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Pessimism can be profitable but the bets are high risk

09/05/10

The world is awash with pessimistic investors right now. Some have used short selling to make the most of their pessimism. Short selling allows you to be miserable about the market's prospects, and make money at the same time.

Short selling is the opposite of a normal stock transaction. You borrow a stock, sell it, and hope to profit by buying it back at a lower price.

Ordinarily, you buy a stock to take advantage of its expected price rise. You might buy it at \$1.50 and then sell at \$3.00, making \$1.50 a share.

Short selling reverses this transaction. If you think a stock's price is going to fall, you might sell it short at \$3.00, and then buy it back at \$1.50, making \$1.50 per share.

In New Zealand, short selling is legal but is not a commonly used strategy, partly because the market is illiquid and it can be difficult to borrow stocks to short sell. Short selling is prevalent in Australia, UK and US and is the strategy of choice for a lot of hedge funds around the world.

During the global financial crisis many hedge funds made serious money as share markets around the world tumbled. In some instances, short selling exacerbated market declines as hedge funds sold large amounts of stock in weak companies, almost ruining them in the process. For a period in 2008, the US authorities banned short selling in an effort to restore market confidence.

On the face of it, short selling sounds like a great strategy to use, if not on its own, at least in combination with your normal investment strategy.

We all have views about which companies are likely to be successful in the future and which ones have failure written all over them. You could make a lot of money by buying winners and selling losers (then buying them back cheaper).

The main problem with short selling is that the cost of getting it wrong is far greater than with ordinary investing.

If you make a mistake in buying a stock for say \$2 per share, and the company fails, you lose \$2. But if you get it right, your gains are almost limitless.

The most you can make from shorting a \$2 stock is \$2, because the price can't fall below zero. If you get your short selling wrong and the stock that you shorted at \$2 goes to \$6, you've lost \$4. The higher the share price goes, the more you lose.

The very hedge funds that made money during the global financial crisis have had a terrible time over the last eighteen months, because share prices around the world have rallied, more or less continuously.



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Those betting that economies and company profits wouldn't recover, have not only lost money on their short sales, but they've also suffered the opportunity cost of missing out on a rising market.

Maybe it's better just to stay miserable, rather than trying to make money from your pessimism.

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