Money Morning Members Only

THE ABSOLUTE *Beginner's* GUIDE to SHORT SELLING

HOW YOU CAN PROFIT in ANY MARKET

MONEY MORNING

YOUR DAILY MAP TO FINANCIAL FREEDOM

Table of Contents

Section 1:
The Other Side of the Trade

The conventional approach to trading has us buying low and selling high.

We set a goal, do our research, and then develop a conviction that a certain stock will go higher.

And so we buy the shares, set our stops, hedge our position against a loss, and wait until the share price starts heading north. Then, if our hypothesis and our methods are sound, we collect a nice profit.

That's the rule. Millions of investors follow it. Simple enough…

But what the conventional approach doesn't account for is that there are two sides to every trade.

Share prices go up, to be sure, but they also go down.

This is a simple truth, but it's one that Wall Street would rather we not think about.

Why? Because they take the other side all the time.

And they make a killing when they do; quadruple-digit gains betting against huge companies like T-Mobile, Best Buy, Ralph Lauren, even Apple.

They even bet against entire countries; on one day in September, 1992, one man, George Soros, brought the entire United Kingdom to its knees and made $1.8 billion in profits betting against the pound sterling.

It may have been the easiest money he ever made, and it was almost certainly the quickest.

But if it became fully and widely understood that the huge Wall Street firms were betting against the market… why, that would undermine the public's acceptance of the false narrative they've been spinning feverishly since 1929 – that they are the sole, noble guardians of capitalism, that they are the builders of dreams, that the wealth they generate for themselves is really for the good of all.

There's another truth to consider: You don't have to be a Wall Street bank to trade like this.

But you do have to be willing to set aside the bogus story that they've been selling for the 85 years.

We can take the other side of the trade, too.

Don't worry – unlike Wall Street, we won't be bringing the U.K. to its knees or destroying anything.

We're not James Bond villains; we're investing for our futures.

We'll learn how and why to trade on declines, and how to protect our investments. We'll learn from experts like Keith Fitz-Gerald and Shah Gilani, who have some excellent guidelines for these situations. And we'll look at some examples of individual trades that paid off, even as share prices retreated.

Section 1: The Other Side of the Trade

Now that we've smashed Wall Street's most potent illusion, let's go and make some money.

It's easy…

How It Works

Shorting a stock is Wall Street speak for betting that a stock will decline. An investor who is "short" a stock only profits if the stock goes down.

And don't worry; the process is not as complex as you might think. In fact, it's about as simple as flipping a switch.

When you know an asset is going to fall, all you need do is take the other side of the trade.

It really comes down to three easy steps:

1. You identify that an asset that is obviously reversing direction…
2. You take the other side of the trade…
3. You haul your money to the bank!

Here is what our Chief Investment Strategist, Keith Fitz-Gerald, had to say about the 'flip-the-switch' strategy:

> *"I'm actually a huge fan of short selling. It's a really valuable strategic tool. It allows you to profit on weak companies as well as strong ones, in bad markets as well as good ones."*

Section 2:

10 Rules for Success

Keith Fitz-Gerald's Best Advice for Short Selling

In its most basic form, short selling is a bet on a company's imminent failure and short-sellers search for stocks they believe are poised to fall.

Typically, a short sale involves borrowing a troubled company's shares from another investor, selling them, and then waiting for the stock's price to decline before closing the position ("covering," as it's called) by buying the shares back on the open market.

The difference between the higher initial selling price and the lower repurchase price represents the short seller's profit.

If this sounds confusing, don't worry.

After reading this report, you will realize how simple it really is. All you need is an intuitive sense of the short selling process and knowledge of some key terms.

The rest is really your broker's job. After all, you *do* pay them a commission.

Before we get to technical, it would be wise to consider Keith Fitz-Gerald's 10 most important rules of short selling.

You will quickly notice that these rules are more like bits of wisdom that Keith has accumulated over the decades he's been in finance.

Unfortunately, your broker is unlikely to share any of them with you directly, but we are.

In fact, we believe that the 10 rules of short selling are invaluable to anyone thinking of taking the other side of the trade.

Let's get started.

1. Timing is far more critical in short selling than when buying stocks.

Timing really is critical when short selling, says Keith Fitz-Gerald, head of research at Money Map Press. Keith identifies short-sale candidates primarily from fundamentals, but waits to actually take action until signaled to do so by overall market action or specific technical indicators.

A technical trigger is important because it may take some time for the market to recognize fundamental weakness in a company – and even longer to actually give up on the stock.

2. Short selling is primarily a short-term strategy.

Unlike on the "Buy" side, there are very few successful "sell-and-hold investors." That's due again to the inherent upside bias in the markets. Even when stock prices are locked into prolonged narrow trading range inflation can push prices up, creating losses for longer-term short positions.

In fact, the bulk of short selling in today's markets is done by day traders and swing traders, all of whom wish to take small profits on the normal daily and weekly price fluctuations. Most long-term short positions are taken by professionals, hedge funds, and savvy individual investors looking to offset downside risk exposure on large portfolios.

3. Restrict most of your short selling to bear markets.

This seems like an obvious rule, but it's amazing how many traders violate it – and pay a painful price, as a result. Though it sometimes seems like we've been in one for a decade, true bear markets actually come along only about once every 3.6 years and historically last just under 18 months.

The rest of the time, the markets are moving upward – and, since numerous studies have shown that the majority of stock gains (perhaps as much as 85%) result from overall market movements rather than internal company fundamentals, it makes little sense to buck the trend.

Unless timing is perfect or you find a dying company a day ahead of everyone else, shorting into a strong bull market (or even in the waning days of a bear move) is like swimming against the tide – and it's almost certain to thoroughly dampen your returns.

4. When there is a bear market, short selling gives you a significant edge.

Stock buyers and traditional buy-and-hold investors really have only two options when a bear market strikes (okay, three if you count hedging your holdings by purchasing "put" options).

Investors can either endure the losses or try to ride out the downturn, or liquidate their stock positions and move into cash or other assets. But if you understand short selling and are willing to use the technique, you can quickly exit your long stock positions – avoiding the bulk of the loss – and then sell the same stocks (or worse ones) short, picking up new profits as the market continues to fall and other investors cry over their losses.

> *"My favorite entry point," Keith explains, "is when we've had a huge up day in the market and the stock I'm watching has gone along for the ride, moving above its Bollinger bands, its Keltner channel or some other statistical measure of that stock's normal trading range. That's because, when I'm short selling, I want every possible advantage working in my favor – fundamental, technical and otherwise."*

5. Being early is much riskier on the short side.

If you buy a stock and have to wait awhile before it finally takes off, the upward bias of the overall market reduces your risk – in many cases costing you nothing but the time value of your money.

The opposite is true when you sell short.

Not only does the upward bias of the market work against you, but there are also interest and margin costs associated with borrowing the stock you sell short. (You *must* have a margin account with your broker in order to sell short; short selling isn't permitted in a regular cash account.)

Even worse, it's always possible for even the most overvalued stock to move higher in price. The dot-com bubble provided painful proof of that fact as many stocks in that sector achieved overvalued status as early as 1998, but would have killed anyone who shorted them in 1999, since the bubble didn't finally burst until 2000. In short, never short a stock simply because you think it's overpriced.

6. Action on the short side is much quicker than action on the long side.

Numerous market studies have shown that, on average, stock prices decline three times faster than they rise. There's also an old market maxim that says that bad news travels 10 times faster than good news.

Both are based on innate human emotions – fear and panic being far more powerful forces than greed and exuberance. Thus, if your timing is good as a short seller, you can generally expect far quicker results than you'd get on your long positions. Even so, always be aware that a crash or panic sell-off isn't required for a successful short trade.

In many cases, a simple lack of news will be enough to quell buying interest and cause a price decline sufficient enough to produce a nice short-selling profit.

7. The risk on short positions can be high – but contrary to the popular notion, it's not unlimited.

Conservative advisors scare many clients away from short selling by claiming it has unlimited risk. "When you buy a stock," they say, "all you can lose is the amount you paid because its price can't go below zero. But there's no limit to how high a stock's price can climb, and your short position will lose money all the way!" This is actually false on two counts:

- You should *never* institute a short position without simultaneously entering a stop order to get you out if prices move too far against you. (Your own goals and risk tolerances will help you determine where to put the stop, but we recommend an absolute loss limit of 25% on short sales.)
- Your broker won't allow you to unwittingly lose more than your original margin deposit. If your equity in the position drops too low, you'll be asked to either cover your short or deposit more funds. (Don't!) If you do neither, the brokerage firm will liquidate your position to protect its own assets, since it must cover unsecured client losses.

8. If the stock you sell short pays a dividend while your position is open, you must pay the dividend to the broker you borrow the shares from.

This is true – and it's a major reason lots of people shy away from selling short. If you really know what you're doing, however, this should never be an issue. After all, why would anyone in their right mind consider shorting a growing company with solid earnings sufficient to allow payment of a decent dividend?

On the other hand… if a company cuts or eliminates a dividend, it might be a stock worth shorting, since such a move almost always indicates deeper problems at play.

9. Not every stock can be shorted.

As a rule, brokers will not allow you to short a stock priced below $5 a share (too much opportunity for monkey business in the penny stock ranks), nor will you usually be able to short stocks that are very thinly traded or that have too small a float.

In those two latter cases, it's too difficult to find shares to borrow, and the lack of shares means volatility will be high, increasing risks.

10. The "short squeeze" is a real risk – but it can be minimized.

As noted earlier, overpriced companies – even those with terrible fundamentals – can sometimes defy logic and move still higher. If they do so dramatically – perhaps even "gapping up" at the market open, traders who are short the stock may become fearful and put in panic "Buy" orders to cover their positions. This can push prices still higher, triggering protective stops, which can generate another gap, creating a new round of buying and perhaps even a self-generating uptrend – a classic "short squeeze."

If you get caught in such a squeeze, you'll usually have to bail out – though there are two ways to avoid such situations:

- Don't short stocks with "squeezable" characteristics, such as a high short-interest ratio, a small float, a low daily trading volume, strong bullish sentiment or advisory support, a record of past short squeezes, or a still-intact uptrend.
- Maintain strict discipline. Always use a stop-loss order, adjust it regularly as the stock price moves in your favor – and, if you see any of the conditions listed above, either tighten the stop or go ahead and take your profits.

Section 3:

First You Borrow, Then You Sell

The Mechanics of a Short Sale

When you sell a stock short, you profit only if the price the stock drops.

Here is how it works.

A short seller does not actually own the stock. He, or she, borrows the shares from a broker and then sells them to a third party.

The borrowing part is a crucial element of short selling.

Because the stock is borrowed, it needs to be returned. As such, it creates a liability that a short seller is responsible for, much like a bank loan that eventually needs to be repaid.

In fact, the broker lending the shares earns interest of a sort, much as a bank does on a loan.

Once the shares have been borrowed, the short seller then sells the stock in the open market, in hopes that the price will drop.

After a period of time, the short seller then buys back the stock in order to return the borrowed stock to the lender and cover his liability

Because the price of the stock has declined since the sale, the investor is now eager to repurchase the shares from the market in order to cover his liability and pocket the profits.

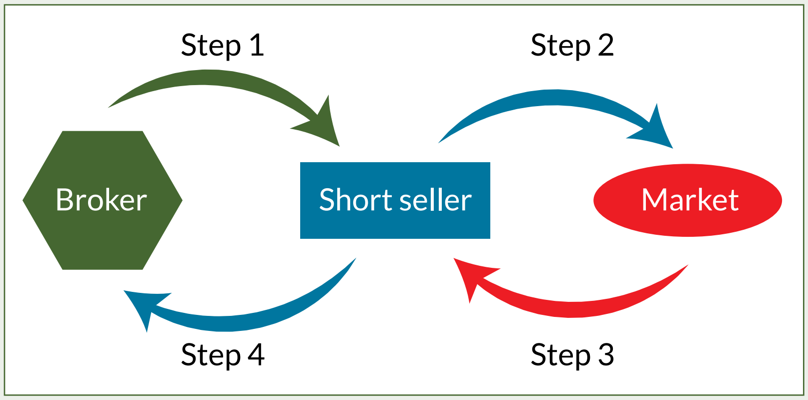
Once the stock has been returned, and the liability has been covered, the difference between the price sold and price bought, represents the profit to the short seller.

Because the repurchase price is lower than the initial sale price, the investor profits.

The illustration to the right really brings the idea home.

Whether an investor profits from the transaction depends entirely on the level of the stock at sale and repurchase.

Here is how things would play out in the real world:



STEP 1: Short seller borrows a stock from the broker
STEP 2: Short seller immediately sells the stock on the market
STEP 3: Short seller buys back the stock from the market
STEP 4: Short seller returns the borrowed stock to the broker

Section 3: **First You Borrow, Then You Sell**

SCENARIO #1: Stock declines → Sell Price (Step 2) > Repurchase Price (Step 3) → Profit

SCENARIO #2: Stock increases → Sell Price (Step 2) < Repurchase Price (Step 3) → Loss

Let's assume that an investor believes the price of ABC stock, currently trading at $25, will decline in the near future. In order to profit from the decline, the investor's first calls his broker to borrow 100 shares of ABC stock for a short sale (Step 1). He/she then immediately sells the shares in the open market and receives a cash inflow of $2500 (Step 2).

A month later, the price of ABC stock has dropped to $20 (Scenario 1) and the investor decides to "cover" his position by buying back the shares on the market for $20. He pays the $2000 to acquire the shares (Step 3) and immediately returns the shares to the lender (Step 4)

Because the inflow ($2500) exceeds the outflow during the repurchase ($2000), the investor has profited in the amount of $500.

The process really is as simple as that.

However, as you have probably guessed, there are a few other things you should know.

After all, why would a broker wish to lend the stock? And how is it possible that a stock is available for lending in the first place?

To answer these questions, we need to understand how margin works, because without margin there is no short selling.

Section 4:

Investing on Margin

Turbo Charge Your Portfolio with "Other People's Money"

In order to initiate short positions, you need a *margin account*. Because shorting requires borrowing, and borrowing is only possible in a margin account.

Think of margin simply as an *extension of credit* from a brokerage house using your own securities as collateral. As such, selling short is a way to borrow from your broker, effectively using broker's money to invest.

Much like a bank loan, your broker requires you to provide collateral as protection against credit risk. Instead of taking your mortgage, for example, the broker asks you to deposit cash or marginable securities instead.

Now, a margin account allows you to do many different types of trades, such as options and other derivatives, debt, buying shares, and shorting a stock.

The common denominator for all margin account transactions is credit, or borrowed capital.

This is the essence of margin investing and it carries the benefit of magnifying the potential upside.

Another example…

Let's assume that both margin and a cash investor purchase 1,000 shares of ABC stock, currently trading at $10 per share. The total purchase price thus equals $10,000 for both.

But – and here is the kicker – the margin investor uses a margin loan of $5,000 from his broker, while the cash investor invests all of his own money, a total of $10,000.

	MARGIN INVESTOR	CASH INVESTOR
Purchase Price	**$10,000.00**	**$10,000.00**
Cash Outflow	**$5,000.00**	**$5,000.00**
Margin Loan	**$5,000.00**	**$5,000.00**
	SCENARIO #1: Stock Rises	
Sale Proceeds	**$15,000.00** ($5K gain)	**$15,000.00** ($5K gain)
Investment Return	**100%**($5K gain on $5K outflow)	**50%** ($5K gain on $10K outflow)
	SCENARIO #2: Stock Declines	
Sale Proceeds	**$5,000.00** ($5K loss)	**$15,000.00** ($5K loss)
Investmetn Return	**-100%** ($5K loss on $5K outflow)	**-50%** ($5K loss on $10K outflow)

Section 4: **Investing on Margin**

Here is what happens to investment returns in both scenarios.

In Scenario 1, the stock increases from $10 to $15, resulting in a total portfolio value of $15,000 for both investors, but…

Because the margin investor only risked $5,000 of his own cash, the effective return on investment is 100% ($5K gain on $5K cash outflow). The cash investor, on the other hand, used $10,000 of his own money, producing a 50% return ($5K gain on $10K cash outflow).

Because the margin investor used only 50% of his own capital, the investment has given him a 100% return.

But, credit can cut both ways.

In **Scenario 2**, the 50% loss in stock value produces a 100% loss in case of a margin account and only 50% loss in the cash account.

Why? Because a margin investor has lost $5,000 on a $5,000 cash outflow, while a cash investor only lost half of his initial outflow.

This is the key difference between a margin account and a cash account; *a margin account will always produce outsized returns relative to a cash account*, whether the price of the underlying stock increases or decreases.

As you can see, the idea behind margin trading, and short selling in general, is fairly intuitive. Once you have the concept in mind, the next thing you need to know is how your broker operates when lending you money, i.e. the rules they must follow in order to protect themselves from credit risk.

Let's take a step back.

Margin investing is possible because the Federal Reserve Board made it legal for a brokerage house to lend up to 50% of a security's value to an investor, a law called Regulation T.

In order to limit their losses, brokerage houses, much like banks, require collateral in place at all times.

This is because collateral is the only way that the lender can maintain reasonable credit risk levels. They do this with something called a margin requirement.

Simply put, a margin requirement is a predetermined amount of collateral that needs to be available in a margin account at all times. Here's how it works.

Section 5:

Margin Requirements

What Your Broker Is Thinking

You might have heard of the term *margin call*.

No mystery there. It is nothing more than a demand by your broker to increase the equity value in your account, effectively eliminating the margin deficiency by raising collateral.

A margin deficiency is the result of the maintenance requirement amount exceeding the equity value in your portfolio.

Maintenance Requirement > Equity Value → **MARGIN CALL**

Maintenance Requirement < Equity Value → **NO MARGIN CALL**

This is fairly intuitive.

Let's assume that you are looking to buy $10,000 worth of security ABC on margin.

Before any type of buying or selling occurs, the brokerage house requires an investor to deposit a minimum margin balance. (See below)

Once minimum margin has been deposited, the next step is to purchase $10,000 worth of ABC shares.

As you've probably guessed, because the Reg. T allows the brokerage house to lend 50% of the market value of the security, an investor is only required to deposit another $5,000 in his margin account. This is called the initial margin and effectively allows an investor to hold $10,000 worth of stock with only $5,000 upfront cost.

MARGIN REQUIREMENT LEVELS

1. **MINIMUM MARGIN:** Minimum amount that an investor has to deposit in a newly activated margin account, before any trades take place. The amount normally ranges between $2,000 and $5,000. Also called minimum equity requirement.

2. **INITIAL MARGIN:** Occurs upon entry of a trade and requires that an investor must pay for at least 50% of the market price of a security which he, or she, wishes to purchase on margin. Also called Reg. T requirement.

3. **MAINTENANCE MARGIN:** A maintenance requirement that is valid after an investor has bought securities on margin. It is the minimum equity level that must be maintained at all times and is normally 25% of the total market value of securities in the margin account.

IMPORTANT: broker will generally notify you regarding the margin deficiency but he, or she, is not required to do so. In fact, they can *legally liquidate any security in your account without prior notice.*

Section 5: **Margin Requirements**

As time passes, one of two scenarios can occur.

Stock price can rise, in which case the investor equity value rises, thereby pushing down maintenance margin requirement, or…

Stock price can decline, in which case the broker is concerned with the equity value meeting the maintenance margin requirement. If the price declines enough to bring equity value below the maintenance margin, the broker will demand that the maintenance deficiency be closed, i.e. a broker will place a margin call.

Here is an example…

PURCHASE

# of Shares	Share Price	Market Value	Margin Debt	Account Equity	Min. Margin
1,000	$10	$10,000	$5,000	$5,000	$2,000

After an initial deposit of $2,000 (Minimum Margin), an investor purchases 1000 shares of ABC stock for a price of $10 per share. Because the initial requirement is 50% of market value of the stock, an investor is required to deposit another $5,000 (Initial Margin). The rest is provided by the broker as a loan, in this case $5,000 (Margin Debt).

STOCK GOES UP

x30%

# of Shares	Share Price	Market Value	Margin Debt	Account Equity	Maint. Margin
1,000	$15	$15,000	$5,000	$10,000	$4,500

If we assume that the stock price increases to $15, then the total market value of investor's holdings increases to $15,000. Account equity increases to $10,000 (Market Value – Margin Debt) and maintenance margin increases to $3,000. It is important to note that maintenance margin is calculated as a *percentage of current market value*, not the initial purchase price. In our case the maintenance margin requirement is 30% of market value, but the number can vary depending on broker and type of asset.

Mrkt. Value	$15,000
Margin Debt	$5,000
Equity Value	$10,000
Cash Investment	$5,000
Net Profit	$5,000
ROI	100%

Because you paid only a portion of the purchase price of the stock but receive 100% of the net profit, you would receive the proceeds from the sale of the stock less margin debt, in our case $10,000. The

$10,000 consists of your initial $5,000 outflow plus $5,000 return on investment. The net profit is therefore $5,000 and the return on investment is 100%, despite only a 50% increase in the stock price.

Not a bad deal at all…

STOCK GOES DOWN

# of Shares	Share Price	Market Value	Margin Debt	Account Equity	Maint. Margin
1,000	$7	$7,000	$5,000	$2,000	$2,100

If the stock price drops to $7, the market value will drop accordingly. Account equity (market value – margin debt) will decrease, thereby lowering the maintenance margin. In our case the maintenance margin is 30%, or $2,100 (.30 x $7,000). Because the maintenance margin exceeds the account equity, no margin call will take place. However, your net loss is $3,000 (Initial Cash Outflow – Account Equity) with a return on investment of -60% (-$3,000 net loss / $5,000). Note that the loss of 60% doubles the 30% loss of a long-only strategy.

Mrkt. Value	$7,000
Margin Debt	$5,000
Equity Value	$2,000
Cash Investment	$5,000
Net Loss	($3,000)
ROI	-60%

SHARE PRICE DROP

x30%

# of Shares	Share Price	Market Value	Margin Debt	Account Equity	Maint. Margin
1,000	$5	$5,000	$5,000	$0	$1,500

Assuming that the stock drops even further to $5 per share, the account equity is wiped out and maintenance margin becomes $1,500, or 30% of total market value. Because the account equity is lower than the margin requirement, the broker will issue a margin call requiring the investor to either:

a) Deposit $1,500 in cash; or
b) Deposit marginable securities; or
c) Liquidate stock.

Mrkt. Value	$5,000
Margin Debt	$5,000
Equity Value	$0
Cash Investment	$5,000
Net Loss	($5,000)
ROI	-100%

The net loss to investor is $5,000, corresponding to a return on investment (ROI) of -100%. Compared to a 50% drop in stock price, the loss in a margin account is twice what it would be with a long only strategy.

Section 6:

What You Need to Know About Margin

5 Things to Keep in Mind

As you've noticed, the example above assumed that the investor is *buying* on margin, rather than *selling short.*

Margin requirements do change when selling short, but not by much.

There are five things to keep in mind:

1. In a short sale, the investor is borrowing, not cash, but securities.
2. Maintenance margin requirements are greater with short positions then long positions.
3. An investor must hold in the account 100% of the security's market value, which equals the cash received from the initial short sale plus any increase which may have occurred.
4. In addition, under Regulation T, an investor must also hold 50% of the initial value of the stock. This equates to 150% of the value of the short sale at the time the sale is initiated.
5. Throughout the life of the trade, an investor is also subject to maintenance requirements, usually 30% of current market value.

MARGINABLE SECURITIES

1. Most securities listed on the NYSE
2. Majority of NASDAQ/ AMEX securities
3. Most mutual funds*
4. OTC stocks approved by the Federal Reserve Board
5. Certain corporate, municipal and government bonds

*Only after 30 days of ownership

IMPORTANT: IRA and 401-k accounts are not marginable and may NOT be used as collateral.

Source: Wikipedia

SHORT SALE

50%

# of Shares	Share Price	Market Value	Init. Margin	Total Margin
1,000	$10	$10,000	$5,000	$15,000

Let's assume that an investor would like to sell short 1000 shares of ABC stock currently trading at $10 per share. As discussed above, the investor would first borrow the shares from his broker and sell them into the open market, for a total sale of $10,000. The $10,000 is immediately deposited in the short sale margin account and cannot be used for purchase of other securities. Furthermore, an additional 50% of the market value must be deposited in the account (initial margin), bringing the total margin requirement to $15,000. The investor effectively borrows $10,000 and deposits his/her own $5,000 as collateral. The equity in the account is therefore $5,000.

Section 6: **What You Need to Know About Margin**

STOCK GOES DOWN

# of Shares	Share Price	Market Value	Account Equity	Current Margin	Min. Margin	Rate of Return
1,000	$7	$7,000	$8,000	114%	$2,100	60%

Once the stock moves in investors favor, dropping from $10 to $7, the account equity increases and margin requirements lessen. Account equity is calculated by taking the initial total value and subtracting the current market value of the position (Total Margin – Market Value). During the life of the trade, the broker is concerned with maintenance margin equaling 30% or higher. In other words, the account equity value must equal $2,100 (.30 * 8,000) or greater. Because the current margin (Account Equity/Market Value) is well in excess of the 30% margin maintenance requirement, there is no danger of a margin call taking place.

If the investor wishes to cash in his/her gains, he/she would buy back shares at $7 in the open market and return them to the lender. The $3,000 profit would result in an ROI of 60% (3,000/5,000). Of course, this does not include commission and interest paid to the broker.

The important thing to keep in mind is that the account equity may not drop below a certain pre-determined level, in our case 30%.

STOCK GOES UP

# of Shares	Share Price	Market Value	Account Equity	Current Margin	Min. Margin	Margin Deficiency	Rate of Return
1,000	$11	$11,000	$4,000	36%	$3,300	None	-20%

If the stock price increases to $11, the investor would face a loss because he/she is now forced to buy back the shares at $11. The market value of holdings increases to $11,000, while investor's equity drops to $4,000 (Total Margin – Market Value). Current margin is now 36% (Account Equity/Market Value) and well in excess of the 30% required margin. In other words, the lowest that investors equity can fall is $3,300 (.30*Market Value). Since the investor's equity is greater than the minimum maintenance margin of $3,300, the investor does not face a margin call, despite a 20% loss on his investment.

If the investor wishes to cut his/her losses, the first step would be to buy back the shares in the open market for $11 per share and return them to the lender. The $1000 in losses would result in a negative ROI of -20%.

Section 6: **What You Need to Know About Margin**

STOCK GOES UP

# of Shares	Share Price	Market Value	Account Equity	Current Margin	Min. Margin	Margin Deficiency	Rate of Return
1,000	$13	$13,000	$2,000	15%	$3,900	($1,900)	-60%

If the stock price increases to $13 per share, the loss of $3 per share reduces the investor's equity by an amount large enough to warrant a margin call. Account equity in this case is only $2,000 (Total Margin – Market Value), or 15% of market value. Because account equity must at all-time equal at least 30% of current market value, in this case $3,900, the investor is facing a margin deficiency of $1,900 (Minimum Margin – Account Equity) and a margin call to fill the gap.

Here is a summary of the main formulas for a quick reference:

- Market Value = Price per Share *x* Number of Shares
- Initial Margin = 50% of Market Value
- Total Margin = Sale Proceeds + Initial Margin
- Account Equity = Total Margin – Market Value
- Current Margin = Account Equity ÷ Market Value
- Minimum Margin = 30% of Market Value
- Margin Deficiency = Minimum Margin – Account Equity
- Rate of Return = (New Price – Old Price) ÷ Initial Margin

Section 7:

It Really Is This Easy

Putting It All Into Practice

Simply put, selling short means selling first and buying later.

It involves selling shares that you do not own. Because the shares are borrowed, you must deposit the proceeds of the sale into your margin account – and you must eventually buy back those shares in order to return them to the lender.

It is only because of the promise to return the shares at a later date, that an investor is able to sell something he/she does not own. Because the sale proceeds are essentially borrowed cash, the lender also requires collateral requirements to be deposited (initial margin) and maintained throughout the life of the trade (maintenance margin).

Contrary to popular opinion, short sellers provide a valuable role in today's markets.

By expressing a contrarian opinion, short sellers provide a counterbalance to market exuberance and contribute to a more efficient price discovery mechanism by helping investors understand a wider range of opinions.

Short selling is complex, carries more risk and demands more responsibility on the part of the investors. That is why it is important to understand the mechanics of a short sale, the motives behind it, margin requirements, and risks involved.

History shows us that, over time, the markets have an inherent upward bias. Investors are optimistic by nature and that optimism always works against you as a short seller. A short seller is fighting millions of investors who want you to be wrong – and are betting against you.

However, if you follow these tips and hone your analytical skills – both fundamental and technical – you could wind up looking forward to bear-market profits just as much as you do to bull-market gains.

Appendix A:

Keep These Things in Mind

- **CASH WITHDRAWAL** – You may withdraw cash from your margin account if you have available funds in excess of your initial equity and maintenance requirements.
- **INTEREST** – Interest is being paid on borrowed securities but the loan does not have to be repaid until the stock is sold.
- **BORROWED SHARES** – The securities in your margin account may be lent out to another party, or used as collateral by the brokerage firm at any time without notice or compensation to you, when there is a debt balance (or negative balance) on the account where you have accessed the margin funds. If the account is in a credit state, where you haven't used the margin funds, the shares can't be lent out.
- **DIVIDENDS** – If your margined shares pay a dividend but are lent out, you don't actually receive real dividends because you aren't the official holder. Instead, you receive "payments in lieu of dividends," which don't qualify for the 15% dividend tax rate. However, you will only have to pay the high income-tax rate if the firm clearly states that the dividend income was payment in lieu on the Form 1099-Div – if it isn't stated, you will receive the lower 15% rate.
- **TECHNICAL ANALYSIS** – If you decide to give short selling a try, take some time to brush up on your technical-analysis skills, with a particular emphasis on recognizing topping patterns and determining the strength of a downtrend. Topping patterns are far more accurate in predicting downturns than bottom patterns are at generating "Buy" signals – that's why you hear lots of market talk about base building and none about roof construction. Similarly, uptrends never last forever, but downtrends sometimes do – with all sorts of bad news potentially capable of leading a company into bankruptcy.
- **RISK MANAGEMENT** – Exercise discipline and use good money management. Always use stops and set targets to give yourself a favorable risk/reward ratio – 4-to-1 will let you be wrong half the time and still make a healthy profit overall. Remember, the best investors aren't right all the time; they just lose the least amount of money when they're wrong.
- **BROKERAGE MATERIAL** – Remember to read any instructional material available from your broker, as margin requirements vary depending on the broker.

Appendix B:

Terms to Know

- **MARGIN ACCOUNT:** A brokerage account in which the broker lends the customer cash to purchase securities, effectively allowing you to invest with your broker's money. The loan given by the broker is collateralized by the securities and cash.
- **SHORT COVERING**: It is the buying back of borrowed securities in order to close an open position.
- **CALLED AWAY:** Occurs when a security used in a shorting transaction requires delivery. The short seller must return the borrowed stock to the lender and may miss out on the investment opportunity as a result.
- **UPTICK RULE:** A trading restriction that disallowed short selling of securities except on an uptick in price. The rule was removed in 2007 when Reg. SHO became effective.
- **SHORT INTEREST:** Number of shares that investors have sold short and not yet covered or closed out. It can be expressed as a percentage by dividing the number of shares sold short by total number of outstanding shares. A 3% short interest means that 3% of the outstanding shares are held short.

SHORT INTEREST = # of Shares Sold Short ÷ Total Shares Outstanding

- **DAYS TO COVER:** Closely related to short interest, days to cover is a measurement of company's issued share that are shorted, expressed in terms of number of days required to close out all of the short positions. It indicates the average number of days it takes short sellers to repurchase all the borrowed shares.

DAYS TO COVER = Current Short Interest ÷ Average Daily Share Volume

- **SHORT SQUEEZE:** Occurs when a heavily shorted stock moves sharply higher as a result of demand for the stock exceeding supply. It occurs because short sellers are forced to close out their short positions. As the price increases more short sellers close out their position, further adding to the upward price momentum.
- **REGULATION T:** A rule designed by the Federal Reserve Board that governs customer cash accounts and the amount of credit that broker/dealers can extend to customers for purchase of securities. Reg T allows for a broker to loan out a maximum of 50% of the market value of securities.
- **MARGIN CALL**: A call by the broker to deposit additional money or securities so that margin account is brought to minimum maintenance margin. Margin calls occur because the account value has declined and the collateral is no longer sufficient to justify the loan.

Please Note: From time to time, Money Map Press will recommend stocks or other investments that will not be included in our regular portfolios. There are certain situations where we feel a company may be an extraordinary value but may not necessarily fit within the selection guidelines of these existing portfolios. In these cases, the recommendations are speculative and should not be considered as part of Money Map Press philosophy.

Also, by the time you receive this report, there is a chance that we may have exited a recommendation previously included in our portfolio. Occasionally, this happens because we use a disciplined selling strategy with our investments, meaning that if a company's share price falls below a certain price level, we immediately notify our subscribers to sell the stock.

NOTE: Money Map Press is not a broker, dealer or licensed investment advisor. No person listed here should be considered as permitted to engage in rendering personalized investment, legal or other professional advice as an agent of Money Map Press. Money Map Press does not receive any compensation for these services. Additionally, any individual services rendered to subscribers by those mentioned are considered completely separate from and outside the scope of services offered by Money Map Press. Therefore if you choose to contact anyone listed here, such contact, as well as any resulting relationship, is strictly between you and them.

THE MONEY MAP PRESS

Privacy Notice

You and your family are entitled to review and act on any recommendations made in this document. All Money Map Press publications are protected by copyright. No part of this report may be reproduced by any means (including facsimile) or placed on any electronic medium without written permission from the publisher. Information contained herein is obtained from sources believed to be reliable, but its accuracy cannot be guaranteed. Money Map Press expressly forbids its writers from having a financial interest in any security recommended to its readers. All Money Map Press employees and agents must wait 24 hours after an Internet publication and 72 hours after a print publication is mailed prior to following an initial recommendation. Money Map Press does not act as a personal investment advisor, nor does it advocate the purchase or sale of any security or investment for any specific individual. Investments recommended in this publication should be made only after consulting with your investment advisor, and only after reviewing the prospectus or financial statements of the company.