



A Primer on Short Selling

CHALLENGE

Selling short can be risky. When you sell short, you're selling a borrowed security in the hope that its price will go down. If it does, you can buy back the stock at a lower price and pocket the difference. But, if the price of the borrowed security increases and you're forced to buy back shares at a higher price than that at which they were sold, you lose.

In theory, the size of a potential loss from short selling is unlimited, because the stock price can keep rising and there can be no assurance that the security necessary to cover a short position will be available for purchase.

How, then, can short selling help you to both reap excess returns and control risk within your portfolio?

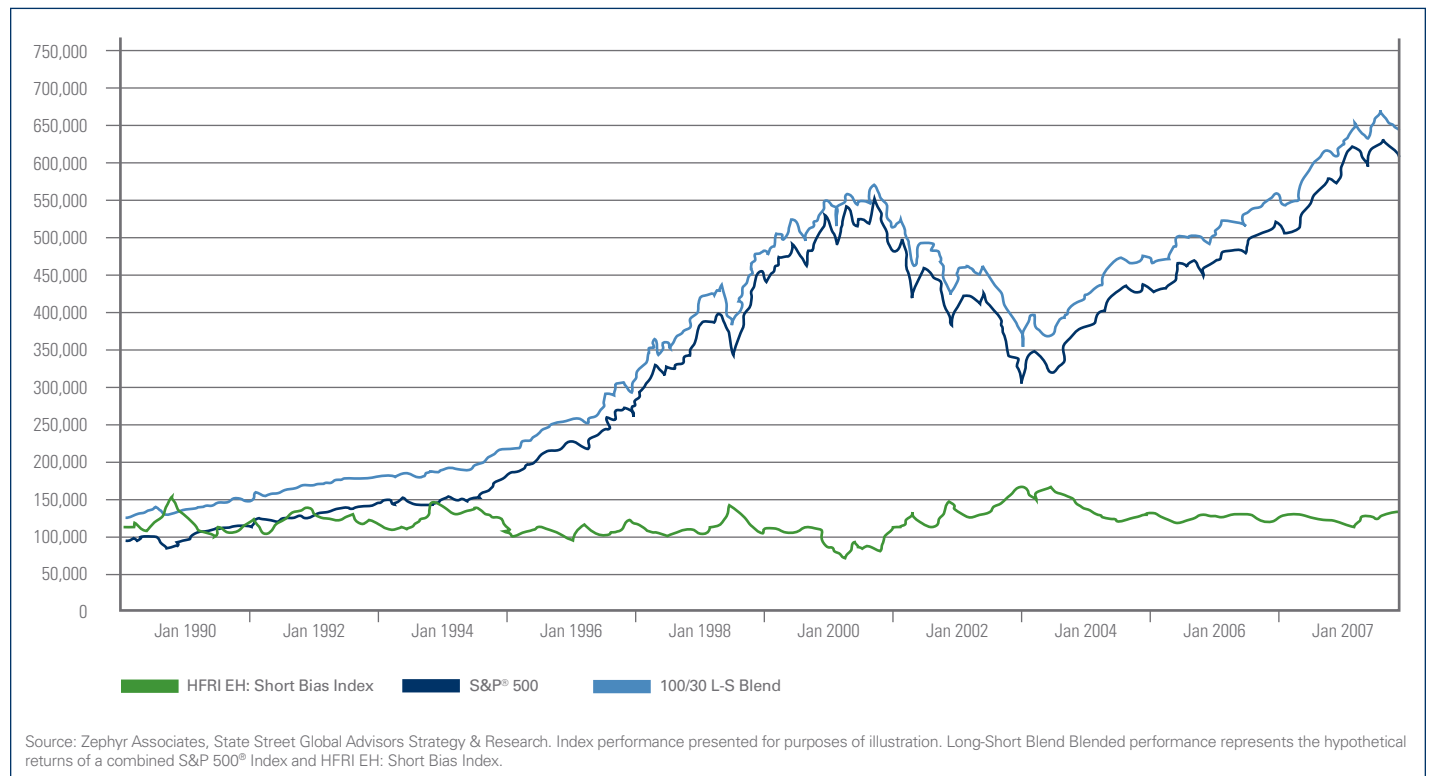
SOLUTION

A well thought-out strategy to employ short selling within the context of a primarily long portfolio can help manage risk to enhance your core portfolio allocation (see L-S Blend Index). Short selling provides diversification to a portfolio due to its negative correlation with a long portfolio and the different set of equity holdings it will target. Due to this negative correlation, shorts may provide a buffer in down markets.

BENEFITS

The way shorts can moderate risk is by preserving capital in down markets. Capital preservation provides a greater base when the market turns up, thus enhancing the power of compounding. Utilizing a careful short selling strategy, then, may enable you to strengthen growth-oriented portfolio performance and enhance returns over the long-term.

SHORT SELLING MAY BE AN EFFECTIVE STRATEGY FOR ENHANCING LONG-TERM RETURNS.



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DEFINITIONS

SHORT-SELLING

The selling of a security that the seller does not own, or any sale that is completed by the delivery of a security borrowed by the seller. Short sellers assume that they will be able to buy the stock at a lower amount than the price at which they sold short. Short sellers make money if the stock price goes down. They lose money if the stock price increases.

COVERING

When you sell short a stock your broker will lend you the security. The stock will come from the brokerage's own inventory, another one of the firm's customers, or from another brokerage firm. The shares are sold and the proceeds are credited to your account. Sooner or later you must "close" the short by buying back the same number of shares (this is called covering) and returning them to your broker. If the price drops, you can buy back the stock at the lower price and make a profit on the difference. If the price of the stock rises, you have to buy it back at the higher price, and you lose money.

SHORT INTEREST

The total number of shares of a security that have been sold short by customers and securities firms but not yet covered. Short Interest is used as an indicator of market sentiment. A rising short interest indicates a large number of people believe the stock will go down.

SHORT INTEREST RATIO

The number of shares sold short (Short Interest) divided by the average daily volume. Referred to as the "Days to Cover" ratio, it tells you how many days it would take short sellers to cover their positions if good news sends the price higher. If too many shares of a given stock have been sold short and the number of days it takes to cover is in excess of 8-10 days, covering could prove difficult.

SHORT SQUEEZE

If a stock starts to rise and a large number of short sellers try to cover their positions at the same time, it can quickly drive up the price of a stock even further. It is, therefore, not advisable to short a stock with a high short interest. Buying stocks in the hopes of a short squeeze is not a smart strategy.

INDEX DEFINITIONS

S&P 500® INDEX

The S&P 500 Index includes 500 leading companies in leading industries of the US economy.

Source: www.standardandpoors.com

HFRI EH: SHORT BIAS INDEX

Short-Biased strategies employ analytical techniques in which the investment thesis is predicated on assessment of the valuation characteristics on the underlying companies with the goal of identifying overvalued companies. Short Biased strategies may vary the investment level or the level of short exposure over market cycles, but the primary distinguishing characteristic is that the manager maintains consistent short exposure and expects to outperform traditional equity managers in declining equity markets. Investment theses may be fundamental or technical and nature and manager has a particular focus, above that of a market generalist, on identification of overvalued companies and would expect to maintain a net short equity position over various market cycles.

Source: www.hedgefundresearch.com

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Definitions source: Investopedia

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Short sales present different risks than those typically associated with long-only equity investing. A short sale involves the risk of theoretically unlimited increase in the market price of the particular investment sold short, which would result in an inability to cover the short position and a theoretically unlimited loss.

Past performance is never an indicator of future results.

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