

What is Short Selling? - Transcript

Tom Mullooly: Hey, in Episode 230 we talk about short selling, since we're getting lots of calls about it.

Welcome to the Mullooly Asset Show. I'm your host, Tom Mullooly. And this is episode number 230. Thanks for tuning in.

What is short-selling? What is that? Well, in a nutshell, it's the opposite of buying and then selling. You're actually selling and then buying. And we're going to walk through this.

So a couple of things, step one, when you're short selling is it's done on margin. That's really important to keep that in your back pocket as we talk about all of this. The second step, very important is, if you're thinking about selling short a stock, are there shares available to short? It's not always the case. Normally if your broker doesn't have shares available to short, he has to call around and borrow the securities. And so there's not always shares available to short.

The third thing is there's always going to be what they call maintenance margin. You're borrowing to sell short so you're always going to have margin maintenance that you're going to have to keep up. We're going to talk about this. The fourth, basically the plan, step four is you want to sell this investment. Now think about it. You don't own it. It's not in your account.

You sell it, and then you want to buy it back in the future at a lower price. So when you're selling something short, you're accomplishing the same thing as when you're buying a stock.

You want to buy low and sell high, except you just did it out of order. You sold high, and you want to buy it back at a lower price.

Something very, very important to remember with short selling. Your risk with short selling is unlimited. So think about you sell a stock short at \$7. If it goes to \$300, as we saw this week, you're responsible for that. So you need to stay within your margin requirements. And so it's very likely, and I did this early on in my career, you're going to see people getting margin calls on, if it's an active stock, you're going to get margin calls almost on daily basis. So you have to be prepared to throw more money into your account. So if the stock moves up, not really what you had in mind. You sell a stock short because you want it to go down. But if you sell a stock short and it goes up, you're going to be to periodically put up money just to keep the margin maintenance, the margin requirement.

So that brings us to naked short selling. What is naked short selling? That is a situation where someone is selling short a stock, and they're selling short shares that aren't available to be shorted. When you short a stock, when you see a stock that has a very, very large short position, or maybe is a 100% sold short, or sometimes even more than that, very likely that there is naked short selling going on. That should not take place. Incidentally, naked short selling, illegal. So remember, step two that we just mentioned a moment ago, we have to find out if the shares are available to be sold short.

All of this brings us to GameStop. Remember GameStop? I don't know if you've been to a mall lately or a local. We have one that's around the corner from us in a strip mall. I don't even know if they're still there. GameStop, the company's had a tough time with the pandemic. They've really struggled. A few weeks ago, the stock was \$7. A research firm put out a report saying this is a stock that's essentially worth nothing. So at \$7 you can consider selling it short and the stock may wind up going to zero or a dollar or something like that.

And so hedge funds started to sell the stock short, and eventually the short position became more than a 100%. So there is some naked short selling going on. Nobody really knows who is doing this, but it got the attention of some of these message boards. People are on there talking about how, "Hey, we can really stick it to some of these Wall Street Firms by buying the stock and if we keep the stock up at \$7 or higher, then they're going to have to put up more money. It's going to turn into a loss for them. It's really going to wind up costing them money."

And that kind of fed on itself. So more and more people started buying GameStop shares. The stock started to come up even higher. There was an individual investor, one of the founders of Chewy actually took a very large stake in the company. Others started buying it. It started getting the attention. There are no fundamental reasons for GameStop to be moving the way that it has over the last week.

Well, a \$7 stock soon became \$20 and then became a \$100. And in the last few days, it's traded as high as \$419 earlier today. So stock's been all over the place. So what's going on now? It's a short squeeze. This is really important. So the folks who sold it short are now in a position where they're taking a massive loss on their short position, they're getting margin calls. So what do they need to do?

Well, there's usually two ways out of a short squeeze. Number one, just buy back the stock and close the position at a loss. That's a little hard to do when there isn't a lot of stock around to buy, because part of the message from the message boards is buy the stock, don't ever plan on selling it. So the next part of that is, "Well, what can we do to relieve the margin call that we have? Well, if we can't resolve the situation with the stock that we sold short, then we've got to sell something else. So let's sell, Disney, Exxon, Google, something that's way more liquid."

So, look, understand that shorting stock is a game that most folks should not get mixed up in. It usually ends in tears for everyone involved, and lawsuits. So the two main takeaways you need to understand with short selling is, one, your risk with short selling is unlimited. The stock moves up. It can keep going up to the moon, to infinity. So your risk with short selling is unlimited. The second thing is this whole business of margin. Stay away. Margin kills. Margin kills more people than bad stock picks.

So there's a lot more that we could talk about when it comes to GameStop, short squeezes, and the whole business of this, but you got to understand the nuts and bolts of how short selling works before you get into the next step. Long-winded answer for Episode 230, but hopefully you'll find that helpful. Thanks for tuning in!