Investments: What Is Short Selling?

What Is Short Selling and How Do I Do it?

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Short selling is the process of making money on an investment when it goes down in price as opposed to going up in price. How is this possible? By short selling, you are betting against another party which would be the called the “long side” of the bet.

As a physical example, let’s say that you believe the price of lawn mowers is going to go down in price. You don’t own a lawn mower but your next door neighbour does. You decide to borrow his lawnmower and sell it for $300. You now have $300 in cash, but you owe your neighbour this lawnmower at some future date and if he asks you for it, you would be obligated to return it. Note that this assumes you can buy the exact same lawnmower at any time in the future. Let’s say you are right about the price of the lawnmower going down in price. In 6 months’ time, you buy an identical lawnmower and give it back it back to your neighbour. You only paid $160 to buy back the lawnmower. You have just made a profit of $140 on this “trade” because you sold the lawnmower initially for $300.

How Does This Work in the Markets?

If you assume that the lawnmower is a share of a company, and your neighbour is the holder of that share, then it is the same mechanism. You would borrow the shares from someone and sell them immediately. That someone is usually your broker, your bank or an institution with access to shares that can be lent out. You would receive the money for the sale but you would owe the stock to whomever you borrowed if from. A common hang-up with most people is that they think you must buy something *before* you can sell it. While this is the common way to do transactions, the person selling the lawnmower in this example did not own it. That share of stock must exist and it must exist in someone’s record books in order for it to be short sold. The record book in this case would be in the secondary market in the exchange where the trade is taking place. In the case of buying stock, companies can issue more shares out of their treasury stock or some equivalent source. In short selling*, you make the sale first, and then buy it back at a later date*. When both sides of the transaction are done or the short sale is covered, then you would see if you made money or not as a net result.

You Have Also Borrowed the Obligations of the Stock

In the case of the neighbour’s lawnmower, if your neighbour would use it to cut grass every month, and you borrowed the lawnmower, then you would have to cut the grass for your neighbour. Since you sold the machine, you would have to “make good” on the promise by cutting grass with some equivalent machine. Since the person whose grass is getting cut does not care which machine you use, it does not matter to your neighbour as long as you fulfill the obligations of owning the lawnmower. If you translate this into a stock example, if you borrow a share of stock from someone and then sell it, you are liable for any obligations attached to this stock until you balance the trade by buying it back. What obligations are these? The common one is the paying of dividends. If you borrowed the stock and sold it, and a dividend is paid, you would have to pay that dividend to the person you borrowed it from. If it is a bond that you borrowed, the same would hold true for interest payments. (9) Should there be a stock split or spin off where one stock becomes 2 or more holdings, you would be responsible for buying back the 2 or more holdings. This would carry additional risks since you are now short more securities than you were originally, and their prices can move at different rates and times. The key to remember is that you have to make the person you borrowed the security from “whole” once you close the transaction. If something changes with respect to the security you borrowed, you must account for these changes in the covering of the transaction and the returning of the security.

Collateral and Margin Accounts

Since you borrowed the stock and sold it, you now have money sitting in your trading account. This money has to be kept available as collateral to cover any adverse movements in the stock price. You would need an account that trades with margin to be allowed to do short selling. This means that your bank or broker is willing to lend you up to a certain percentage of the money for your transactions. This also means that they are trusting you with their money: they want to make sure you will pay it back when the time comes. There are levels of screening that are applied – including a “know your client” questionnaire, trading experience, and a historical trading account record. You would not be able to do this with an institution until you have been a client for a while and have a good history in terms of paying for your trades. (1) Since a margin account is used, interest is also charged on any money (or securities) that are borrowed. This interest would have to be factored into your profit and loss at the end of the trade. In some cases, it is not a lot of money if the amounts borrowed are small, the interest rate is low and the time period is short. Should one of these factors change, the interest charges will start to add up.

The Amount You Can Lose As a Risk

The reason why you would try to short sell is because you believe that a security or market will come down in price. The financial theory will tell that short selling is more dangerous than going long because the losses in going long are limited to the amount you invested, but on the short side, the losses are infinite because a security can go up forever. In practice, securities do not go up forever and going long can have severe losses, but the point should be adhered to for long time periods. Since many people doing short selling are dealing with borrowed money as well, a security move against them may force them to buy back the stock due to lack of funds. If this is done by a large number of people, the amount of buy orders all at once would push up the price of security quickly. This is called a *short squeeze*. This would in turn exaggerate losses in the short term for people who want to remain short. Since banks and brokers do not want to be left with unpaid bets, if your account is not adequately margined, your short sale may be bought back or liquidated. If you are going to do short selling, you will need a lot more money that the amount generated from the short sale to cover these situations.

Who Am I Borrowing the Securities From?

You never know who you are borrowing the securities from because you never know who is on the other side of your trade. This goes for all trades, long or short, stock or bond, or dollar amount. In order to do a short sale, you would need to have an account with a broker who has access to the security you want to borrow. The broker gets the security from their own inventory, another customer account or in some cases a custody account – which is an account at an institution who holds securities on behalf of another institution as a record keeper or custodian. Most of the securities that are eligible for short sale are frequently traded shares of large corporations that are commonly held. This makes it easier to borrow shares if needed. If you have only 10 lawnmowers of a certain type and sell one and try to buy it back, it will be more difficult than having 1000 lawnmowers of that type and trying the same thing. Most of the shares of a given company are held by institutions – mutual fund companies, index funds and pension plans. They tend to be “buy and hold” investors which means that shares will sit there for years or sometimes decades unless something drastic happens to the company. Since shares just sit there, institutions are willing to lend shares to the brokers for the purposes of short selling. They get paid for this as the broker would not have to use their own inventory to facilitate a short sale. Institutions also have good record keeping and are known to the brokers so tracking the whereabouts of a share of stock is straightforward. (10)(11)

What If My Stock Gets Called Back?

Since you are not really the owner of the lawnmower – you borrowed it – your neighbour can always come and ask for it back. You are obliged to return his lawnmower, or an identical one back on demand. In the case of a stock, it is the same. If you borrow a security and the original owner wants it back, you would have to go back into the market and buy that identical stock and return it to the owner at any time. The price of the stock at the time when they request it to be returned can be higher or lower than when you borrowed and sold – so you may make money or you may not. This is called covering the short trade. Since it is most likely that an institution is lending you the stock for the short sale, why would they want it back? There are many possible reasons. An example would be if the share price of a company soars by 50% and the institution decides to rebalance their portfolio: they would sell some of their holding and would want to retrieve some of the borrowed stock. Another example is a corporate action. A corporate action is a decision by the company’s management that affects the company indefinitely – like a takeover, a merger, a stock split, or a spin off. Whenever these events happen, they would have to be voted on by the shareholders. In some cases, shares would be returned and shares in a new company would be issued. This is like saying the old lawnmower will not be serviced anymore and we will give you a new one. Any shares that have been borrowed would have to be returned to complete the corporate action because the record keeper has the lenders’ name next to the shares, not the borrowers’ name.

How Do I Assess the Risks in Short Selling?

The major risks of short selling have been itemized in the article so far. These would be the risks of the price of the security moving against you, the nature of the security changing in a corporate action, paying the obligations as if you owned the security, margin and collateral requirements, having the security called away from you at any time, as well as market participants running the security price against you in a short squeeze. To assess some of these risks, there are two ratios that are commonly used to gauge the market perception of the security you want to short sell. These indicators are attempting to measure the market perception of your security, and when the risks of a short squeeze or price movement may be highest. These numbers do not explain all of the risks in short selling.

> **Short interest** – This is the total number of shares held short in a given stock. It is often expressed as a percentage by dividing it by the total number of shares outstanding. These numbers are reported regularly. In general, the higher the short interest, the more the sentiment is considered bearish. However, at a certain point, too much short interest becomes a contra-indicator, which is actually bullish. (Remember: all those shorts will eventually need to buy-to-cover.) (1)
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> **Short interest ratio (days-to-cover)** – This popular indicator refers to the number of short shares outstanding, compared to the average daily trading volume in the same security. If all of the activity in a particular stock was only short covering, and the stock still traded the same average daily volume, days-to-cover tells you how many days it would take for all the shares held short to be covered. The higher the ratio, the more days it would take to cover the short positions. This gives traders an indication of the potential buying pressure in a particular stock. The more days needed to cover, the more bullish the indication. (1)

Using Derivatives To Short Sell Instead

The idea of infinite losses on the upside or constant margin calls can be alleviated by using derivatives to short sell. You would need to isolate which security you think will go down in price, and then see if there are options that trade for that security. A call option is *"an agreement that gives an investor the right (but not the obligation) to buy a stock, bond, commodity, or other instrument at a specified price within a specific time period."* (5) and a put option is *"an option contract giving the owner the right, but not the obligation, to sell a specified amount of an underlying security at a specified price within a specified time."* (6) The put can be used in lieu of a short sale directly. You can also combine these derivatives to play the short side of the market. You would use the derivative instead of the security directly to bet on its direction. The advantages are that losses can be limited to the amount of your bet. A drawback with options is that they are standardized, have an expiry date and have a time and volatility premium embedded in the price. Standardization is a drawback because you can sell short at certain times and at certain prices. If you are in-between these times and prices, your trade will not be as effective. The expiry date makes it challenging because your timing has to be accurate. If you short sell a security directly, you can keep that holding as long as the lender does not want it back or you don't run out of money. With options, the expiry represents a third variable. The time and volatility premium makes an option more expensive than dealing directly with the security because there are people using options for other reasons other than short selling. Since the time is limited, if a security fluctuates in price, a bet can be profitable more easily than otherwise. People also make bets on how volatile a stock is. With short selling directly, these issues are minimized because there is no time limit.

Using Exchange Traded Funds (ETFs) To Short Sell Instead

The examples so far have focused on individual securities. There are ETFS and hedge funds that do long and short, so they incorporate the short selling into the product. The fees are very high and the results can vary quite markedly. Using a fund to do this is easier in a lot of respects because the fund absorbs much of the execution risk that happens when you borrow shares yourself. These funds may be designed for buy and hold strategies as opposed to frequent trading. You need to pay more attention to how the product is run to make sure that you are buying what you think you are buying, and the product would work for the time horizon that you have in mind. (7)(8)

Conclusion

Short selling can be a very useful way to profit in down markets or to neutralize some of the downside market movements in your portfolio. Short selling is more complicated than going long, so extra homework and diligence would be required. If you are getting someone to do it for you, make sure you understand what they are doing and what can happen to your account, because at the end of the day you will get the profit and the loss.

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