ABOUT SHORT SELLING

What is Short Selling

Traditionally the premise of investing is that you buy an asset and hold it until it rises enough to make a sizable profit, it doesn't get much easier than that. What about the times you come across a stock that you wouldn't invest a penny in, you know that stock is doomed, a sure loser. If you knew that the stock was going to decline wouldn't be nice to be able to profit from its decline.
Well you can profit from the decline of a stock and although it sounds easy, there are substantial risks and pitfalls that you need to watch out for. The mechanics of a short sale are somewhat complicated and the investor's risks are high so it is important that you understand the transaction before getting into it.

What does it mean to sell short?

If you sell a stock you don't own, you are selling short. (Yes, it's legal.) You are now short the stock.

A short seller sells a stock that he believes will fall in value. A short seller does not own the stock before he sells it. Instead, he borrows it from someone who already owns it. Later, the short seller buys back the stock he shorted and returns the stock to close out the loan. If the stock has fallen in price since he sold short, he can buy the stock back for less than he received for selling it. The difference is his profit.

Short selling allows investors to profit from falling stock prices. "Buy low, sell high" is the goal of both short selling and purchasing shares ("going long"). A short sale reverses the order of a typical stock purchase: the stock is sold first and bought later.

For example, in March 2002, Andy thinks HLL is overvalued. He sells short 100 shares of HLL at Rs. 250 per share. The stock market crashes in April and HLL's share price falls to Rs. 210 per share. Andy buys back 100 shares of HLL and closes out the short sale. Andy gains the difference between the sales proceeds and the purchase costs and pockets Rs. 4,000 from the short sale, excluding transaction costs.

Where Does The Broker Get The Stock?

The short answer is from other customers or the Stock Holding Corp. of India.

Short selling is a marginable transaction. In plain English, that means you must open a margin account to sell short. This is the same account you would use if you want to use your stocks as collateral margin to trade in the markets.

When you open a margin account, you must sign an agreement with your broker. This agreement says you will maintain a cash margin or pledge your stocks as margin.

How Do I Sell Short?

Unlike a stock purchase transaction, which involves two parties (the buyer and the seller), short selling involves three parties: the original owner, the short seller, and the new buyer. The short seller borrows shares from the original owner, and immediately sells them on the open market to any willing buyer. To finalize ("close out") the short sale transaction, the short seller must then go out into the stock market and buy the same amount of shares as he sold so that the broker can return them to the original owner.

To sell short you first must set up a margin account with your broker. A margin account allows you borrow from your brokerage company using the value of your portfolio as collateral. The general rule is that the value of your portfolio must equal at least 50% of the size of the short sale transaction. In other words, If you have Rs. 100,000 worth of stock/cash in your margin account, you can borrow Rs. 200,000 of stock to sell short.

To sell a stock short, you must borrow stock. To initiate a short sale, you simply call up your broker and ask to sell short a specific number of shares of your selected stock. Your broker then checks with the Margin Department to see whether the shares are available or can be borrowed. If they are available, the brokerage borrows the shares, sells them in the open market, and puts the proceeds into your margin account. To close out your short sale, you tell your broker that you want to buy the same number of shares that you shorted. The broker will purchase the shares for you using the money in your margin account, return the shares and close out the short sale transaction.

While your short sale is outstanding, your account will be charged interest against the value of the short position. If the stock you shorted goes up in price, or the value of the stock you are using as collateral goes down in price, so that your collateral is less than the "maintenance" requirement you will be required to add money to your margin account or buy back the stock that you sold short. You must also pay any dividends issued by the company

whose stock you sold short.

Why Sell Short?

The two primary reasons for selling short are opportunism and portfolio protection. Occasionally investors see a stock that they believe has been hyped to a ridiculously high level. They believe that the stock price will fall when reality replaces the hype. A short sale provides the opportunity to profit from the overpriced stock. Short sales are also used to protect an investor's portfolio against a market downturn. By shorting stocks that the investor believes will fall sharply when the market as a whole falls, investors can help insulate the value of their portfolios against sudden market drops.

Short selling is also used to protect portfolios against erosion due to a broad market decline. Short sellers make money when stock prices fall. An investor can diversify a long portfolio by adding some short positions. The portfolio will then have positions that make money both when prices rise and when they fall. This reduces the volatility in the portfolio's returns and helps protect the value of the portfolio when prices are falling.

By shorting carefully selected stocks that are priced near their peak but that will fall sharply if the market falls, an investor can use the profits from the short sales to help offset losses in his long position to protect the value of his portfolio.

Short selling just like long buying is essential for proper functioning of the stock market. It provides essential liquidity which in turn leads to proper price discovery.