MODULE 16

The Opposite of Buying: Shorting

Shorting a stock allows investors to earn money when a stock's price declines. Investors short a stock at a certain price with the expectation that the price will fall. This allows them to sell the stock by borrowing it from another investor. When the stock's price drops, investors cover their short by repurchasing shares.

But be warned... ***It's a little more complicated and a lot more risky.***

POWERED BY

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Key Takeaways From This Module

Guiding Questions

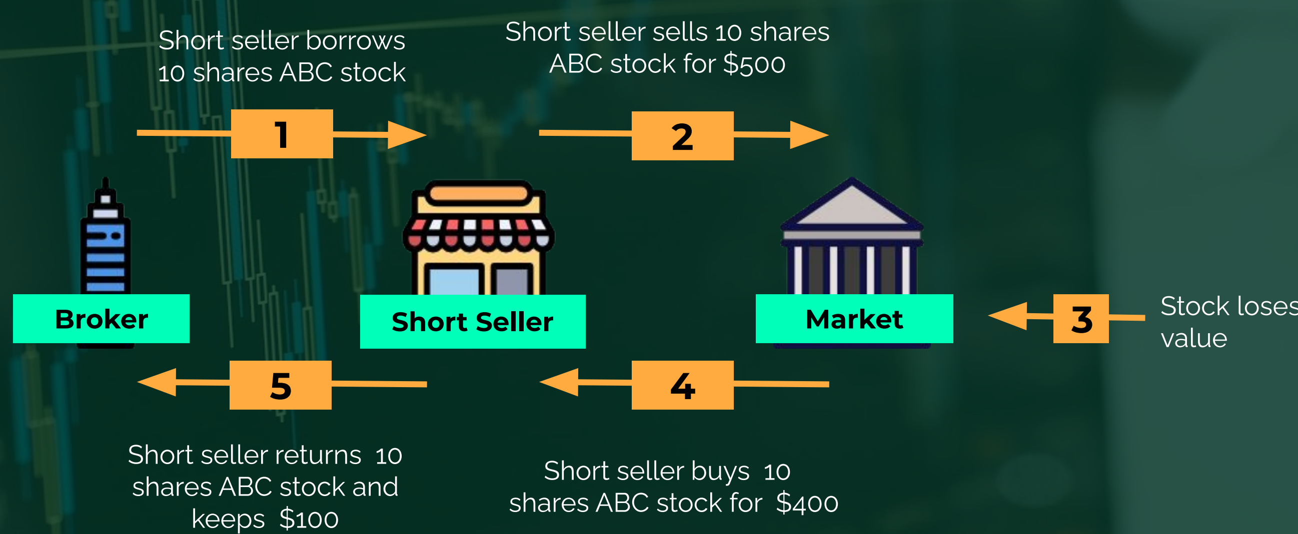
- How do investors choose what to invest in and what happens if the investor believes a stock price will decline?
- What does it mean to short a stock and how can investors leverage shorting as a tool?
- How do investors make money from shorting?
- What are the risks associated with shorting?
- Why is shorting a stock more risky than just owning a stock and hoping the price increases?

Enduring Understandings

- Shorting can be thought of as the opposite of investing, because an investor will earn a profit if the price per share decreases instead of increasing.
- Shorting occurs on margin, which means investors who short a stock use debt to do so, because they must first borrow the stock.
- For inexperienced investors, shorting can lead to significant losses.
- When shorting a stock, your risk is unlimited because a stock's price can increase infinitely.

How Shorting Works

Short selling consists of an investor borrowing a stock and selling that stock. Then the investor buys the stock back and returns it to the lender. The investor is hoping that the price of the stock will decrease so that they make money from selling what they borrowed.



Don’t Forget About Dividends

When shorting a company, you do not get dividends paid to you like when owning a normal stock. In fact, you may be on the hook for paying the dividend if you’re not careful!

If a short seller does not close their position before the stock's ex-dividend date, they will have to pay the dividend amount on the pay date to the individual who lends them the share of
0 stock they shorted.

This can be costly for short sellers who are holding a large number of shares, especially if they are short a stock with a high dividend yield.

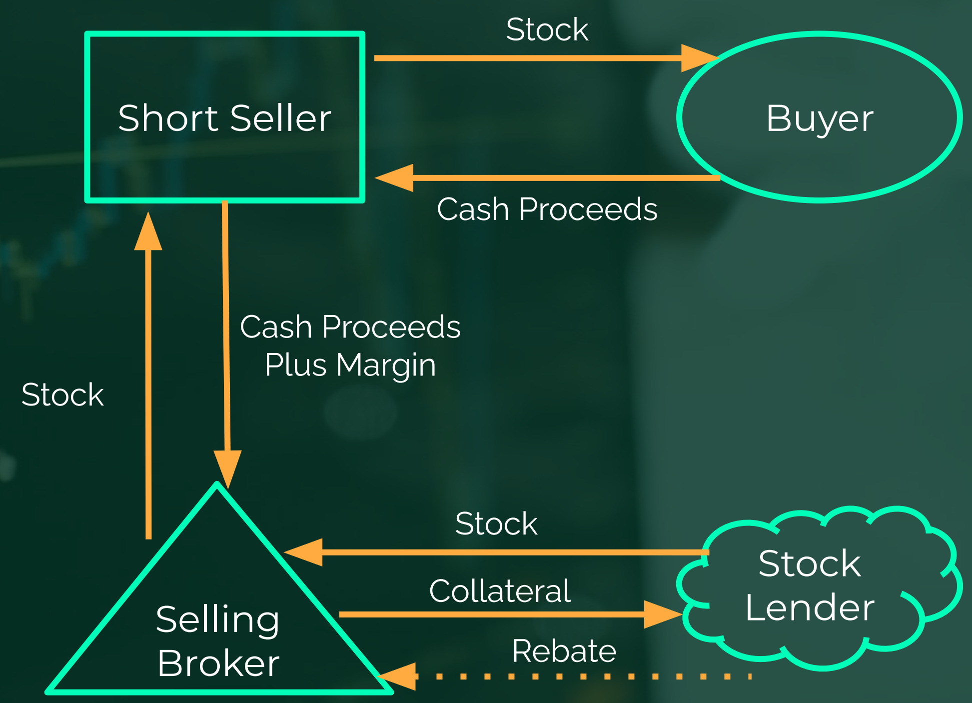
In the worst situations, if a short seller does not have enough cash in their account to cover the dividend, the brokerage will issue a margin call and their position will be closed immediately.

Who Makes Money While You Short?

When shorting a stock, you have to maintain a **margin account** with the brokerage firm that you are using to short. This account provides **assurance to the brokerage firm that any losses will be covered.**

Brokerage firms also **accrue interest while shorts are out** so they make money either way the share price moves.

Process of Short Selling



The Perils of Shorting A Stock

Margin Interest

You will incur **margin interest** for the period you have your shorts out. This will be deducted from some of your gains from the short so you need to **ensure that you are making more than the fees.**

Unlimited Losses

Shorting brings **potentially unlimited losses** because if the stock skyrockets then you will be liable for a large amount of money.

Short Squeeze

A short squeeze is where all of the shares of a company are purchased and **there are no shares for the people with shorts to buy**. This causes the price to jump drastically.

Key Takeaways From This Module

CORE & FUNDAMENTALS

- Investors who wish to short a stock, initially borrow shares to sell, and then ideally buy them back at a lower price in the price.
- Stockbrokers lend shares to investors and charge a percentage interest fee, which is called margin.
- The risks of shorting a stock are theoretically infinite, which makes shorting a risky trading strategy.

APPLIED KNOWLEDGE

- Shorting can lead to high returns but comes with an infinite amount of risk because a stock price can always go up.
- It is best to short companies that show multiple signs of financial ineptitude because these companies will not perform well in the future.
- Investing is like betting on the success of a company, while shorting is betting on failure.

RELEVANCE FOR YOU

- As you become more comfortable with normal investing, you can figure out metrics to find stocks you'd like to short
- Shorting is a great way to add higher returns to your portfolio, but remember that with higher returns comes higher risk!
- When shorting a stock, your risk is unlimited because a stock's price can increase infinitely.