Module 16 Article

How To Short A Stock

Key Terms

- **Short Squeeze**: A rapid increase in the price of a stock causing shorters to buy back their borrowed stock due to margin calls and to prevent greater losses.
- **Covering A Position**: Buying back borrowed shares from an original short position in order to no longer be short a particular stock.
- **Hedging**: Reducing risk in portfolio by buying one asset and shorting another.

The Basics

Once you're comfortable with traditional investing- that is, purchasing shares of companies that you believe will generate future profits and returns, now it's time to discuss the opposite! Shorting a stock is a way to profit from the decline of a company's share price.

Short sellers borrow shares of the company they are betting against from a broker, sell those shares at the current price, and then buy them back at a later date to give back to the lender. If the share price does drop, the short seller collects the difference between the higher and lower price. This model has the potential for significant profits, depending on the timing of the short.

Quick Calculations

Say you're convinced that all Americans will become vegetarian in the next two years, putting all meat packing companies out of business. You establish a short position in a meat packing establishment, and borrow 10 shares at $7 each from your broker. If you later buy back and return the shares at $2 each, you earn a profit of $50.

Why Go Short?

Investors take short positions to profit from declines either across the market or in a specific sector or company. Short positions can also mitigate risk in a portfolio. However, short selling is best attempted by experienced or institutional investors. As much potential as short selling has to result in profit, there is infinite potential for loss as well.

The Bottom Line

Shorting allows investors to capitalize on market downturns by borrowing the stock from a shareholder and selling it with a promise to repurchase later.

Losses with shorting can technically be unlimited, so proceed with caution before shorting a stock. Hedge funds and experienced investors take short positions to protect long term gains and sometimes they get big returns.