Selling Short Analogy – Educational Piece ONLY, not Financial Advice

Basic Terms

Long = Own = Bought

You want what you Bought (or went Long) to go up so that you can sell it and make money from appreciation.

Short = Loan = Sold

You want what you Sold (or went Short) to go down so that you can buy it back cheaper and make money from it declining.

HOUSING

Let's assume that someone has the money and credit to buy a House and/or Rent; then compare going Long or Short to a housing purchase or renting.

If a house is selling at a price that makes sense for your budget and you want to live there for a certain number of years that makes this purchase feasible, you might be more inclined to buy versus rent in that area.

There are lot of other factors to consider, but we will be keeping this example very simple and its only to be used for Educational purposes.

Assumption: A House is purchased for $200,000; the buyer owes $6,000/year in interest; $4,000/year in property taxes; and $2,000/year on maintenance. All in $12,000/year or $1,000/month.

(Side Note: Keep in mind if you put down 20% or $40,000 on this house and you sell it at the same price you paid, you might lose up to $10,000 in realtor fees or 25% of your $40,000 ($10,000/$40,000). By way of comparison, you can buy/sell millions worth of stock for close to ZERO as a percentage of your purchase price)

Let's further assume you can rent a similar valued house. The market is competitive and as such you can live anywhere. If there are more places available than people; this puts pressure on rental rates.

Assuming nothing is out of balance; the price to own a house should be approximately equal to the cost to rent This does not consider the impact tax rates have on valuation; this might tilt things in favor of owning. It really depends on the market: projected property tax increases, job opportunities, quality of life, etc.

Market is in Balance:

You should be indifferent as to what you should do if you are only deciding based on price.

Career Mobility, Life Path – Schools, Family, Single, these social factors are being ignored in these examples. It would be a far more complicated model. We mentally do many of these calculations on the fly but if we put a pen to paper and "Did the Math" we might make better decisions. Some don't find that as exciting (I happen too).

Going back to 2008-2009 when Housing fell 20%. That $200,000 House fell to $160,000. If you bought it with 20% down it would require you put down $32,000 vs $40,000 (saving you $8,000) and you would owe $128,000 vs $160,000. I'm rounding here for simplicity; but you would be paying about $800 a month vs $1,000 just 6-12 months earlier.

Just imagine that House rose to being worth $250,000 or 25%. Rents didn't go up; because there were still not enough people to meet supply of housing. (Sometimes House Values rise because the Sellers simply go on strike, they don't want to sell). To purchase this more expensive house you would need $50,000 not $40,000; 20% of the $50,000 increase, $250,000-$200,000. You would have a mortgage of $200,000 versus $160,000 and it would cost you about $1,250 a month vs $1,000. As I stated in the assumption up front, the rents were still $1,000 a month. So if you purchased anyways, you have to believe that you wanted to be there long term and didn't want to run the risk of not being able to live in that area, otherwise you just like spending $250 more per month than you should. (Please remember, I didn't include taxes in this analysis as this adds a level of complexity not needed to make the point).

Most people attempt to maximize their dollar spend so they would rent instead. Renting is like going "short" if you don't believe Housing prices will stay high because more supply will come online. If more supply doesn't come online, you might simply move to a different area if you don't believe any increase in rental rates justifies what you get from living in that particular area, you will likely move.

We go "short" all the time in our lives. We don't buy something until it goes on sale. We don't go on vacation until we get a cheaper airfare. We don't buy an SUV if gas is over $4/gallon. We just don't realize that this is the same terminology used in the stock market.

So just imagine you own a House and you decide to rent it out. Well if you own a stock, you can "lend it" out and agree to let someone sell it to someone else at price that they think is too high with the hopes they can buy it back cheaper and then return those shares they sold (that you lent them) back to you. This closes out their "short". They "OWED YOU" those shares. For you to agree to this, you should get "paid". Often you agree to have your stocks be made available to be "lent out" when you sign a margin agreement. Keep in mind, if you are not a big client, many firms "collect these short rebates" for themselves. There is no free lunch. If someone is agreeing to do something for "FREE" really investigate how they make money. I haven't met that many people "that take from the rich and give to the poor." They tend to take and keep it for themselves.

Next, let's assume there are 100 pieces of stock in a company. Each piece of "stock" controls 1% of the company (keep in mind you can break this into millions of shares, but for simplicity 1% is easier to visualize). Now imagine each of these 1% pieces of this company represents 1 house instead. Tally it all up and you have 100 houses or a "corporate neighborhood." Depending on what is going on in that neighborhood, it might be the "hot place" to live, just average, or on a bad trajectory.

Let's imagine that 1 person bought 9 of these houses and another person bought 13 of the houses. Collectively, they controlled 22% of the houses in this neighborhood. Please keep in mind in the stock market, it is illegal to "collude" and attempt to "corner a stock or asset;" this is called "market manipulation" and will land you in prison and hefty fines if the SEC catches you.

So, assuming these 2 owners that controlled 22 houses out of 100 simply "like the area;" they thought it would do great over time, then nothing is wrong with them acquiring that many houses. They went Long (or Bought) and time will tell if they made good investment decisions.

From a practicality perspective, these 2 buyers can't live in 22 houses in this example, but in the stock market they realize they can take their shares and "rent them out." Remember the rental property analogy. What they might do instead is, move them into a "Non-Rental" status (take them out of margin and into Cash status, in order to do this, they have to be fully paid for… keep in mind they might have outside loans to pay for them, but that's a different analysis). As a result of taking this supply offline from the market, there are only 78 houses available to rent.

Now imagine if a bunch of the neighbors in this neighborhood decided to go on chat boards and encouraged each other "NOT TO RENT." Keep in mind in some condo associations, they restrict your rights to rent your place as a condition to own in specific buildings.

After doing this, 28 out of the 78 house owners in this area agree "not to rent." So now, 50% off the 100 houses are not available to rent and 50% of them are available to rent.

Then suddenly… BOOM… People are told on the internet (we know everything is true on the internet, right?) that this is a "Hot Area" and that these properties are going to experience huge demand. A billion-dollar complex is going to be built next door and these properties are needed to complete the project. [Sunnyvale Mobile Home Park Sells for $237 Million – CBS San Francisco (cbslocal.com)] This happens from time to time, 300 Mobile Homes sold for $237 Million or $790,000 each.

GAMESTOP (GME)

Let's look at GameStop or GME. The stock was at about $20 a share on 1/12/2021. It had two owners, one South Korean (9% of shares) and a Canadian owner (13% of shares) according to filings with the SEC (keep in mind there can be a lag so perhaps they might not own the shares and sold them right before the run up). I can't help but wonder if these two folks know each other, perhaps time will tell. The stock rose to approximately $40 within 8 days, then $77 in the next 5 days, then $148 a day later, then $350 a day after that and hit $513 premarket Thursday, 1/28/2021, and the stock traded over 8 million shares – premarket. This is a staggering sum (of between $2 and $4.1 Billion or 2,000 to 4,100 million) of money to trade pre-market. Most individual investors don't know how to trade pre-market, so I would guess this might be "larger players"? Keep in mind the stock hit an intraday low of $112.25 yesterday or almost 80% from the peak experienced just hours earlier, then traded back up to $308, then down to $217 then up to $492, then down back to $194. Keep in mind the stock has 65.2 million shares as of the latest filing, down from 94.8 million shares from 18 months ago or a 31% reduction in share count. Think of it as 31 houses being "destroyed" in this case as the company bought back the shares.

Why is this happening? Well, if you refused to lend the stock that you own out and some people went on and sold it anyways hoping that you or another owner would lend it to them (this is called a short sale locate, most firms require that the seller or "short seller" need to find someone who will agree to lend them the stock to go short). Keep in mind, there are some people that sell without waiting for the locate, this is called Naked Short Selling and is **prohibited**. While it is prohibited, there are a certain number of days to "cure the error." The fines at times don't appear to be large enough to dissuade these errors from occurring. It reminds me of what I read about Bill Gates getting speeding tickets all the time in his early days of Microsoft because he didn't care about the fines; the tickets weren't "cost prohibitive" enough for how much he was earning.

Please keep in mind, each firm that you have an account with might have more restrictive short sale terms than what regulators set as the bare minimum. They reserve this right, so people getting upset for not reading the fine print doesn't take you very far. The language in many of these agreements also makes it clear they can **close you out** at any time if they think it is your best interest **or** to protect their firm. Once again, one needs to read the fine print to see what applies to them. Most often, the firm will contact you before they close out a short sale and ask you to "locate" some shares that are assigned to your short sale. If you cannot find those shares, it is not very complicated, you must buy them on the open market, or they will do it for you. If your account balance falls below minimum margin requirements and/or it's a fast or volatile market they might be more inclined to do it without waiting for you. Think of the swings in GameStop yesterday. Imagine if the stock doubled to $1,000 in the middle of the day? The firm doesn't want to be on the hook if clients don't have enough funds to cover such massive swings in volatility.

How does this relate to renting an apartment? Imagine if a yearly lease was written in a way that it was daily instead (no different than hotel rooms) and you signed it. It would give the landlord the ability to change the daily rental rate on your apartment to whatever the market rate was daily.

Nothing to worry about, right? Well, a huge conference is scheduled to take place and 1000 people are coming into town and your place went from $33 a day rental rate to $300. Now, you can stay in your apartment if you pony up the $300 a day or you are legally obligated to get out and let someone else pay that rate. Now imagine if that housing unit went from being worth $200,000 to $1,000,000. Now if your landlord had a contract in hand to sell that House for $1,000,000, they are not going to want to wait a year for you to get out. They will want you to move out immediately. They can't wait to get that $1,000,000 fast enough. Well, in the case of GameStop, the stock was $20 and hit $513, so imagine that $20 represented $200,000 then it was worth $5,130,000 at peak price. Today, Friday, 1/29/2021, last time I checked it was $3,260,000 from where it was 17 days ago or 16.6x your money. It hit $470 premarket today on almost 5 million shares.

Now, I'm not suggesting GameStop is overvalued or undervalued as this is an educational piece simply meant to help people ponder what Short Selling is and how it relates to something more relatable. Please do not Short or go Long without taking the time to understand what you are doing or hire a professional. If you save 10% of what you make and you make $40,000 a year after taxes, that $4,000 you save is about $80 a week or $2/hour. At a minimum, however much you might lose in an investment should have a certain number of hours assigned to due diligence. The larger the sum of money you are investing, the more due diligence you should perform. It could take years, if not longer, to make up losses from one or two bad decisions even though it took you years to accumulate that precious capital.

When you purchase a security, the maximum amount you can lose is what you purchased it for if you didn't use Margin or Credit to buy it and paid for it in full. When you Short a security, the Losses can far exceed what you put up as initial collateral. You can lose multiples of the price you shorted a stock at. Please seek professional advice before engaging in Short selling, as the losses that might occur can be absolutely devastating to your wealth and mental well-being.

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