What Is Short Selling?

Short selling is an investment or trading strategy that speculates on the decline in a stock or other security's price. It is an advanced strategy that should only be undertaken by experienced traders and investors.

In short selling, a position is opened by borrowing shares of a stock or other asset that the investor believes will decrease in value by a set future date—the expiration date. The investor then sells these borrowed shares to buyers willing to pay the market price. Before the borrowed shares must be returned, the trader is betting that the price will continue to decline and they can purchase them at a lower cost. The risk of loss on a short sale is theoretically unlimited since the price of any asset can climb to infinity.

## Understanding Short Selling

To open a short position, a trader must have DEMAT ACCOUNT and will usually have to pay interest on the value of the borrowed shares while the position is open. ﻿

To close a short position, a trader buys the shares back on the market—hopefully at a price less than what they borrowed the asset—and returns them to the lender or broker. Traders must account for any interest charged by the broker or commissions charged on trades.

The process of locating shares that can be borrowed and returning them at the end of the trade is handled behind the scenes by the broker. Opening and closing the trade can be made through the regular trading platforms with most brokers. However, each broker will have qualifications the trading account must meet before they allow margin trading.

As mentioned earlier, one of the main reasons to engage in short selling is to speculate. Conventional long strategies (stocks are bought) can be classified as investment or speculation, depending on two parameters—(a) the degree of risk undertaken in the trade, and (b) the time horizon of the trade. Investing tends to be lower risk and generally has a long-term time horizon that spans years or decades. Speculation is a substantially higher-risk activity and typically has a short-term time horizon.

## Short Selling for a Profit

Imagine a trader who believes that XYZ stock—currently trading at $50—will decline in price in the next three months. They borrow 100 shares and sell them to another investor. The trader is now “short” 100 shares since they sold something that they did not own but had borrowed. The short sale was only made possible by borrowing the shares, which may not always be available if the stock is already heavily shorted by other traders.

A week later, the company whose shares were shorted reports dismal financial results for the quarter, and the stock falls to $40. The trader decides to close the short position and buys 100 shares for $40 on the open market to replace the borrowed shares. The trader’s profit on the short sale, excluding [commissions](https://www.investopedia.com/terms/c/commission.asp) and interest on the margin account, is $1,000: ($50 - $40 = $10 x 100 shares = $1,000).

## Short Selling for a Loss

Using the scenario above, let's now suppose the trader did not close out the short position at $40 but decided to leave it open to capitalize on a further price decline. However, a competitor swoops in to acquire the company with a takeover offer of $65 per share, and the stock soars. If the trader decides to close the short position at $65, the loss on the short sale would be $1,500: ($50 - $65 = negative $15 x 100 shares = $1,500 loss). Here, the trader had to buy back the shares at a significantly higher price to cover their position.

**Naked short selling:**

A naked short sale happens when the trader indulges in shorting without borrowing the stock or arranging to borrow them. When the trader does not borrow the shares before the clearing period, he is unable to tender the shares to the buyer. The trade is then considered “failed to deliver” unless the trader either closes the position or borrows the stock. Naked short selling is illegal in most countries as it defies demand and supply rules. If conducted in vast quantities, a naked short sale can destabilise the market.

This is usually done in intraday trading where a trader sells a stock at higher price and buys it the same day on a comparatively lower price. Here he does not have to borrow the shares as the settlements are done on the next day and the net position after selling and buying is zero.

## Pros and Cons of Short Selling

Selling short can be costly if the seller guesses wrong about the price movement. A trader who has bought stock can only lose 100% of their outlay if the stock moves to zero.

However, a trader who has shorted stock can lose much more than 100% of their original investment. The risk comes because there is no ceiling for a stock’s price, it can rise to infinity and beyond. Also, while the stocks were held, the trader had to fund the margin account. Even if all goes well, traders have to figure in the cost of the margin interest when calculating their profits.

When it comes time to close a position, a short seller might have trouble finding enough shares to buy—if a lot of other traders are also shorting the stock or if the stock is thinly traded. Conversely, sellers can get caught in a short squeeze loop if the market, or a particular stock, starts to skyrocket.