Short Selling Australian Stocks

The 45-year old billionaire pulled his mobile phone out of his pocket, and proceeded to post a tweet that was targeted for trading rooms around the world.

Some traders who read it grinned wryly - not unlike the grin that was on the billionaire's face as he pressed send. But other traders squirmed uncomfortably as they read the words. For them it was an unwelcome reminder that they were currently hemorrhaging money.

The billionaire delivering the message was the world famous Elon Musk, both creator of the revolutionary electric Tesla motorcar, and head of SpaceX, the company which was rewriting the rulebook on how we explore the realms of outer space.

The four-word message that Musk tweeted was simply: "Stormy weather in Shortville".

This article explores why such a simple message carried so much impact.

Short Selling – Wat Is It?

Elon Musk's reference to "Shortville" was his humorous twist on an activity that's been going on in financial markets for a long time. It's called "short selling", "going short" or simply "shorting".

Now, in order to successfully explain what short selling is, I need you to read the following words very carefully. That's because the first time someone tried to explain it to me (in a trading room in Sydney over 30 years ago) my head started to hurt.

Short selling means selling something that you don't actually own. In terms of financial markets that could be pretty much anything – shares, currencies, oil futures, bonds and so the list goes on and on. The principles underlying the activity of short selling are much the same for any commodity or financial instrument that you wish to name. But I'm going to limit discussion in this article to the short selling of shares.

So *why would you*, and come to think of it *how could you*, actually sell shares that you don't even own?

Why Sell Something You Don't Even Own?

Traders short sell because they believe that a company's share price is heading south. They sell it now at a high price with the aim of buying it later at a lower price, so pocketing the difference between the two prices. It's pretty much the opposite of how investors usually go about things – that is by buying at a low price and hoping to sell later at a higher price.

And this explains why Elon Musk was grinning as he posted his tweet – the one directed at those traders in "Shortville". The traders had sold short Tesla shares. Musk knew that all who short a stock (sell) must eventually buy an equal number of shares to close out their short position (you can't simply sell and then do nothing). And since Tesla's share price was rocketing (sorry about that) the traders who were short Tesla were staring down the barrel of huge potential losses.

How Can You Sell Something You Don't Even Own?

Short selling just doesn't sound right does it? So clearly the question needs to be asked – is it legal in this country? The answer is yes and no. Let me explain.

There are basically two types of short selling. They are referred to as covered short sales and naked short sales. And no, the distinction has nothing to do with the state of dress or undress of the trader when executing the trade.

A naked short sale refers to selling shares when there is no offsetting form of ownership of those shares. And that's illegal.

But the Corporations Act does allow the second type of short sale; that is covered short sales. This is where, prior to the sell order being executed, a share lending arrangement is entered into. That arrangement is established between the person or entity planning to undertake the short sale and a third party (who does presently own the shares). The Act describes this as a *"presently exercisable and unconditional right to vest the securities in the buyer".* Basically what it means is the short seller pays a third party (who owns the shares) to enter into an agreement with them so that they can borrow the third party's shares for a while. Then the short sale is Kosha. And hence the term "covered".

What Will They Think Of Next?

If you think this all sounds like another New Age, whizzbang, 21st century, digitally driven creation of some Y-Gen financial Quant nerd then you'd be wrong. Short selling shares has been with us for centuries – in fact for four centuries.

The first time that shares were freely traded between stock-punters (like shares are today) was in 1602 when shares in The Dutch East India Company were created. And it was only six years later, in 1608, that Antwerp merchant, Isaac Le Maire, organized a syndicate to short sell Dutch East India stock. Le Maire probably didn't realise it at the time but he kicked off a craze that became a really big thing. Short selling has been a favourite sport of traders (and hedgers, but that's another story) ever since.

Has Short Selling Been Given a Bum Wrap?

Over the past 400 years short sellers have copped more abuse than an umpire at a Carlton – Collingwood match. The simple fact is that there are lots of people who believe that short selling is the scourge of the financial markets. There's nothing new about this view but, by way of example, consider the recent outburst from Gerry Harvey, the Chairman of Harvey Norman. Following a 15% plunge in Harvey Norman's share price in mid-March Harvey lashed out at short sellers claiming they were partly responsible for the price plunge. (Gerry has a track record of getting upset with those who threaten his bank balance – he recently referred to Amazon as "parasites".)

The reality is that short sellers are always active but most of the time people don't really care about what they're up to. But attitudes towards short selling can change very quickly, especially when people start losing money (hence Gerry's outburst). Broad based investor sentiment can also turn against short sellers when the whole stock market is in meltdown as happened in 1987 and 2008/2009.

In fact, if you look back in history, short selling has been implicated, to some degree or other, in just about every past stock market crash you can name. The first legislation banning it was by the Dutch authorities in the wake of Isaac Le Maire's 1608 raid.

Flicking further through the annals of history (or alternatively through my book *UnCommon Sense – Investment Wisdom since the Stock Market's Dawn*) we find that the English government also banned it the year after the infamous South Sea Bubble of 1720. It legislated *"an Act to restore Publik Credit"* which, amongst other things, restricted investors from shorting stock by selling forward shares they didn't currently possess.

And so the legislation train has been rolling on through the centuries. Governments typically introduce bans on short selling in the wake of financial calamities only to later lift them as the public consciousness fades.

Many investors, both past and present, have questioned the morality of short selling. That is, is it fair to profit from another's loss? To me their case is ill considered. As a counter argument simply reflect on how most other people hope to make money in the share market – that is to buy low and ultimately sell high. Have not they profited at the expense of another? Has not the person or people who sold given up profits (to the buyer) that they might have otherwise received?

It seems that when people are making lots of money in a rising market there is no concern about short sellers. Yet when the market turns south everyone is seeking scapegoats. And short-sellers are an easy target. After all, they're the ones who are smiling when everyone else is feeling pain.

The Final Word

There are two last things that I want to say:

Firstly retail investors are allowed to short sell. But it takes effort, a solid understanding of the process and it involves way more risk than a simple buy-and-hold strategy does. So if you're interested don't just jump in. Do lots of homework, engage a good broker and please take baby steps.

Secondly, The Australian Securities & Investments Commission (ASIC) publishes, on their web site, a regularly updated list of Aussie companies which are "being shorted". What's more it details the percentage of the company's shares that are. It's called the "Short position reports table" and it contains some interesting information - so take a look here:
http://asic.gov.au/regulatory-resources/markets/short-selling/short-position-reports-table/

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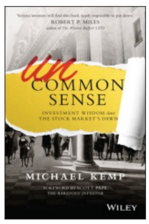

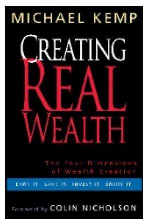

Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.