Biotech Daily
Marc Sinatra's Bioguide

April 1, 2008

SHORT SELLING OR SELLING YOURSELF SHORT?

I wanted to include a section on short selling in the article on margin lending in yesterday's edition, but ran out of space. In the meantime, several readers have raised question about short selling.

Short selling is a process whereby an investor can profit when the price of a share falls.

To do this, the investor borrows stock from a shareholder, pays the shareholder a fee, sells the stock, buys the stock back within a predetermined time and returns it to the original shareholder. If the price of the stock goes down, the short seller makes money and, if it goes up, they lose money. Easy, right?

Maybe an example will help. BioXYZ's share price is $5 and I have 1000 shares worth $5000. My friend, Grigory Rasputin (MBA), knows (expects) the share price will fall. He borrows my 1000 shares and gives me a fee of $200. He then sells them for $5 each and when they hit $2.50, buys them back and returns them to me. He makes $2,500 minus the $200 fee and we are all happy, except my portfolio is down $2,500.

Short selling has been blamed, in part, for the share price woes of a number of companies, especially ABC Learning which I used as an example in yesterday's article.

So, is short selling bad?

When based on company fundamentals, short selling has a positive effect on markets. It allows more people with an understanding of a stock to influence its price, leading to a more efficient (accurate) market. Efficiency decreases risk, which, in turn, ultimately increases share prices.

But it is not for the ignorant, impecunious, or faint-hearted.

There are situations where short selling can have undue detrimental effects and this generally occurs where investment strategies are not based on company fundamentals.

It is believed that hedge funds heard that some ABC Learning directors, including Eddy Groves, had very large margin loans on their holdings. These funds are believed to have short sold ABC shares to the point where the directors had to dump stock as the result of the margin calls. The hedge funds then bought the stock for much less then they sold it.

The main point is that the hedge funds actions would have been unlikely to have altered ABC's share price in the medium term because their selling and buying actions would have canceled each other out - if it wasn't for the directors' margin loans.

Changes to regulations regarding short selling and margin loans are being looked at and some changes are probably needed. It should to be remembered, though, that short selling and margins loans are not the root causes of the current set of problems.

The root cause is investors taking risks that force them to sell their stock.

marc@biotechdaily.com.au