Short Selling

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In investing parlance, going long a security means the holder of the position will profit if the price of the security goes up. Basically, buying low and selling high.

Short selling is the practice of betting against a security. Short sellers profit from a decline in the price of the security. This is accomplished by selling high and buying low.

A short sale involves borrowing shares from your broker, then immediately selling it in the market. The short-seller then purchases the shares at the new, lower price and return them to the lender. The difference between the initial selling price and the subsequent price is the gain from shorting – or the loss, if the price went up instead of down. If you get out of a short at a loss, you must cover (buy back and return your borrowed shares).

Economics of Shorting

When you go long a stock, your downside is 100% (the stock goes to zero) and your upside is infinite profits (the stock keeps rising).

When you go short a stock, your upside is 100% (the stock goes to zero) and your downside is infinite (the stock keeps rising).

The maximum payoff of an unlevered short position is 2:1 but your downside is bankruptcy. Also, while you wait for your short to play out, you are also responsible for all the dividends that the company pays out.

Given those payoffs, why take the risk?

He that sells what isn't his'

Must buy it back or go to prison.

- Daniel Drew, stock manipulator

Popular Arguments for Shorting

- Having a short book allows you to be more aggressive on the long side
- Enormous psychic rewards
- Some bubbles are plain obvious
- Some businesses are frauds/playing accounting games
- Hedge against a market decline

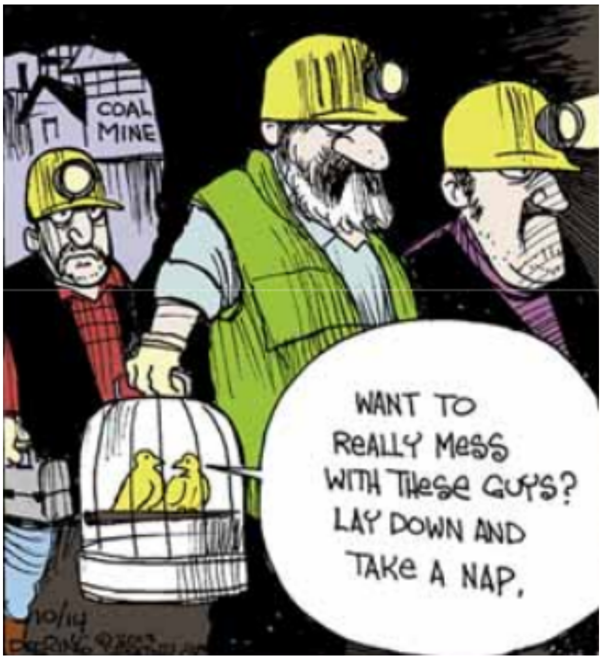
Role of Short Sellers

There is nothing fundamentally evil or unethical about betting against a company. If you're *good*, you can make money shorting over-valued stocks of companies run by promotional and fraudulent management teams. But it's stressful and requires constant monitoring.

However, short sellers perform a socially useful role in the capital markets. They help with price discovery and market transparency.

By selling overvalued stocks, they can dampen bubbles as they emerge; by repurchasing the same stocks as they fall, they provide a soft landing. Imagine a country that is long-only. They're going to have bubbles after bubbles. In fact, only when there was a mechanism to go short housing (the launch of ABX index in 2006) did the bubble in single family home prices pop.

Good short sellers such as Jim Chanos (publicly shorted Enron) can act as a canary in the coal mine. The shareholders who listened and sold have been big beneficiaries.



I believe the SEC could benefit from an open door policy with the short selling community where concerns about the economy, balance sheets, accounting issues etc. can be shared. But, not all short sellers are created equal – not all are worth listening to. For instance, if someone spreads false rumors about a company in order to make an investment gain, then they should be prosecuted.

Shorting is hard

Short sellers usually look for dishonest management, low or negative growth, weak margins and returns on capital, ugly balance sheets and weak competitive advantages – all at a high valuation. On the surface this seems like the opposite of long investing. In reality, it's much harder and way more dangerous.

Dad, why don't you just short your longs and long your shorts? If only it were that easy…

- David Einhorn

When you short, you are borrowing both time and money. If your timing is bad, you can be right and yet lose all your money.

The stock price of a fraudulent company may drop 99% in 3 years from where you shorted but may rise 200% in the interim, thus wiping you out.

A mistaken short grows to be a larger and larger percentage of your portfolio. Therefore, a short cannot be a long term position. Conversely, if you are wrong on a long, it becomes a smaller percentage of your portfolio.

Overall, shorting is tax inefficient, stressful, hard, financially risky and on top of it all you have the long-term upward trend of the market which works against you.

> *'You'll see way more stocks that are dramatically overvalued than dramatically undervalued. It's common for promoters to cause a stock to become valued at 5-10 times its true value, but rare to find a stock trading at 10-20% of its true value. So you might think short selling is easy, but it's not. Often stocks are overvalued because there is a promoter or a crook behind it… [As a short seller] you could run out of money before the promoter runs out of ideas.*
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> *Everything we've ever thought about shorting worked out eventually, but it's very painful. It's a whole lot easier to make money on the long side. You can't make big money shorting because the risk of big losses means you can't make big bet.'*

- Warren Buffett, BRK Annual Meeting 2001