WealthCE

Short Equity

Short sales fit into your toolbox as a multi-pronged trade strategy. Shorts allow you to earn returns from falling investments and overvalued securities. Short Sellers borrow shares from their broker and sell the shares at a high price. Short sellers watch the value of shares decrease, then buy the shares at a lower price and return them to the broker. The difference between the high sale and the lower buy equal the short seller's profit, before any fees or commissions paid.

Your selection for short sales is important, since the risk for loss occurs when prices rise. Shorts are a leveraged maneuver since they are initiated by borrowing shares, which increases the downside to risk. You should avoid using leverage to short shares, or margin short sales. Potential losses suffered with short sales are already theoretically infinite. Share prices can rise forever, but they can only fall to zero. This means that short selections must be valid on their own standing. It also implies you should never linger in a short sale after profits since you are giving shares recovery time. If a price rise occurs during a short, you are better off closing out if you are debating whether you should or not.

Shorting requires both bad or deteriorating fundamentals and a list of potential negative situations that are likely to occur on the near horizon. If a firm is hurtling towards calamity, shorting the firm can be profitable. This should only occur if there is little or no chance of a turnaround in price. The riskiest moves for short sales are targeting firms that are likely to increase in price or to be acquired by another firm in the near term.

Wisely picking shares for a short sale is critical to success. Shares should be selected on fundamentals and the prospect that they are overvalued. If you can identify additional events which are likely to spark mass sales of shares, such as failing to meet estimated growth projections, you should pay careful attention to trends and news surrounding that firm's shares. Timing the short is critical if short sales are subject to "uptick rules". Uptick rules states that shares can only be used for a short if the last price movement was an upward tick (upward price movement). The rule slow mass short sales that can fuel market downturns. As of 2014, there is no uptick rule in the United States.

Short Sales: Analysis Indicators

There are many indicators that you can use to judge whether a firm's shares are preparing for a downfall in price. The more of these you can identify, the better your chances of a short sale situation occurring. Fundamental and Ratio changes should identify firms, but they are not enough to warrant shorting shares. The success of the short is ultimately based on demand. You are betting that the market price of shares will fall, potentially that shares are overvalued, and that other investors will realize this and unload their shares. This requires that other investors see the investment as bad and desire to unload their positions. You should still find potential firms based on downward movement and identify potential blowup events for firm values. These fundamentals, ratios, and events can result in short-sale setups. They are not a guarantee that shares will decline in price.

Fundamentals are listed throughout the Income, Balance, and Cash flow statements. If these fundamental changes are occurring then a firm may be a candidate for short sale. Beginning with the income statement, you will seek firms with falling or static revenue and for rising expenses. Costs of goods sold should be increasing as a percentage of actual revenue, the number increasing on its own means very little. Sales, general, and administrative costs will be rising as a percentage of revenue, preferably spiking. The firm's interest expenses will also be rising, both overall and as a percentage of revenue. This indicates the costs of debt are catching up to the firm, and has strong impact when revenue is falling. Earnings per Share should be decreasing while the above signs are occurring. There are also signs from the balance sheet. The short term debt will be high, especially long term debt due. Additions to Retained Earnings will be decreasing. The Cash Flow statement will show decreasing cash flow from operations, or negative operational cash flow. This will be accompanied with rising cash flow from financing and balance sheet liabilities, especially Long Term Debts.

If these signs are combined with high capital expenditure requirements and depreciation requiring reinvestments soon, they may indicate substantial problems on the horizon.

You should also pay attention to the following ratios to indicate a firm may be a short sale candidate. These ratio changes are strong indicators if multiple appear at once, especially combined with trending poorly fundamentals over time. Much like fundamental changes, these signs do not automatically indicate a share should be short sold immediately, since the success of the short is ultimately based on demand. The first indicator is a strong decrease in current ratios or quick ratio, especially if the Current Ratio is already close to 1, or the Quick Ratio is below 1. You will also look to turnover to indicate negative signs. Decreasing Inventory Turnover indicates a slowing demand for products and potentially slowing revenue. Decreasing Asset Turnover will indicate a firm has slowing efficiency. Falling Return on Assets indicates the same slowing efficiency. If interest costs are the same or rising while return on assets are decreasing, the return earned from assets may eventually fall below the cost of capital used to purchase them. This is a strong indicator of a potential short sale target. Decreasing Return on Equity or Invested Capital also will factor into your indicator for a short sale candidate, since this lowers demand for shares and may result in sales. Lastly, decreasing or eliminated Free Cash Flow indicate business problems have eradicated income which could be freely extracted from the business.

There are several events that can identify a short sale candidate, substantially more than this list. If these events occur to a firm with decreasing fundamentals, metrics, and ratios investors may suddenly become acutely aware of how bad their investment actually is. They'll make economic or emotionally based sales of their investment. Essentially, you are looking for a spark that will create a chain reaction resulting in decreased demand and lowered prices. The following potential events can indicate a firm is a potential candidate for short sale.

- Firm is locked in highly competitive industry and cannot raise prices to boost margin while expenses increase, they are stuck in a financially unfavorable place. They can't raise prices to offset expense without driving customers to other competitors in the industry, further reducing market share. At the same time, they can't refuse to raise their prices, since expenses are reducing earnings and shareholders can simply look to invest in other firms. If they are further undercut by a competitor who still has earnings or margin, they are more likely to do badly in the marketplace.
- A firm's substantially stronger competition announces movement into their niche service or product category.
- There are changes in Equity Structure occurring that are undesirable to shareholders. This may cause them to sell and create share price drops.
- The trends in the economy, industry, technology, manufacturing, or services are rendering the firm unpopular. This results in customers skipping their products, and their revenue dropping. The most common example of this is typewriters after the development of personal computers and word processors. Another example is point-shoot cameras and palm pilots after smartphones carrying advanced operating systems like Android.
- Interviews with managers, suppliers, customers, competitors, advisors, journalists and analysts are creating downward projections for the firm. They do not necessarily have to indicate fundamentals deteriorating, but it is better when they do. The realization of negative news may orient investors toward selling shares or stock.
- The firm's management is caught lying, using fraudulent figures, or abusing one-time categories. The firm's management is caught releasing false financial statements or releases statements that can't be understood. These can indicate fraud, or simply there are deeper mistakes that should be looked at. Either way it will either scare investors towards selling. If the real problem is discovered, and happens to be far worse than expected, investors may jump ship rapidly.
- The firm's management is selling massive amounts of shares, converting share options, and fleeing the firm. This is an indicator that something is wrong, and the management knows but does not want to be involved when the firm goes down for the count.
- There are large asset value write-downs or a series of asset value write-downs or write-offs. This indicates that returns or earnings have disappeared, and may spook investors to selling. If these write downs reduce return on assets below cost of capital or turns profit into losses, this may result in large selloffs.
- Media and Consumer reports indicate potential large scale negativity towards crucial new product lines or services. The more popular the product or service review publication is, the more likely it will result in customers panning the product or service line. If negativity towards products or services a firm needs to do well become viral, this can affect the firm's

reputation for quality. Hard times may be ahead for the firm's product sales.
• Analysts specifically state that a share's market price is overvalued, or are lowering the firm's rating from buy to hold, or from hold to sell. Analysts typically only downgrade firms if something is very wrong, due to political connections. No analyst likes risking their connections with company management by placing a sell label on a firm. It takes a lot for an analyst to move a firm's ratings. If the analyst is extremely popular (like CNBC's Jim Cramer) their viewpoint alone can provoke or encourage a selloff of an already depressed firm.

Short Sales: Orders

The most crucial transaction order in a short seller's toolbox is the Stop-Buy order. This order will purchase shares if the price rises above a set price. Typically used to purchase shares automatically on an upswing, this order can also purchase shares to automatically close a short sale if the short begins to incur losses. This protects against losses while shorting shares. To use this order, you should set the Stop Buy price slightly above the opening short sale price, and then readjust your Stop-Buy order slightly above the price as it falls over time. This locks in "gains" from the short sale and prevents future losses. Note that this share can only be used to buy shares above the market price, and you should remain aware of any fees or commissions expended adjusting your position.