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Building wealth through shares

EMAIL BULLETIN No2

December 1999

This Newsletter was also sent out in response to requests from readers of Shares magazine to an offer to send additional information on the meaning of the terms “long”, “short” and on short selling, a concept not well understood by most share investors in Australia.

In response to your request for more information on the terms “long” and “short” and the concept of short selling, I hope this further explanation is of assistance in understanding these things:

“Long”, “Short”, Short Selling

Understanding “Long” and “Short”

Going Long and Making a Profit

To go long means that we buy an asset with a view to making a profit by selling it later at a higher price.

Monday: We buy 1000 shares in XYZ Ltd at \$1.00
We are now said to be long 1000 XYZ at \$1.00

Friday: We sell the 1000 shares in XYZ Ltd at \$2.00
We are now said to have closed our long position.

Result: Proceeds of sale minus cost of purchase
 $(1000 \times 2.00) - (1000 \times 1.00) = \$ 1000$
As the result is positive, we have made a profit.

Going Long and Making a Loss

A loss is made on a long position, if we sell what we bought at a lower price than we paid for them.

Monday: We 1000 shares in XYZ Ltd at \$2.00
We are now said to be long 1000 XYZ at \$2.00

Friday: We sell the 1000 shares in XYZ Ltd at \$1.00
We are now said to have closed our long position.

Result: Proceeds of sale minus cost of purchase
 $(1000 \times 1.00) - (1000 \times 2.00) = \text{Minus } \$ 1000$
As the result is negative, we have made a loss.

Going Short and Making a Profit

To go short means that we sell an asset with a view to making a profit by later buying it at a lower price.

Monday: We sell 1000 shares in XYZ Ltd at \$2.00
We are now said to be short 1000 XYZ at \$2.00

Because we do not own what we sold, we borrow the stock from a shareholder to deliver to the purchaser.

Friday: We buy 1000 shares in XYZ Ltd at \$1.00
We are now said to have closed our short position.

We now repay the shares that we borrowed on Monday.

Result: Proceeds of sale minus cost of purchase
 $(1000 \times 2.00) - (1000 \times 1.00) = \$ 1000$
As the result is positive, we have made a profit.

Going Short and Making a Loss

A loss is made on a short position, if you we buy what we sold at a higher price than we sold them for.

Monday: We sell 1000 shares in XYZ Ltd at \$1.00
We are now said to be short 1000 XYZ at \$1.00

Friday: We buy 1000 shares in XYZ Ltd at \$2.00
We are now said to have closed our short position.

Result: Proceeds of sale minus cost of purchase
 $(1000 \times 1.00) - (1000 \times 2.00) = \text{Minus } \$ 1000$
As the result is negative, we have made a loss.

Derivative Markets

In futures markets it is not necessary to borrow stock, because we are always trading a contract. If we buy a contract to take delivery of an asset on a future date, we are long (just like signing a contract to buy a car for delivery next week). If we sell a contract to make delivery of an asset on a future date, then we are short (just like signing a contract to sell our house for settlement in six weeks time). We reap our profit or loss by selling the contract we bought or buying back the contract we sold.

The process in option and warrant markets is similar.

Call options and call warrants are contracts giving the owner the option, but not the obligation, to buy shares before a specified date for a specified price. They will generally rise in value if the price of the underlying shares rises.

Put options and put warrants are contracts giving the owner the option, but not the obligation, to sell shares before a specified date for a specified price. They will generally rise in value if the price of the underlying shares falls. They can therefore be used for shorting the underlying shares, or hedging a position held in the underlying shares.

Short Selling Australian Shares

Introduction

There is a common misconception that you cannot short sell shares in the Australian market. There are good reasons for this.

One reason is that the ASX, for some reason, seems very reluctant to tell anyone about it. In researching this section, the writer was unable to obtain any assistance from the ASX other than the offer to allow him to purchase a copy of the rules.

Some brokers are also reluctant to give information about it. One of the writer's brokers even refuses to execute short sales. However, another of his brokers was more than helpful. Possibly, brokers are reluctant to handle the additional procedures, but more likely, they see themselves as trying to protect investors from themselves. This springs from the logical idea that, if you go long, your potential loss is limited, while your potential profit is unlimited. However, if you go short, your potential loss is unlimited, while your potential profit is limited.

This logical idea is true in theory:

- In a long trade, the worst that can happen is that you lose 100% of your capital. However there is unlimited profit opportunity, because there is no theoretical limit to how high prices can go.
- In a short trade, the best that can happen is that price falls to one tick, so you make 100% on your capital (assuming no leverage). However, there is no limit to your potential losses, because there is no theoretical limit to how high prices can go.

Indeed, the history of financial markets is littered with stories of famous “short squeezes”, where short sellers found that all of the remaining stock was held by a “corner”. Alternatively, short sellers found that they had shorted more stock than was issued. In these situations, there is no practical limit to the price that can be demanded by a holder from short sellers desperate to close their positions. However, as will be shown below, the rules for short selling on the ASX make it very difficult to establish a “corner” and for all practical purposes, such a possibility can be discounted.

Nevertheless, short selling has features that make it more risky than trading from the long side. This article is not written to encourage anyone to short sell shares. It is simply to inform readers, who might otherwise not be aware that short selling is a factor in the Australian share market. The writer can not be aware of the personal and financial circumstances of any reader, so is not making any recommendation in this article. Readers wishing to short sell shares should seek advice from their broker and/or financial adviser.

Which Stocks may be Sold Short

Not all stocks may be sold short. This is part of the ASX protection against corners. Moreover, the list is changed by the ASX quite regularly. At August 1997, there were 225 stocks on the “Approved Securities” list. The basic guidelines are:

- The stock must have at least 50 million shares on offer
- The stock must have a capitalisation of at least \$100 million
- The ASX must be satisfied with the level of liquidity.

If a stock meets these guidelines, it will most likely be on the list. As the list changes all the time, there is no point listing the stocks here. However, any broker should be able to provide an up to date list.

Limits on Short Selling

There are restrictions on how many shares may be sold short. A short sale of an Approved Security may not be made if the sale would have the effect of causing more than 10% of the issued number of shares to be sold short. This, combined with the guidelines described above, is the major way in which the abuses of the past can be avoided.

There is one other important limitation on executing a short sale. That is the ASX requirement that a short sale not be made at a price lower than the price at which the last sale took place. This is designed to prevent short sellers driving the price down. It can make it difficult to do a short sale in a weak market.

Procedures and Requirements for Short Selling

Firstly, the short seller must inform the broker in advance that the order is to sell short. The broker then has the responsibility to ensure that the stock is on the Approved Security list and that the number of shares is within the 10% limit. When the deal is executed, the sale is flagged to the market as a short sale with the parameter “S”. It is also shown on the contract note as a short sale.

Secondly, the broker must secure from the short seller a margin of 20% or more of the value of the short sale, which is held in trust until the short sale is covered by repurchasing the shares. The margin may be in the form of cash or listed securities. In the case of securities, they are counted at up to 90% of their market value, the actual discount being at the discretion of the broker. Should the price of the shares sold short rise by 10%, the broker will require additional cash or up to 90% of the value of securities to be lodged to bring the margin back to 20%. Similarly, if the value of the securities lodged as margin falls, additional margin will be required. The broker also has the power to at any time call for margin to the extent of the entire cost of covering the short position. If this call is not met promptly, the broker has the power to cover the position on the short seller’s behalf.

Thirdly, the broker and the short seller have a responsibility to deliver scrip on the T+5 rules. This is done by borrowing stock, naturally at a cost. This process carries a risk and is costly to monitor and maintain, so additional fees may be charged by the broker. Generally, the short seller is also required to pay the lender any dividends and the lender may also be entitled to any attaching franking credits, which, if the short seller cannot supply, must be settled in cash in addition to the amount of the dividend. The cost of borrowing scrip can, of course, be offset by the income from placing the up to 80% of capital not required as margin on the money market.

Most brokers will also require the short seller to sign a "Risk Disclosure" agreement similar to that required by the Australian Options Market.

Conclusion

It is possible to short sell Australian shares and it happens all the time. The advantage may lie in the fact that markets generally fall much more quickly than they rise. However, the process is more complicated than taking a long position and does involve greater risk.