

A SIMPLE GUIDE TO SHORT SELLING

What is short selling ('shorting')?

The value of assets (such as stocks) varies over time, reflecting underlying performance and broader market conditions. Short selling ('shorting') is a form of investment that can profit if the underlying asset falls in value, making it possible to deliver a positive return for an investor even when market conditions are challenging.

The most common technique is to borrow an asset (for a fee) and then sell it, hoping that the price for that asset will fall, so you can buy it back for less money, before returning it to the original owner. If correct, the strategy can make money from assets that are depreciating. The risk is that if the investor wrongly predicts a fall in price, and an asset has instead risen in value, the position will lose money.

Investors use short selling for a variety of reasons, from looking to profit from assets they believe will fall in value, to hedging, a strategy used to reduce volatility or potential losses from other investments, although the potential risks of short selling can be higher compared to other investing. It is also a highly flexible form of investment that can be applied to various financial instruments, including:

Stocks	Indices	Currencies	Commodities
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How does it work?

1. Borrowing: An investor agrees to 'borrow' an asset, such as a stock, agreeing terms like loan duration, lending fee, and any collateral requirements, usually through a broker. This is a temporary transferral of ownership and the party borrowing the shares is not entitled to any dividend payment from shares they borrow.

2. Shorting: The borrower sells the acquired asset on the open market, effectively 'shorting' it. While they have no actual position in the asset, they retain a contractual obligation to return it to the owner.

3. Repayment: To close the position, the borrower buys back the same number of shares that they borrowed (known as 'covering' a short) and returns them to the lender. The difference between the sale and repurchase price determines the profit or loss they make.



Derivatives use in short selling

'Physically' borrowing stock is not the only way to short an asset. Taking short positions can involve the use of 'derivatives', which are generally more complex types of investment than simply holding or borrowing shares.

Typically, investors look to strike a balance between seeking profits and the amount of risk they take, relative to their broader investment strategy and risk appetite.

The use of derivatives comes with a financial cost, but they enable a manager to increase or decrease the risk being taken when making an investment.

Short selling using derivatives can be executed using various types of instruments, such as futures contracts, options, or different types of 'swaps', such as equity swaps and contracts for difference (CFDs). Equity swaps are commonly used for hedging purposes, or to replicate the performance of an index. CFDs are usually for shorter-term, more speculative trades.

Example 1 – CFDs:

Consider an investor who believes the price of Clothing Store Inc, a retail business, is about to fall. Rather than borrowing a stock via a broker, the investor can take a short position by using swaps. The example we use here is CFDs.

A CFD is a contract that mirrors the price movement of the underlying asset. With CFDs, an investor does not actually buy or own the asset, even temporarily. Instead, they make an agreement with another investor, broker, or investment bank, to pay each other the difference if the price of an asset rises or falls.

For an investor taking a short position in a CFD, if the price of the underlying asset falls, they effectively 'buy back' the CFD at the lower price, making a profit. If the

price of the underlying asset increases, the investor buys back the CFD at the higher market price, making a loss.

- CFDs can be a cheaper or more flexible way to take a short position, given the relatively small upfront cost.
- They can be used for different assets, such as stocks, commodities or currencies. They can be highly flexible on their terms, and if both parties agree, they can also be rolled over (renewed).
- Costs can escalate, due to ongoing financing fees (such as overnight funding charges) particularly if the investor uses leverage (borrowing) to magnify their exposure.

Example 2 – Equity swaps:

In their simplest form, equity swaps are a type of derivative where one party agrees to pay the return on a stock or equity index and the other agrees to pay a fixed or variable 'floating' interest rate (eg. SOFR). This is effectively an exchange of cash flows, based on how one or more underlying assets perform over a set period of time.

Much like CFDs, investors do not have to own or borrow stock to take a position. They can just take offsetting positions with other investors, with an agreement in place to settle any relevant change in price for the underlying asset (plus any dividends), once the existing contract reaches its end date.

- Equity swaps have a pre-determined duration and cannot be renewed. This acts as a built-in limitation on their potential outcome.
- The interest rate (fee) can be paid at regular intervals, or at the end of the contract.
- If the performance of the underlying asset, plus any dividend, is less than the pre-agreed fee, the 'short' effectively generates a profit.
- If the underlying stock performs well, delivering a return higher than the agreed fee, the 'short' investor settles the difference, effectively losing money.

Things to consider

Short selling differs to just buying and holding shares in a company (a 'long' position). What are some of the key features to keep in mind?

- By using short selling, investors can take positions that reflect their views on assets across the market cycle, rather than just those assets that they expect to rise in value over time. If they are correct, they can make a profit when assets are falling in value.
 - When investors buy shares in a firm, their losses are limited to the money invested to buy that stock. When taking a short position, profits are limited by how far a stock can fall in value. But should the price of the underlying stock increase, losses can quickly escalate for the short seller with, in theory, no limit to how high a stock can rise.
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- Short selling can help to maintain a healthy market by drawing attention to stocks that might arguably be inflated by excessive optimism, while also helping to support market liquidity.
 - A short seller can limit their potential losses through various trading strategies such as using 'out of the money' call options (another form of derivative), or a stop-loss order, where a position is automatically closed if the price of the underlying asset rises to a pre-determined level. Investors can also increase their exposure using leverage (borrowing) to amplify potential gains or losses.
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How can investors use short selling in their portfolios?

Short selling can be a time-consuming strategy that relies on constant monitoring, extensive research, and a strong trading discipline. While it is possible for individual investors to take short positions, it is generally considered a 'sophisticated' investment technique usually utilised by experienced (professional) investors and investment funds:

Absolute return (long/short) funds: A type of investment vehicle that aims to deliver a positive ('absolute') return to investors, regardless of market direction, generally with lower volatility than by just holding stocks – although a positive return is not guaranteed. With this aim in mind, absolute return funds tend to be benchmarked against the return (interest) available from holding cash on deposit. Absolute return funds may make use of more complex instruments and techniques to manage risk.

Broker: Investors can take short positions by using a brokerage firm, which requires holding a certain amount of collateral to cover a portion of any unexpected losses (margin requirement), which may also need to be topped up (margin calls). This allows investors to borrow assets, which the broker can then trade (sell). When an investor is ready to close their position, the broker buys back the asset to the required amount (at the prevailing market price) and settles the trade.

Hedge funds: Probably the most recognisable investment vehicle that utilises short selling, commonly employing it as part of a strategy that combines 'long' positions (assets held in the expectation that they will rise in value over time) and short positions. Hedge funds can often use highly complex strategies, incorporating various methods to manage risk exposure and volatility.

Market makers and institutional investors: Short sellers need to borrow assets that they can sell, and this need is often met by institutional investors, such as insurance companies, mutual funds, pension funds, or brokers, who receive a fee, and possibly interest, for lending out their assets for short selling.

“ An absolute return strategy aimed at delivering consistent real returns, irrespective of market trends, and equipped to yield positive outcomes even in downturns, can play an important role to help navigate today's unpredictable financial waters.”

Luke Newman, Portfolio Manager

At a glance

- ✓ Short selling is a complex investment strategy commonly used by investment funds and professional investors.
- ✓ The use of 'short' positions allows a profit to be made if the value of a stock, index, commodity or currency falls.
- ✓ Short positions can help to improve diversification across a well-balanced portfolio.
- ✓ As part of an actively managed absolute return strategy, short positions can be used as a tool to help manage risk and exposure throughout the market cycle.
- ✓ While short positions can generate significant performance, the potential losses are higher. The use of more complex instruments and techniques can help to manage that risk.

By speaking to a financial adviser, you can discuss whether such an investment may be right for you.

Glossary

- **Absolute return investing:** A type of investment strategy that seeks to generate a positive return over time, regardless of market conditions or the direction of financial markets, typically with a low level of volatility.
- **Active investing:** An investment management approach where a fund manager actively aims to outperform or beat a specific index or benchmark through research, analysis and the investment choices they make.
- **Contract for difference (CFD):** A financial contract between two parties where the profit or loss depends on the changing price of an underlying security, with the difference paid in cash. It provides exposure to the benefits and risks of taking a long or short position in a security, without needing to own it.
- **Derivative:** A type of financial instrument where the price is derived from one or more underlying assets, such as shares. It is a contract between two parties. It does not imply any ownership of the underlying asset(s). Instead, it allows investors to take advantage of price movements in the asset(s).
- **Hedge:** A trading strategy that involves taking an offsetting position to another investment that will lose value as the primary investment gains, and vice versa. These positions are used to reduce or manage various risk factors and limit the probability of overall loss in a portfolio. Various techniques may be used, including derivatives.
- **Liquidity:** Liquidity is a measure of how easily an asset can be bought or sold in the market. Assets that can be easily traded in the market in high volumes (without causing a major price move) are referred to as 'liquid'.
- **Long position:** A security that is bought in the expectation it will rise in value, such as purchasing shares in a company.
- **Macroeconomics/Microeconomics (macro):** Macroeconomics is the branch of economics that considers large-scale factors related to the economy, such as inflation, unemployment or productivity. Microeconomics is the study of economics at a much smaller scale, in terms of the behaviour of individuals or companies.
- **Margin account/requirement:** A requirement to establish an account with a broker to hold eligible assets as collateral for any short selling activity. There is a minimum capital requirement for the value of that collateral.
- **Margin call:** A demand from a broker to an investor using a margin account, to deposit additional funds to meet minimum capital requirements.
- **Short position:** Fund managers use this technique to borrow then sell what they believe are overvalued assets, with the intention of buying them back for less when the price falls. The position profits if the security falls in value. Derivatives can be used to simulate a short position.
- **SOFR (Secured Overnight Financing Rate):** A benchmark interest rate that reflects the cost of borrowing cash overnight, secured by US Treasury bonds.
- **Volatility:** The rate and extent at which the price of a portfolio, security or index, moves up and down. If the price swings up and down with large movements, it has high volatility. If the price moves more slowly and to a lesser extent, it has lower volatility. It is used as a measure of the riskiness of an investment.

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