

# understanding short selling

Short selling has been in the media a lot over the past several years, particularly as a result of the market turbulence during GFC. Its practitioners have been described as anything from the champions of the free market system to unscrupulous profiteers or, even worse, as the architects of the financial crisis. Short sellers are widely regarded with suspicion because, to many people, they are profiting from the misfortune of others. This ill feeling is not new. Short selling has been a target of ire since at least the 17th century when England banned it outright.

## WHAT IS SHORT SELLING?

In basic terms, short selling is when you sell a stock which you do not actually own, in the attempt to make a profit from a potential decline in the share price. Stocks are borrowed (not bought) from a broker for a small fee, and then sold on the open market. The funds generated from this sale are deposited into an account (or even reinvested in something else). You will be required to buy back the same number of shares sometime in the future and return them to the broker. If the share price does in fact fall, you can buy back the same number of shares at a lower price at a later date – thereby creating a profit for yourself.

For example, you believe that ABC Learning has problems and you expect the share price will fall. You borrow 1000 ABC Learning shares from a broker and immediately sell them on the market for \$1.00 per share. You receive \$1000 from the sale. If at the time you buy the shares back the price has fallen to \$0.80, then it only costs you \$800 to buy the required 1000 shares and return them to the broker. This leaves you with a profit of \$200, less a little bit for expenses.

## THE RISK

But what if the share price goes up instead of down? Short selling carries potentially unlimited risk, as share prices can go higher with no limit on where they stop, and you can therefore lose much more than the initial value of the

shares you sold short. Using the previous example, say the price of the ABC Learning shares rose to \$10.00 per share instead of falling, as you had hoped. You would then be required to buy back the 1000 shares to honour the loan, at a cost of \$10,000 – which would result in a loss of over \$9,000. This is nine times the original investment!

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While shorting provides you with an opportunity to gain from a falling share price, it is not without its risks. It is important to note that buying shares and then selling them (called “going long”) has a very different risk profile from selling short. In the former case, losses are limited (the price can only go down to zero) but gains are unlimited (there is no limit on how high the price can go). In short selling, this is reversed, meaning

the possible gains are limited (the stock can only go down to a price of zero), and the seller can lose more than the original value of the share, with no upper limit.

Every short position needs someone to take the other side of the trade. This means that one of the ‘experts’ either doing the short selling or buying the stock is going to be wrong. Someone is going to lose money.

## IT GETS EVEN MORE RISKY

Another more risky form of short selling is called naked shorting. It is the practice of selling a stock short without even first borrowing the shares, or even ensuring that the shares can be borrowed, as is done in a conventional short sale. It is a very short term and highly speculative trade. If the seller cannot obtain the shares within the required time frame to actually give them to the buyer, (normally a few days after the trade took place), the result is known as a “fail to deliver”. This can occur in a volatile market, resulting in potential losses all round.



This article by Patrick Bennett (above), Head of Research.

There are conflicting views on this practice. Some claim that naked shorting can be beneficial in enhancing liquidity in difficult-to-borrow shares, and also that it adds efficiency to the securities lending market. Critics of the practice argue that it is often used for market manipulation, that it can damage companies and even that it threatens the smooth operation of the market as a whole.

## PROS AND CONS

The conventional wisdom is that short selling drives down the price of the stock being sold. Some supporters of the practice point to the fact that short selling, albeit inadvertently, may help markets stay in balance by allowing the negative sentiment to be reflected in certain stocks' prices. Some short selling is necessary to prevent prices from reflecting only the views of the most optimistic investors in the market. In doing this, short sellers moderate prices both when they are shorting and when they later cover. It is promoted as a survival of the fittest, where inherently weak companies that may be over-leveraged are sold down quicker than would otherwise be the case. Nonetheless, short selling has long been unpopular with security owners because they believe it can depress stock prices. Unless you are the one doing the short selling and benefiting from it, other shareholders may be at a disadvantage as the share price is driven lower.

Do the social benefits of speculative short selling (primarily the possibility of discovering more rational prices for overpriced securities) outweigh the costs

(primarily the possibility that prices do not reflect rational demand and supply for the shares)? The evidence is mixed. Short selling does seem to improve the pricing of some securities, while simply making others more volatile. Those effects are hard to disentangle.

## LEAVE IT TO THE EXPERTS

Short selling is a practice mainly used by hedge fund managers to try and produce profits in falling markets. It requires a high level of presumed skill and it requires a deep understanding of the merits or weaknesses of a company, a willingness to 'bet against the market' and a willingness to sustain potentially unlimited losses. This is a very real risk. As Meynard Keynes famously observed, the market can be 'wrong' for a lot longer than you can remain solvent. We do not in any way advocate advisers or clients try it. The risks are just too great.



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