CJ Investment Mini-Lessons

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# Mini-Lesson: Short Selling

With the major indices appearing ready to turn over, it looks like an appropriate time to discuss short selling as a means of making profits in a bear market.

***Definition*** In "normal" (*long* position) investing, an investor buys a security thinking that he or she can sell the security later at a higher price. Short selling *reverses* this process. The investor who sells short actually sells a "borrowed" security thinking the security's price will decline, at which time the investor can buy back the security (closing the transaction) for a capital gain.

A security can be "borrowed" from the long positions of investors' accounts held by the clearing agent, in our case Southwest Securities. The reason a security must be "borrowed" is that the regulatory agencies requiring this are preventing the amount of short sales from exceeding the amount of shares traded in the primary and secondary market exchanges (the "float"). Imagine the type of manipulation that could occur by unscrupulous investors if more shares could be sold than the total of all shares in the float! Essentially, the law of supply and demand could be invalidated. Beware: some exchanges outside the US do not have a "borrowed" stock rule.

***Differences from Long Investing:***

- There is a maximum gain from short selling of 100%.
- ***There is no theoretical maximum loss.*** As long as a short position has not been closed and the security continues to rise in price, losses can continue to increase indefinitely.
- Because of the potential unlimited loss risk, by law some accounts in the US are not allowed to sell short. Custodial accounts (UTMA's, UGMA's, etc.) and qualified retirement accounts (IRA's, Roth's, 401(k)'s, etc.) are the most common examples.
- An account must be a *margin* account in order to sell short, since the account must be able to borrow against existing assets.
- Short positions are responsible for any payments made by the underlying security. In the case of dividend paying stocks, the short seller must pay the "owner" of the long position underlying the short position dividends declared.

Selling short can be one of the few profitable tools available to use when bear markets are in force. Theoretically, selling short does carry a higher risk than long investing, but, in practice, losses would be stopped before becoming crippling, just as they should be in long investing. I wonder if the long investors in 2000-2002 felt long investing was "safer" as they lost enormous value in their portfolios' long positions?

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