SHORT SELLING

Short selling (or "selling short") is a technique used by people who try to profit from the falling price of a stock. Short selling is a very risky technique as it involves precise timing and goes contrary to the overall direction of the market. Since the stock market has historically tended to rise in value over time, short selling requires precise market timing, which is a very difficult feat.

Here's how short selling works. Assume you want to sell short 100 shares of a company because you believe sales are slowing and its earnings will drop. Your broker will borrow the shares from someone who owns them with the promise that you will return them later. You immediately sell the borrowed shares at the current market price. When the price of the shares drops (you hope), you "cover your short position" by buying back the shares, and your broker returns them to the lender. Your profit is the difference between the price at which you sold the stock and your cost to buy it back, minus commissions and expenses for borrowing the stock. But if you're wrong, and the price of the shares increase, your potential losses are unlimited. The company’s shares may go up and up, but at some point you have to replace the 100 shares you sold. In that case, your losses can mount without limit until you cover your short position.

Here are a few reasons why short selling might make sense.

- Some investors are better at identifying overpriced, bad companies than underpriced, good companies.
- Brokers and analysts focus on what to buy, not what to sell, so the good news is more widely known than the bad news. When an analyst issues a sell recommendation on a stock, they find it much harder to get information from the company's investor relations department, and the analyst's firm would never get an opportunity to raise capital or float a bond for the company, so they focus more on good news than bad. If you discover bad news, it might not yet be totally factored in to the current price of the stock.
- Many institutions just won't do short selling, leaving unexploited short selling opportunities from which you can benefit.

- A portfolio which includes both long and short positions in stocks which tend to move together will generally have lower volatility than one which has only long positions.

But short selling is not as easy and profitable as it may sound; there are a lot of caveats.

- As we mentioned, there's unlimited downside potential (i.e. if the stock price keeps rising, you keep losing). Most short sellers set a limit to how much they're willing to lose, but then they become vulnerable to a short 'squeeze', in which long investors buy shares as the stock rises and demand delivery. As short sellers buy to cover their losses, the price continues to rise, triggering more short sellers to cover their losses, etc. This is a risk especially for small, illiquid companies. The danger is that even if the stock is overpriced, it may become even more overpriced, and you will have to buy it at some point to cover your position. When you sell short, you're not just betting on what the stock is worth, you're betting on what the market will be willing to pay for the stock in the future.
- You're fighting the trend of the market, which is, in the long run, up. When you buy a stock that you're confident is greatly undervalued, you should feel content to wait as long as it takes for the dividends to start rolling in (provided you have a sufficiently long investment horizon). When you're on the short side, however, you will eventually need to buy the shares back, at whatever the market price happens to be; and while you wait and wait for the speculative bubble to burst, the rest of the market will probably continue on its upward trajectory.
- SEC rules allow investors to sell short only on an uptick or a zero-plus tick. In other words, you cannot sell a stock short if it is already going down. This rule is in effect to prevent traders known as "pool operators" from driving down a stock price through heavy short selling, then buying the shares for a large profit.
- Money from a short sale isn't available to the seller, but is escrowed as collateral for the owner of the borrowed shares. You aren't earning interest on the money (although big institutions sometimes do, in the form of rebates).

- You have to pay any dividends that are earned (since in effect you have a negative number of shares).
- You pay the (usually higher) short term capital gains tax on your profits, regardless of how long you held the short position.
- Another company could acquire the company you're shorting, possibly at a significant premium, which would drive up the share price.
- Sometimes shares aren't available to short.

🗝 5.2 VOCABULARY NOTES AND COMMENTARIES

selling short "коротка" продаж; продаж цінних паперів без покриття

short "squeeze" "короткий стиск"

position позиція

short position коротка позиція (при грі на зниження – обсяг зобов'язань за терміновими угодами)

to cover shorts покривати коротку позицію

collateral забезпечення, гарантія

uptick (plus tick) rule правило"плюс тік"

margin маржа

margin account маржовий рахунок

margin call вимога про внесення додаткових коштів на маржовий рахунок (для покриття збитків щодо нього)

✍ 5.3 INSERT THE WORDS (change the word form if necessary):

to short sell, margin call, "up-tick" rule, cheap, high, "short squeeze", to cover, collateral, to lend, to borrow, margin account, short sale, long.

1. You must have a **…** with your broker before you can short stocks.
2. This means you must maintain the proper **…** in this account or you may be subject to a **….**
3. In order to sell stock short you will have to comply with the so-called **….**
4. This rule states that your **…** must be executed at a **…** price than the transaction

immediately preceding it.

5. This is intended to prevent the **…** of stock that is already declining in price so as to avoid sending the stock price into a free-fall.
6. Many traders have been burned by the much-feared ….
7. Buying stock by some investors induce others with short positions … them by re-purchasing and replacing the stock.
8. When you buy a stock in the hope that it will increase in price, you are said to be … the stock.
9. An investor "sells short" a particular stock by requesting a broker … him the shares.
10. You are said to be "short" a stock, which you **…** in the expectation that you can return or replace this stock at a **…** price in the future.

✍ 5.4 INSERT THE PREPOSITIONS WHERE NECESSARY

When someone shorts a stock (sometimes called "selling short"), they borrow shares **…** a company **…** an investor and sell those borrowed shares **…** the current market price. The hope is that the stock price will fall so the short seller can repurchase the stock **…** a lower price and pay back the person they borrowed **…**.

*Example***:** You decide to short 10 shares **…** a stock that costs $50. You enter a short order with your broker, who borrows the stock **…** another one **…** his or her clients. Once you have the borrowed shares, you sell them. Since you didn't own those shares, you are going to have to pay the owner back **…** a short amount of time. The stock price falls **…** $40, so you purchase the shares. This costs you $400 [10 shares x $40 per share] and give them back **…** the original owner. Since you sold their shares **…** $50 earlier, you made $500 [10 shares you borrowed x $50 per share]. Your profit is the difference **…** the two, **…** this case, $100 [because $500 - $400 = $100].

5.5 CHOOSE THE RIGHT VARIANT TO SUBSTITUTE THE UNDERLINED WORDS AND WORD COMBINATIONS

1. These borrowed shares are then sold on the open market and **the proceeds** deposited to the investor's account.

profit

return

income

outcome

2. If the stock **subsequently** falls in price, the investor replaces the shares at a cheaper price.

later

lately

late

of late

3. On the other hand, if the price of the shares rises, the investor will be obligated to replace the shares at a higher price **thereby** suffering a loss.

thus

that is why

since

further

4. This potential loss will be **unlimited** in theory as there is no limit to how far a stock price may rise.

oceanic

bottomless

unrestricted

great

5. This extra buying demand will **push up** the price of the stock further.

advise in

advise about

advise on

advise for

6. It is **obvious** that short selling can be highly profitable.

manifest

evidence

statement

disclosure

7. If the price does rise, the investor will still be required to cover the short sale and pay the market price **regardless of** how high the price goes.

in spite of

despite of

in spite

without regard

8. The **difference** between the two prices (less commissions and other transaction costs) is the investor's profit.

spread

sprang

sprat

spout

9. **Because** the shares are borrowed, the investor must replace and return the shares to the lending broker at some point in the future.

for

therefore

as for

as far

10. There is significant risk **involved** because there is no limit on how high a stock price may rise.

entail

enfold

include

contain

11. The trader does not currently **own** any shares of the stock.

possess

dispose

propose

obtain

12. This trader thinks the stock price will **go down**.

be knocked down

be knocked out

be knocked away

be knocked behind