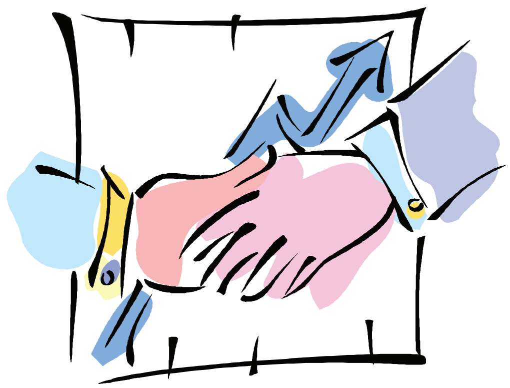
Shorting: A Strategy for Profiting From Price Declines

An Interview With Greg Swenson, CFA

Article Highlights

- Short selling involves selling shares of a stock an investor does not own in hopes of buying back the stock in the future at a lower price.
- The potential gains from a short sale are always limited since a stock can only fall to $0.00, whereas potential losses are unlimited since a stock can keep increasing in price.
- Traits that make a stock a potential short-sale candidate include a high valuation, weakening price movement, a growing balance sheet and profit margin deterioration.



Greg Swenson co-manages the Grizzly Short Fund (GRZZX), a contra market fund. Greg and I talked about short selling, including how he identifies potential candidates and handles the risks inherent with shorting.

—Charles Rotblut, CFA

Charles Rotblut (CR): *For our members who are unfamiliar with the concept, could you explain what a short sale is?*

Greg Swenson (GS): A short sale occurs when an investor thinks that the market, a particular stock or a basket of stocks is going to decrease in price, and the investor wants to profit from those expectations. The mechanics are that I, the investor, would go out and—through a broker—borrow shares of a stock from someone who holds it long (a current shareholder). I then sell the shares I borrowed. When I want to close out the position, ideally at a lower price, I buy shares and deliver the shares back to the person I borrowed them from through my broker.

Ideally, you borrow and sell the shares high and then buy back low and deliver the shares back to the owner to profit from the decline in price.

CR: *Individual investors who short stock pay their brokers margin loan interest based on the dollar value of the shares shorted. How similar or different is it for your fund? [A margin loan is a loan taken from a broker that uses the account's assets as collateral.]*

GS: It depends. Right now, for us, we usually get paid interest on our short sale proceeds. We don't use leverage at all in our fund. If an investor gives us $1.00, we short that dollar in a stock, hang on to that dollar and then get the dollar back from the short sale. So we always have two dollars for every one dollar that we're actually short.

[Editor's note: For each dollar of inflows the Grizzly Short fund receives, it shorts a stock by an equal amount. This gives the fund $1 from inflows, $1 from the proceeds of selling the stock and an offsetting liability of $1 for the short position the fund needs to cover.]

CR: *Let's discuss some of the risks that an investor can have if they short a stock.*

GS: If someone's not familiar with shorting, they may need to flip things upside down a little bit to get their mind around the concept. There are several different risks between shorting and going long (buying a stock). One risk is just that, from the very beginning, there is kind of a skewed gain/loss potential.

If you short a stock, your gains are pretty much locked in at potentially 100%. As an example, if you short a stock at $10.00 and it goes down to $0.00, you would be gaining 100% on that short. Your loss potential, however, is much higher, because there's no ceiling to where a stock can go. So, depending on whether the stock moves for you or against you, your gains are limited while your losses are unlimited. This is really one of the disadvantages to shorting.

Some people say that's not true, because you can add to your short position, which would increase your gains above 100%. We don't do that; I think that's always kind of risky to

Table 1. Performance of the Grizzly Short Fund

	Total Return (%) 2015	Total Return (%) 2014	Average Annual Return (%) Last 3 Yrs	Average Annual Return (%) Last 5 Yrs	Average Annual Return (%) Bull Market	Average Annual Return (%) Bear Market	Expense Ratio (%)
Grizzly Short (GRZZX)	**3.8**	**(11.1)**	(12.2)	(12.2)	(83.6)	**123.8**	1.58
Contra Market Cat Average	(4.5)	(17.7)	(17.2)	(17.7)	(80.0)	72.9	1.65

Bold returns are in the top 25% of all funds within in the investment category.

Source: AAII's "The Individual Investor's Guide to the Top Mutual Funds 2016."
Data as of December 31, 2015.
Bull market defined as March 1, 2009, through May 31, 2015; Bear market defined as November 1, 2007, through February 28, 2009.

short into a stock that's already getting hit real hard.

One of the main risks is that on the long side, when a stock is falling in price, it becomes a smaller and smaller part of the overall portfolio. In other words, its weight in the portfolio becomes smaller. On the short side, when a stock goes against you by rising in price, its weight within the portfolio becomes bigger and bigger and bigger. This causes the losses to mount faster.

So that's something we're always having to watch. If stocks aren't working for us and they're going against us and getting bigger, we have automatic levels where we just trim the positions back. No questions asked—no matter how good we think the stock is from a short perspective.

***CR:** On those automatic levels, I presume you have rules in place should a company deliver an unexpected upside surprise that could either change your assessment or just cause the price to jump.*

GS: Correct. If that happens, it'll trigger a lot of different things including the stock going up, obviously, and it'll change the unattractiveness of the stock. We typically don't react right away when something like that happens, unless the stock crosses portfolio weight thresholds where we just automatically have to cover our short position by buying shares. But a lot of times, once news comes out, it's often already kind of late to react, so we don't automatically just cover stocks that have kind of big pops based on news.

***CR:** So it's a similar reaction if you are long and there's unexpected news: Your tendency is to try and, if possible, wait a little bit, to see if some of the emotions, for lack of a better word, calm down a bit.*

GS: I don't even think that's lack of a better word. I think that's pretty much spot on. Right away, when something happens, a lot of times the price can skyrocket or fall apart. If you're acting with the crowd, I think a lot of times you're selling into a panic, or, on the short side, buying into a squeeze, which is just a huge disadvantage.

Another risk that I would say is just on the short side is that there tends to be a lot of interest in the same group of stocks, or there definitely can be. Positive news can drive a stock that's a popular short up a lot faster than it can for just the normal stock. That's because a lot of the shorts will come in and try to cover all at the same time. This will very quickly drive the stock's price quite a bit higher.

That's a really uncomfortable position to be in: When you're short a position and you can see it going up really fast. You know the news doesn't quite warrant that type of move—that it's a lot of people trying to get out of their short position—and you feel kind of helpless. That's one of the worst positions to be in as a short.

***CR:** What about volume and liquidity? As a mutual fund, you have to have a certain minimum volume in a stock to transact in it easily. But in terms of shorting, is there an additional limitation where you look for a higher level of volume than, say, if you were actually buying stocks instead?*

GS: Yes there is, because there's definitely a higher chance that you're going to try to get out of a short position quicker than you would a long position. So, when we buy a stock—I've run long funds as well and so can speak to both sides—sometimes I'm comfortable being able to buy into the stock over a several-day time period. But for a short position, we usually want to be able to get in or get out of that position the same day. The reason for this is that news causes the stock to jump in price and there are people trying to get out of their short position—causing the stock to rise even further—and we really want to get out and be able to just cover that position.

At the same time, with the short fund, we know that both our clients and we—because we use the strategy as a hedge internally—might put on or take off a decent amount of exposure all at once. If someone, or if we, gets very bearish in the market, we might put a big chunk of money into this strategy over a one- to two-day time period. So the fund is always run at a much higher level of capacity than what we actually have in the fund, both for us and our clients.

***CR:** And for an individual, are there any guidelines you could share for what they should think about in terms of volume from a shorting perspective? Because, obviously, they're deploying much smaller amounts of money than you are.*

GS: That's actually a good question. I've never really thought about that from an individual perspective. We don't short stocks, or tend not to short stocks, that trade less than about $10 million in volume per day. That's a guideline for us. I don't know how relevant that is for an individual who's putting much smaller amounts of money to work. But that's the target that we usually use, and we scale our positions accordingly as far as liquidity going up from there.

***CR:** In terms of identifying a stock as a good candidate for shorting…I was glancing at your portfolio and it looks like you're mostly* *targeting higher valuations and companies with a lower quality of fundamentals, correct?*

GS: Just speaking to the portfolio in general, if you were to view our portfolio as kind of a stock and look at its metrics, you'd see that it tends to look like a stock you would want to short. It's overpriced. It has lower growth. It tends to have lower margins. It might be heavily leveraged. The portfolio just tends to look like a lower-quality, expensive stock.

We use a quantitative model to identify a broad list of stocks to short. What we're looking for are stocks that tend to be expensive or overvalued—or we hope at some point overvalued—that might have a reason why they might be re-rated, so to speak.

Shorting just based on valuations is a really tough game, because stocks can get expensive and stay expensive for a very long time, and even become much more expensive. We look across the landscape to find overvalued stocks. And then, for whatever reason, the market signals to us that their valuations are going to be called into question.

It could be the price movement, meaning the price is breaking down relative to other stocks in the universe.

It could be growing capacity, which is a theme that you hear a lot on company conference calls: CEOs trumpeting that they're gaining market share and they're growing capacity. That sounds like a great thing, but it's actually the inverse. If you look at the set of companies that have grown their balance sheet or increased capacity the most out of the whole universe of stocks, those stocks tend to underperform going forward. Because most CEOs think they have the best idea and think that what they're spending their capital expenditures on is going to work. The ones that really over-leverage themselves tend to not have everything turn out perfectly and run into issues that way.

Insider selling is another clue that we look for. If a stock is expensive and there are some key insiders offloading their shares, that can be kind of a heads-up that everything's not great.

Profit margin deterioration would be another one. If margins are slowly eroding, that could signal further pain for the stock.

CR: *Regarding capacity, is this a case where you're looking for both higher levels of capital expenditures (capex) on the cash flow statement and looking for higher debt on the balance sheets?*

GS: The two ways that we look at it would be increasing capex and also absolute growth of the assets on the balance sheet.

CR: *Okay, and then you're also looking for something else to suggest the CEOs are overconfident?*

GS: It would be a lot of things. What we rely on is for it never to be just one thing that's telling us the stock is a good candidate for shorting. We like to apply a sum of the parts—a weighted evidence type of approach—where there are several different clues flashing that the stock might not be performing well going forward.

CR: *If you get into a short position and you realize you're either too early or it's just not working the way you thought it would, is there a certain trigger you look for to get out of the position? Is it price movement? Or is there a certain time period where you say, for instance, "Okay, this is not working. We're going to deploy our assets elsewhere."?*

GS: We have a couple of different ways we do that. One would be if a stock doesn't hit a new relative strength low in, say, 17 weeks, we usually get out of it. So no matter how good it still looks in our model—even if it still looks like a good short candidate—if the stock is just not behaving like we think it should for a period of time, we'll get out of it.

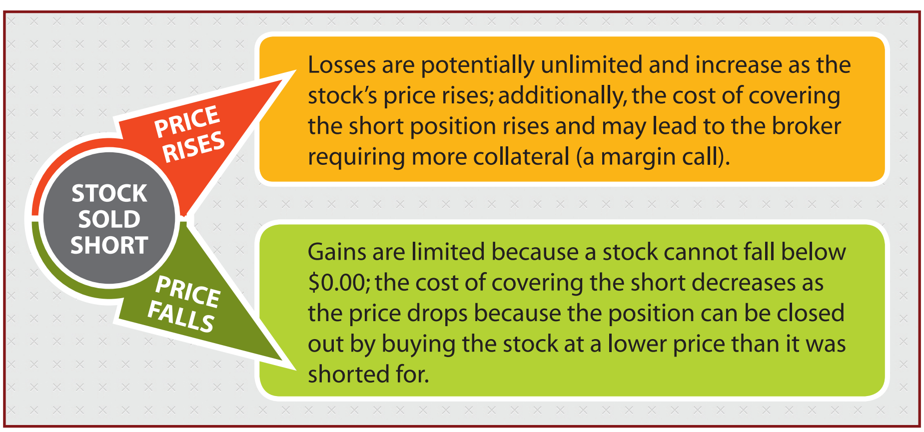
We also take into consideration volatility-adjusted relative strength. The way that works is if it's a higher-beta stock, we give ourselves a longer leash, so a little above a 20% loss on a beta-adjusted basis. And if it's a lower-beta stock, we give it a shorter leash. The idea is that higher-beta stocks are going to swing a little bit more and we might need a little bit more time for those to work.

CR: *If somebody's long a stock, are there signs that they should get out? Or are there signs that they should avoid taking a long position in a prospective stock?*

GS: I think if you were to see a lot of short interest in a stock you own that would be cause for concern. Shorts, over time, tend to be right more often than wrong. So if you see the short interest ratio—or short interest as a percent of total shares outstanding—all of a sudden rapidly increase, assuming it wasn't that way when you bought it, I would suggest reevaluating what's going on. Check to see if the shorts have a reason to be involved in the stock.

Relative strength breakdowns are another one I would look at. If a stock has been trending really well for a long time and then, all of a sudden, it runs into a lot of trouble and maybe it's expensive at the same time, that could be a reason to get out of it.

Figure 1. Returns From a Short Position



What If the Stock Drops to $0?

Gains in a short position are limited to 100% because a stock price can only fall to $0. The overwhelming majority of profitable short trades realize gains of less than 100% because the positions are closed at prices above $0.00 (many short trades result in losses, however). For example, if a stock is sold short at a price of $20.00 and it falls to $5.00, the short seller's profit is 75% ($15 price drop ÷ $20 original price).

But what if the shares shorted actually become worthless? This could happen if the company goes bankrupt. I asked Greg this question after our interview. In such situations, he would try to close the short position before the stock ceased trading—often at extremely low prices. If the stock were to go to zero and completely stop trading, then he would have to wait for the broker who facilitated the short position to release the collateral (the entire proceeds from the initial short) back to him.

—Charles Rotblut

***CR:** In regard to your fund, you obviously follow a different type of strategy from most funds and your best performance seems to come during bear markets. How does your fund fit into a typical individual investor's portfolio?*

GS: Our goal is to do better than the inverse of the S&P 500 index. So, if the market is up 15%, we want to be better than down 15%. And then vice-versa: if the market's down 15%, we want to be better than up 15%. We're always trying to take a 100% negative exposure to the market, so that our clients know when they buy the fund how much negative exposure they're getting.

The way people typically use the fund is if, let's say just as a number, they have 80% of their portfolio long equities. If they're getting nervous about the market, they may want to take that exposure down to 60%. By putting 20% of their portfolio into the fund, they would know that would reduce their equity exposure by 20%.

The reason they would put it with us, instead of buying an S&P 500 inverse fund or just shorting the SPDR S&P 500 ETF (SPY), is because we try to provide performance above and beyond just the inverse of the benchmark.

They could also just sell their long positions, but buying the fund is a more tax-efficient way to bring the equity exposure down. If you have a lot of long holdings with gains and you don't want to realize those gains, you can bring your equity exposure down by taking on short exposure. When you're not bearish anymore, take the short exposure off, and your equity exposure goes back up without selling your longs.

***CR:** This leads to a question about the flow of shareholder dollars. Do investors typically allocate more cash to your fund toward the end of bull markets and withdraw dollars as they sense a new bull market starting?*

GS: Yes. We get a lot of flow into the fund when the market gets really volatile and there are people taking risk off the table. When that happens, we see pretty good inflow into this type of fund, which is specifically for people who are seeing their risk aversion go up.

***CR:** Finally, let's discuss your fund's performance. During bear markets your returns are great. During bull markets, there are years where your, and your competitors', returns are negative. How should an individual investor looking at the performance view those trends?*

GS: When analyzing a fund like ours, you have to realize that over time the market goes up. So, if we have 100% negative exposure to the market, we're most likely, over long periods of time, going to have negative returns. I think an investor needs to view the performance in the context of the market cycle. If the market's been moving higher for a long period of time, does it make sense to take equity exposure off the table? A fund like ours will do better when the market goes down.

Investors really have to view our performance in the context of what the goal of the fund is—to provide downside protection.

Go to AAII.com to hear bonus audio from Charles' interview with Greg Swenson about which macro environments are more and less favorable for shorting, as well as the investing lessons he's learned. ▲

Greg Swenson, CFA, co-manages the Grizzly Short Fund (GRZZX). Find out more at www.aaii.com/authors/greg-swenson. Charles Rotblut is a vice president at AAII and editor of the AAII Journal. Follow him on Twitter at twitter.com/CharlesRAAII.