



## INTEGER WEALTH GLOBAL

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### Short Selling: A definition, the Pro's and Cons.

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#### What you need to know about this investment strategy

Short selling is an investment or trading strategy speculating on a stock's decline or other security's price. It is an advanced strategy that should only be undertaken by experienced traders and investors.

Traders may use short selling as speculation, and investors or portfolio managers may use it as a hedge against the downside risk of a long position in the same security or a related one. Speculation carries the possibility of substantial risk and is an advanced trading method. Hedging is a more common transaction involving placing an offsetting position to reduce risk exposure.

In short selling, a position is opened by borrowing shares of a stock, bond, or other asset that the investor believes will decrease in value. The investor then sells these borrowed shares to buyers willing to pay the market price. Before the borrowed shares must be returned, the trader is betting that the price will continue to decline and they can purchase the shares at a lower cost. The risk of loss on a short sale is theoretically unlimited since the price of any asset can climb to infinity.

#### KEY TAKEAWAYS

Short selling occurs when an investor borrows a security and sells it on the open market, planning to buy it back later for less money.

Short sellers bet on, and profit from, a drop in a security's price. This can be contrasted with long investors who want the price to go up.

Short selling has a high risk/reward ratio; it can offer big profits, but losses can mount quickly and infinitely, often resulting in margin calls.

#### Understanding Short Selling

With short selling, a seller opens a short position by borrowing shares, usually from a broker-dealer, hoping to buy them back for a profit if the price declines. To close a short position, a trader repurchases the shares—hopefully at a price less than they borrowed the asset—and returns them to the lender or broker. Traders must account for any interest the broker charges or commissions on trades.

To open a short position, a trader must have a margin account and will usually have to pay interest on the value of the borrowed shares while the position is open. The Financial Industry Regulatory Authority (FINRA), which enforces the rules and regulations governing registered brokers and broker-dealer firms in the United States, the New York Stock Exchange (NYSE), and the Federal Reserve have set minimum values for the amount that the margin account must maintain—known as the maintenance margin.<sup>1</sup> If an investor's account value falls below the maintenance margin, more funds are required, or the broker might sell the position.

The process of locating shares that can be borrowed and returning them at the end of the trade is handled behind the scenes by the broker. Opening and closing the trade can be done through the regular trading platforms with most brokers. However, each broker will have qualifications the trading account must meet before allowing margin trading.



## Why Sell Short.?

The most common reasons for engaging in short selling are speculation and hedging. A speculator is making a pure price bet that the security will decline. If they are wrong, they will have to repurchase the shares at the higher price, thereby incurring a loss. Because of the additional risks in short selling due to the use of margin, it is usually conducted over a shorter time horizon and is thus more likely to be an activity conducted for speculation.

People may also sell short to hedge a long position. For instance, if you own call options, which are long positions, you may want to sell short against that position to lock in profits. If you want to limit downside losses without actually exiting a long stock position, you can also sell short in a stock that is closely related to or highly correlated with it.

### Example of short selling for a profit

Imagine a trader who believes that XYZ stock—currently trading at \$50—will decline in price in the next three months. They borrow 100 shares and sell them to another investor. The trader is now “short” 100 shares since they sold something that they did not own but had borrowed. The short sale was only made possible by borrowing the shares, which may not always be available if the stock is already heavily shorted by other traders.

A week later, the company whose shares were shorted reports dismal financial results for the quarter, and the stock falls to \$40. The trader decides to close the short position and buys 100 shares for \$40 on the open market to replace the borrowed shares. The trader’s profit on the short sale, excluding commissions and interest on the margin account, is \$1,000, based on the following calculations:  $\$50 - \$40 = \$10$  and  $\$10 \times 100 \text{ shares} = \$1,000$ .

### Example of short selling for a loss

Using the scenario above, let’s now suppose the trader did not close out the short position at \$40 but decided to leave it open to capitalize on a further price decline. However, a competitor swoops in to acquire the company with a takeover offer of \$65 per share, and the stock soars.

If the trader decides to close the short position at \$65, the loss on the short sale would be \$1,500, based on the following calculations:  $\$50 - \$65 = \text{negative } \$15$ , and  $\text{negative } \$15 \times 100 \text{ shares} = \$1,500 \text{ loss}$ . In this case, the trader had to buy back the shares at a significantly higher price to cover their position.

### Example of short selling as a hedge

Apart from speculation, short selling has another useful purpose—hedging—often perceived as the lower-risk and more respectable avatar of shorting. The primary objective of hedging is protection, as opposed to the pure profit motivation of speculation. Hedging is undertaken to protect gains or mitigate losses in a portfolio, but since it comes at a significant cost, the vast majority of retail investors do not consider it during normal times. The costs of hedging are twofold. There’s the actual cost of putting on the hedge, such as the expenses associated with short sales, or the premiums paid for protective options contracts. Also, there’s the opportunity cost of capping the portfolio’s upside if markets continue to move higher. As a simple example, if 50% of a portfolio that has a close correlation with the Standard & Poor’s 500 Index (S&P 500) is hedged, and the index moves up 15% over the next 12 months, the portfolio would only record approximately half of that gain, or 7.5%.

### Pros and Cons of Short Selling

Selling short can be costly if the seller guesses wrong about the price movement. A trader who has bought stock can only lose 100% of their outlay if the stock moves to zero.

However, a trader who has shorted stock can lose much more than 100% of their original investment. The risk comes because there is no ceiling for a stock’s price.



Also, while the stocks were held, the trader had to fund the margin account. Even if all goes well, traders must figure in the margin interest cost when calculating their profits.

#### **Pros**

- Possibility of high profits
- Little initial capital required
- Leveraged investments possible
- Hedge against other holdings

#### **Cons**

- Potentially unlimited losses
- Margin account necessary
- Margin interest incurred

### **Short squeezes**

When it comes time to close a position, a short seller might have trouble finding enough shares to buy—if many other traders are shorting the stock or the stock is thinly traded. Conversely, sellers can get caught in a short squeeze loop if the market, or a particular stock, starts to skyrocket.

On the other hand, strategies that offer high risk also offer a high-yield reward. Short selling is no exception. If the seller predicts the price moves correctly, they can make a tidy return on investment, primarily if they use margin to initiate the trade. Using margin provides leverage, which means the trader does not need to put up much of their capital as an initial investment. If done carefully, short selling can be an inexpensive way to hedge, providing a counterbalance to other portfolio holdings.

Beginning investors should avoid short selling until they get more trading experience. That being said, short selling through exchange-traded funds (ETFs) is a safer strategy due to the lower risk of a short squeeze.

### **Additional Considerations with Short Selling**

Besides the risk of losing money on a trade from a bond or stock's price rise, short selling has additional risks that investors should consider.

#### **Shorting uses borrowed money**

Shorting is known as margin trading. When short selling, you open a margin account, which allows you to borrow money from the brokerage firm using your investment as collateral. 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 and forced to put in more cash or liquidate your position.<sup>1</sup>

#### **Wrong timing**

Even though a company is overvalued, its stock price could take a while to decline. In the meantime, you are vulnerable to interest, margin calls, and being called away.



## Short squeeze

If a stock is actively shorted with a high short float and days-to-cover ratio (more on that below), it is also at risk of experiencing a short squeeze.

A short squeeze happens when a stock begins to rise, and short sellers cover their trades by buying their short positions back. This buying can turn into a feedback loop. Demand for the shares attracts more buyers, which pushes the stock higher, causing even more short sellers to buy back or cover their positions.

## Regulatory risks

Regulators may sometimes impose bans on short sales in a specific sector, or even in the broad market, to avoid panic and unwarranted selling pressure. Such actions can cause a sudden spike in stock prices, forcing the short seller to cover short positions at huge losses.

## Going against the trend

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 or the rate of price increase in the economy should drive its stock price up somewhat. This means that shorting is betting against the overall direction of the market.

## Costs of Short Selling

Unlike buying and holding stocks or investments, short selling involves significant costs in addition to the usual trading commissions that have to be paid to brokers. Some of the costs include:

### Margin interest

Margin interest can be a significant expense when trading stocks on margin. Since short sales can only be made via margin accounts, the interest payable on short trades can add up over time, especially if short positions are kept open over an extended period.

### Stock-borrowing costs

Shares that are difficult to borrow—because of high short interest, limited float, or any other reason—have “hard-to-borrow” fees that can be quite substantial. The fee is based on an annualized rate that can range from a small fraction of a percent to more than 100% of the value of the short trade and is prorated for the number of days that the short trade is open.

As the hard-to-borrow rate can fluctuate substantially from day to day and even on an intraday basis, the exact dollar amount of the fee may not be known in advance. The fee is usually assessed by the broker-dealer to the client’s account either at month-end or upon closing of the short trade. If it is quite large, it can make a big dent in the profitability of a short trade or exacerbate losses on it.



## Dividends and other payments

The short seller is responsible for making dividend payments on the shorted stock to the entity from which the stock was borrowed. For shorted bonds, they must pay the lender the coupon or interest owed. The short seller is also on the hook for making payments because of other events associated with the shorted stock, such as share splits, spinoffs, and bonus share issues, which are unpredictable.

## Short Selling Metrics

Two metrics used to track short-selling activity on a stock are:

- The short interest ratio (SIR)—also known as the short float—measures the ratio of shares that are currently shorted compared to the number of shares available or “floating” in the market. A very high SIR is associated with stocks that are falling or stocks that appear to be overvalued.
- The short interest-to-volume ratio—also known as the days-to-cover ratio—is the total shares held short divided by the average daily trading volume of the stock. A high value for the days-to-cover ratio is also a bearish indication for a stock.

Both short-selling metrics help investors understand whether the overall sentiment is bullish or bearish for a stock.

For example, after oil prices declined in 2014, General Electric Co.’s (GE) energy divisions began to drag on the performance of the entire company. The short interest ratio jumped from less than 1% to more than 3.5% in late 2015 as short sellers began anticipating a decline in the stock. By the middle of 2016, GE’s share price had topped out at \$33 per share and began to decline. By February 2019, GE had fallen to \$10 per share, which would have resulted in a profit of \$23 per share for any short sellers lucky enough to short the stock near the top in July 2016.<sup>2</sup>

## Short-Selling Regulations

In the U.S., short selling is regulated by the U.S. Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934. Regulation SHO, implemented in 2005 to update previous rules, is the primary rule governing short selling. Regulation SHO mandates that short sales can only be executed in a tick-up or zero-plus tick market, meaning the security price must be moving upward at the time of the short sale.<sup>3</sup>

Another key component of Regulation SHO is the locate requirement. Before executing a short sale, brokers must locate a party willing to lend the shorted shares, or they must have reasonable grounds to believe that the shares could be borrowed. This prevents naked short selling, where investors sell shares they have not borrowed.<sup>3</sup>

The SEC also has the authority to impose temporary short-selling bans on specific stocks under certain conditions, such as extreme market volatility.<sup>4</sup>

In October 2023, the SEC announced new rules to increase transparency in short selling. The regulations require investors to report their short positions to the SEC and companies that lend shares for short selling to report this activity to FINRA.

These new rules come after increased scrutiny of short selling, particularly following the GameStop (GME) meme stock saga in 2021, when retail investors drove up the stock price, causing losses for hedge funds that had shorted the company. The SEC plans to publish aggregate stock-specific data on a delayed basis, which would provide a fuller picture of market-wide short bets. However, some hedge funds have expressed concerns that these rules could expose investors’ strategies.



## Short-selling regulations outside the US

Short-selling regulations vary across jurisdictions outside the U.S.

**European Union:** In the European Union (EU), the European Securities and Markets Authority (ESMA) oversees short selling. The EU has a two-tier model, where positions exceeding 0.2% of issued shares must be disclosed to regulators, and those exceeding 0.5% must be publicly disclosed. 5

**United Kingdom:** The United Kingdom's Financial Conduct Authority (FCA) is the regulatory body overseeing short selling. Generally, the regulations are similar to those of the EU. 6

**Hong Kong:** The Securities and Futures Commission (SFC) regulates short selling in Hong Kong. Short selling is only allowed for designated securities and must be backed by borrowed shares. Naked short selling is illegal. 7

- **Japan:** The Financial Services Agency (FSA) oversees short selling in Japan. Short selling is allowed only at a price higher than the latest market price. 8
- **Australia:** The Australian Securities and Investments Commission (ASIC) mandates that short positions exceeding \$100,000 or 0.01% of total shares must be reported. 9

## Ideal Conditions for Short Selling

Timing is crucial when it comes to short selling. Stocks typically decline much faster than they advance, and a sizable gain in the stock may be wiped out in a matter of days or weeks on an earnings miss or other bearish development. The short seller thus has to time the short trade to near perfection. Entering the trade too late may result in a huge opportunity cost for lost profits since a major part of the stock's decline may have already occurred.

On the other hand, entering the trade too early may make it difficult to hold on to the short position in light of the costs involved and potential losses, which would skyrocket if the stock increases rapidly. There are times when the odds of successful shorting improve, including:

### During a bear market

The dominant trend for a stock market or sector is during a bear market. So traders who believe that “the trend is your friend” have a better chance of making profitable short-sale trades during an entrenched bear market than they would during a strong bull phase. Short sellers revel in environments where the market decline is swift, broad, and deep, like the global bear market of 2008–2009, because they stand to make windfall profits during such times.

### When stock or market fundamentals are deteriorating

A stock's fundamentals can deteriorate for several reasons—slowing revenue or profit growth, increasing challenges to the business, and rising input costs that pressure margins, for example. For the broad market, worsening fundamentals could mean weaker data that indicate a possible economic slowdown, adverse geopolitical developments like a threat of war, or bearish technical signals like new highs on decreasing volume.

Experienced short sellers may prefer to wait until the bearish trend is confirmed before putting on short trades rather than doing so in anticipation of a downward move. This is because of the risk that a stock or market may trend higher for weeks or months in the face of deteriorating fundamentals, as is typically the case in the final stages of a bull market.



## Technical indicators confirm the bearish trend

Short sales may also have a higher probability of success when the bearish trend is confirmed by multiple technical indicators. These indicators could include a breakdown below a key long-term support level or a bearish moving average crossover like the death cross.

An example of a bearish moving average crossover occurs when a stock's 50-day moving average falls below its 200-day moving average. A moving average is merely the average of a stock's price over a set period of time. If the current price breaks the average, either down or up, it can signal a new trend in price.

## Valuations reach elevated levels amid rampant optimism

Occasionally, valuations for certain sectors or the market as a whole may reach highly elevated levels amid rampant optimism for the long-term prospects of such sectors or the broad economy. Market professionals call this phase of the investment cycle "priced for perfection," since investors will invariably be disappointed at some point when their lofty expectations are not met. Rather than rushing in on the short side, experienced short sellers may wait until the market or sector rolls over and commences its downward phase.

John Maynard Keynes was an influential British economist whose economic theories are still used today. Keynes once said, "The market can stay irrational longer than you can stay solvent," which is particularly apt for short selling. It can be hard to predict, but the optimal time for short selling is when there is a confluence of the above factors.

## Short Selling's Reputation

Short selling is sometimes criticized, and short sellers are sometimes viewed as ruthless operators out to destroy companies. However, the reality is that short selling provides liquidity—meaning enough sellers and buyers—in markets and can help prevent bad stocks from rising on hype and over-optimism. This benefit can be seen in asset bubbles that disrupt the market. Assets that lead to bubbles, such as the mortgage-backed security (MBS) market before the 2008 financial crisis, are frequently difficult or nearly impossible to short.

Short-selling activity is a legitimate source of information about market sentiment and demand for a stock. Without this information, investors may be caught off-guard by negative fundamental trends or surprising news.

Unfortunately, short selling gets a bad name due to the practices employed by unethical speculators. These unscrupulous types have used short-selling strategies and derivatives to deflate prices and conduct bear raids on vulnerable stocks artificially. Most forms of market manipulation like this are illegal in the U.S. but still happen periodically.

Put options provide a great alternative to short selling by enabling you to profit from a stock price drop without the need for margin.

## Real-World Example of Short Selling

Unexpected news events can initiate a short squeeze, which may force short sellers to buy at any price to cover their margin requirements. For example, in October 2008, Volkswagen briefly became the most valuable publicly traded company in the world during an epic short squeeze.<sup>10</sup>

In 2008, investors knew that Porsche was trying to build a position in Volkswagen and gain majority control.



Short sellers expected that once Porsche had achieved control over the company, the stock would likely fall in value, so they heavily shorted the stock. However, in a surprise announcement, Porsche revealed that they had secretly acquired more than 70% of the company using derivatives, which triggered a massive feedback loop of short sellers buying shares to close their position.

Short sellers were at a disadvantage because 20% of Volkswagen was owned by a government entity that wasn't interested in selling, and Porsche controlled another 70%, so there were very few shares available on the market to buy back the stock. Essentially, both the short interest and days-to-cover ratio exploded overnight, which caused the stock price to jump from the low €200s to more than €1,000.

But a short squeeze tends to fade quickly, and within several months, Volkswagen's stock had declined back to its normal range.

### **Why Do Short Sellers Have to Borrow Shares.?**

Since a company has a limited number of shares outstanding, a short seller must first locate some of those shares to sell them. The short seller, therefore, borrows those shares from an existing long and pays interest to the lender. This process is often facilitated behind the scenes by one's broker. If there are not many shares available for shorting, then the interest costs to sell short will be higher.

### **Is Short Selling Bad?**

While some people think it is unethical to bet against the market, most economists and financial professionals agree that short sellers provide liquidity and price discovery to a market, making it more efficient.

### **Can I Sell Short in My Brokerage Account.?**

Many brokers allow short selling in individual accounts, but you must first apply for a margin account.

### **What Is a Short Squeeze.?**

Because in a short sale, shares are sold on margin, relatively small rises in the price of the stock can lead to even more significant losses. The holder of the short position must buy back their shares at current market prices to close the position and avoid further losses. This need to buy can work to bid the price of the stock even higher if there are many people trying to do the same thing. This can ultimately result in a short squeeze.

### **The Bottom Line**

Short selling allows investors and traders to make money from a down market. Those with a bearish view can borrow shares on margin and sell them in the market, hoping to repurchase them at some point in the future at a lower price.

While some have criticized short selling as a bet against the market, many economists believe that the ability to sell short makes markets more efficient and can actually be a stabilizing force. Technical traders and analysts often look at a stock's short interest and other ratios involving short positions to inform trading ideas. However, large short positions can become squeezed due to margin calls.





The buying that is required to close short positions can force prices higher and accelerate a rally, making losses to shorts even more severe.