

## >: Protect Your Short

Tuesday, October 16, 2007 / Jason Jovine

I am not a huge fan of shorting stocks. When you short a stock, it means that you are bearish on the underlying stock; you think the stock will decrease in price.

More specifically, selling short involves the sale of securities that you don't even own. In other words, you borrow the securities from the brokerage firm that you are doing business with, in anticipation that these securities will decline in value.

If the securities can be purchased at a later time for a lower price, you will make money on the short sale. On the other hand, if the securities increase in value, you will need to buy the securities back at a greater price and will lose money on the trade.

### **How do you get to sell a stock that you don't even own?**

The brokerage firm provides short sellers with stock that the firm has borrowed from another margin customer's account. The other customer has given consent to lend the stock by signing a loan consent agreement at the time that the account was opened.

If you sell a stock short, you are obligated to return the shares that you borrowed. You are also responsible for paying back any dividends that are received on the stock while you are borrowing it.

When you short, you are, of course, utilizing margin. In other words, you are borrowing money from the firm. You will also be responsible for paying margin interest on the amount borrowed.

**Example:** Let's say you anticipate a decline in price and decide to sell short 1,000 shares of XYZ stock at \$20. Later, XYZ goes to \$15 per share, and you decide to cover your short (buy back the stock that you borrowed). You will realize a \$5,000 profit, less any dividends that were paid out on the stock while you had it and any interest paid on the money that you borrowed (i.e. \$10,000). In other words, you usually need to initially put up half of the money with a short position.

On the other hand, let's say that XYZ goes against you. Let's say that it goes to \$30 per share instead, and you decide to cover your short. You will have to buy the stock back at \$30 and will lose \$10,000 plus any dividend paid to the stock and interest received on it.

Shorting stocks can be great, but it obviously carries a whole lot of risk. We should know by now that risk and reward go hand in hand.

In our previous example, the maximum reward is \$20,000. XYZ stock could theoretically go to zero and you would make \$20,000. On the other hand, the maximum risk is theoretically infinite. The sky is the limit as to how high XYZ could go in price.

Obviously, you would and could cover your short if things started going against you. The scary part is, what if the stock shot up really fast? (e.g. Out of the blue the company had great news like they were awarded a huge contract, etc.) Or what if you didn't want to cover your position so soon and wanted to ride the short out for a longer period of time?

### **What could you do?**

There are really two things that you could do.

- 1) You could buy some call option contracts on the short. In other words, since you bought 1,000 shares of XYZ stock, to hedge against a rise in XYZ's price, you would buy 10 call option contracts on XYZ. This way, if the stock went up instead of down as you originally planned, you would be losing money on the stock but making money on the option contracts.
- 2) You could do a Buy Stop Order. A buy stop order is placed above the current market price. It is typically used to limit a loss or protect a profit on short sales.

Getting back to the XYZ example. You would place a buy stop order, say at \$25 per share. If XYZ trades at \$25 or above, this buy stop order will be activated, and you will buy 1,000 shares at the market. Keep in mind that you are not guaranteed an execution price, but you are guaranteed that the position will be closed out (i.e. your short will be covered). This buy stop order will limit your loss to around \$5,000. You do it for protection

from too much of a loss.

If you don't have the stomach to short stocks, but believe that a stock will go down in price, you can always just buy puts.

**Until the next time folks, spend your hard-earned money wisely.**

**P.S. I wrote an [article last week](#).**

**I was off by one letter on the symbol I gave you for Barclays Global Investors muni ETF, and some of you pointed it out. The symbol should have been ?MUB?, not ?MUN?. Thanks for paying attention. Jason**



Jason Jovine  
Chief Investment Officer

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