first and then bought last to complete the transaction.

It is a bit more complicated than these examples, but that is essentially how the concept works.

Why Short Sell?

Numerous reasons entice investors to implement short-selling:

- Prices tend to fall quicker than they climb, so there is a chance to earn profits faster.
- Although there is a historical upward bias to the stock market, there are periods of light, moderate and severe declines. Rather than sacrificing profits or experiencing losses while riding out difficult times, declines can be opportunities to make profits.
- Short-selling allows for hedging or protection strategies to be implemented.
- Short-selling increases market liquidity and efficiency.
- Short-selling can help prevent prices from becoming overvalued.

The Dangers of Short Selling

Short selling stocks involves borrowing shares from your broker with the hope of returning the shares in the future after buying (replacing) them at a lower price.

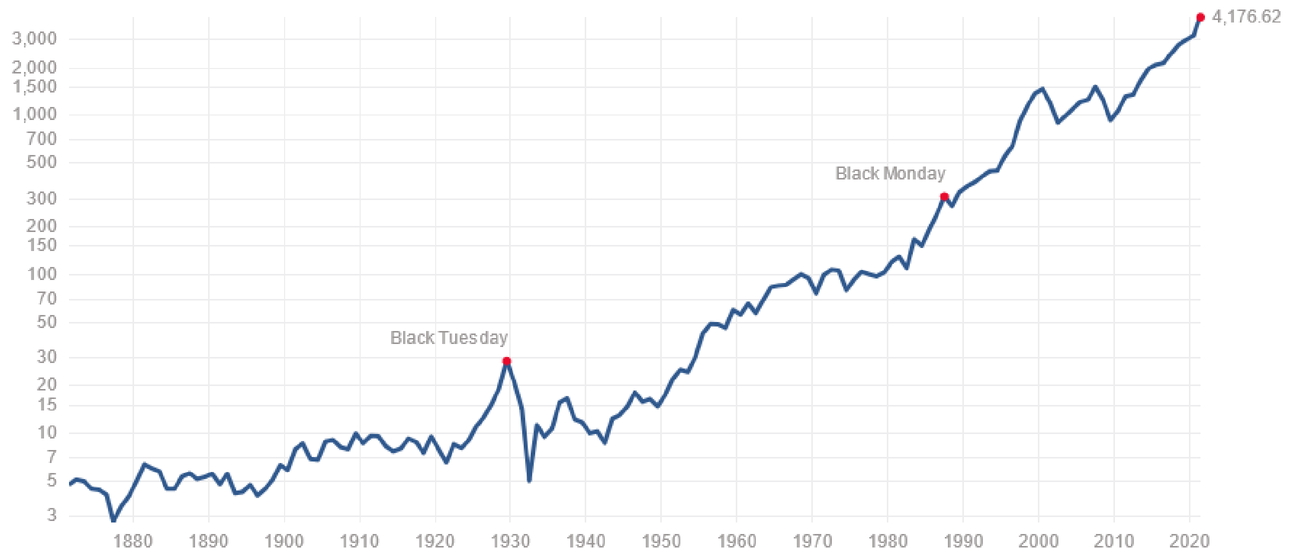
If things go wrong, the pain can be extreme. This can include:

- As painful as losing any money can be when going long, the pain can be even more severe when going short. With long positions, the lowest price a stock can go to is zero. If you didn’t sell before hitting zero, this would result in a 100% loss if you invested $1,000 without using margin. That is all you can lose.
- It is possible to lose more than your initial financial requirement to maintain the short position when short-selling. There is no limit to how high prices can go. Also, any losses MUST be covered. There have been times when short-sellers have lost their businesses, cars, homes, etc., due to extreme losses.

- The financial requirements are more stringent for short-sellers. Not only is it necessary to keep any proceeds received in your brokerage account when selling the stock, but additional funds will also be required to cover any potential losses. The amount of the “additional funds” can change daily. Many investors may lack the financial resources to implement short selling.
- The funds required to be in an account may be better used elsewhere by being deployed into other investments, which may provide better returns.
- When going long, many investors may “buy it and forget it.” If a stock is not purchased using margin (borrowed money), an investor may prefer not to watch a long position closely. If an investor is showing a loss yet still has confidence in the stock, an opportunity to wait for better days is possible. When going short, it is necessary to keep a close eye on current values. If prices go up, short-sellers may be forced to react even if undesired. They may not have a choice since it is necessary to cover their short positions to limit losses. Short-sellers do not always have the luxury of waiting for prices to move in their favor.

Market Cycles and Time

Since most market participants only make money when prices go up, increased value is the desired outcome. However, the reality of life is that there are times when stocks go down. When looking at a long-term chart of the S&P 500, there have been some severe declines. However, for most of history, stocks tend to go up. The challenge has always been having enough time to wait for things to rebound. Also, just because this has been the historical norm does not guarantee it will be the same in the future.



Source: https://www.multpl.com/s-p-500-historical-prices

Fast Market Conditions

There are times when prices can move quickly up or down, often within minutes. This is called fast market conditions. Most investors notice this when a market crash happens as prices fall and fall without seemingly ever wanting to stop. However, this can also occur when prices climb. A strong upward push can also seem to be out of control. One reason for this is that short-sellers are exiting positions to either realize a profit or cut a loss. To understand the dynamics behind this, it is helpful to understand how transactions occur at the bid and ask prices.

The Bid/Ask Price

When a stock is purchased, an investor buys to enter at the current Ask Price.

When a stock is sold, an investor sells to close at the current Bid Price.

Short-sellers do just the opposite.

Short-sellers sell at the Bid Price to enter a position.

Short sellers buy at the Ask Price to exit a position.

When a short seller starts to experience a loss, it is required to take action much quicker.

If a stock that was expected to fall starts to climb, a short-seller must “cover” any losses by exiting the position. This means they must buy to close the position.

When a stock starts to run away to the upside, forcing short-sellers to cover, this is known as a “Short Cover Rally” or a “Short Squeeze.”

This can make prices look like they are going uncontrollable to the upside because short-sellers can’t wait and see. They must act.

Short Selling Losses

Let’s go back to our Superbowl ticket example:

You can “sell” the tickets for $1,000 each. That money can be used to buy the tickets for $800. You have made a profit of $200 on each ticket.

What if something goes wrong?

Instead of the Superbowl tickets costing $800, your heart sinks when you realize the lowest price is now $1,200.

You have already sold the tickets for $1,000. But now you have to buy the tickets for $1,200. You have made a loss of $200 on each ticket.

What if the price climbs higher?

$2,000? ($1,000 you made for selling the tickets - the price you have to pay = -$1,000).

$3,000? ($1,000 you made for selling the tickets - the price you have to pay = -$2,000).

The sky is the limit!

The Stock Should Be Going Down!

No matter how much analysis is performed that concludes a stock price should rise or fall, the ultimate determination is the actual price action. If a short-seller concludes that prices should fall, but instead, they rise, the short-seller must react no matter how much logic suggests otherwise. This will open the door to an excess of emotions, which almost always leads to a one-way ticket to failure.

Short-Seller Haters

Some investors don’t like short-sellers. A few reasons include:

- Short selling is more complicated than “going long.” People often fear and have contempt for things they don’t understand.
- The financial requirements are considerable, which may be beyond what individual investors are willing to risk.
- Some investors feel that this is a game only played by “the fat cats on Wall Street,” who can do things individual investors can’t do.
- Losing more than your investment is an immediate turn-off.
- Some may feel that it is immoral, unethical, or unpatriotic to profit from declining prices. If a risk is assumed, it should be by taking a chance on a company's positive future or bright outlook for a country.
- Some may think that short-sellers are the ones who drive prices lower.

Whether the above attitudes are correct or not is irrelevant and prevails with some people.

Useful Information

When short-sellers initiate a position by selling at the Bid Price to open, this is measurable, which can be helpful. Many investors prefer stocks that have a high number of short positions, called short interest. Why? Logic would dictate that if there is a sizeable amount of short interest,

perhaps you should be short as well? However, many sentiment measurements gauge how investors feel about things. Since emotions tend to be wrong much of the time, such measurements are often used as contrary indicators. If most investors feel the market should go up, perhaps you should consider the market going down?

Short Interest Ratio

When looking at an investment, it can be wise to look at the Short Interest Ratio, also called the Short Ratio. The ratio is calculated by dividing the total number of shares sold short by the average daily trading volume.

Typically, this is measured in terms of Days to Cover.

Days to Cover measures the expected number of days it would take to close out all short positions in a stock.

Short-sellers must buy to close their position at the Ask Price. If there are numerous short-sellers simultaneously closing positions, this can push prices higher and higher.

The higher the number or ratio, the more "built-in" buyers there are on the sidelines that must come in and buy (cover) their short positions if prices go against them.

This can cause a Short Squeeze or Short-Cover Rally when they must act, which can see prices soar much higher since it is a "buying frenzy." Buyers are not pushing prices higher because they see more value. Prices are pushed higher because there are short-sellers losing money that must exit their positions!

A better alternative

There is one thing I need to make clear: I do not teach short-selling directly. I teach strategies that profit when prices fall, but I do not teach or even endorse short-selling how it has been explained here. The goal of this article is to understand the concept. I believe safer alternatives can

take advantage of declining prices without assuming the same level of risk as short-sellers.

Inverse Mutual Funds and ETFs

Inverse mutual funds and ETFs go up in value as prices fall. All of the short-selling has been handled by the issuer. To make it sound bizarre, you can go long (buy) a short position. When you conclude prices will fall, you can buy an inverse mutual fund or ETF. When you figure the decline is over, you sell the inverse mutual fund or ETF by hopefully realizing a profit.

Why is this a better alternative? As with any investment, there can be losses. That is part of life. The goal is to limit losses as much as possible. A regular short position has a limited profit with an unlimited loss potential. You can lose more than you invest. Using inverse mutual funds and ETFs, the loss is limited to your investment if margin is not used. As terrible as that can be, it is much better than the alternative. Please understand that there is still risk involved. Inverse mutual funds and ETFs merely provide alternative vehicles and are generally short-term in nature.

Inverse Mutual Funds and ETFs

Rydex, ProShares, and Direxion issue inverse mutual funds and/or ETFs. Typically, inverse mutual funds and ETFs are based on an index such as the S&P 500, Nasdaq 100, Dow, or Small-Cap indexes.

Conclusion

Short selling can be challenging to understand but is a common practice in the financial markets and life. Markets go up and down. Short-sellers seek to profit as prices fall. Short positions have risks that can be greater than long positions due to theoretically unlimited losses. Long positions are opened by buying at the current Ask Price and closed by selling at the current Bid Price. Short positions are opened by selling at the current Bid Price and closed by buying at the current Ask Price. When short-sellers

cover, this can produce a Short Squeeze or Short-Cover Rally. Also, the Short-Interest Ratio can be used to make decisions since a high ratio means short-sellers must buy to close. Some market participants may find better alternatives to short selling using inverse mutual funds and/or ETFs. There is always a risk of being wrong, but if handled correctly and maintained, taking advantage of downward price movement can enhance returns.