

Taking Stock: Short sell's a long shot

by *Malcolm_Berko*

Dear Mr. Berko: I think that the stock market is headed lower and I believe the Dow Jones average will fall below 9,000 in the next 12 to 18 months. So I'd like to sell short some stocks because if they go down I can make a good sum of money. I came to the conclusion that the market will crash because real estate prices are tumbling, the Chinese market is crashing and many big companies are reporting lower earnings like Home Depot, Lowe's, Gap, Borders and Federated to name a few. So please explain a short sale to me and tell me how to do it. I don't want to take much risk so I would prefer to short sale companies that are really going to have earnings troubles like Lennar, Beazer Homes and builders and suppliers.

C.T.

Everett, Wash.

Dear C.T.: There are 38.7 good reasons for the market to turn tail and "smusch" to 9,000. The best I can tell you is that the market will always do what it's supposed to do but NEVER when it's supposed to.

A short sale allows a speculator to make a bet (and hopefully a profit) on the declining price of a stock.

Assume a speculator believes that Lennar Corp. (LEN-\$48), a \$16 billion revenue home builder, will post lower profits in 2007. Well, most investors agree that the price of a stock is dependent on its revenues and earnings. Increasing revenues and earnings have a positive effect on a stock's price while declining numbers usually have a negative influence on a stock's price. If the speculator is correct and LEN, which posted earnings of \$3.69 last year, reports earnings of \$1.50 this year, then there's a good probability the stock price will decline. So this speculator (who doesn't own LEN) borrows 100 shares from his brokerage and sells this borrowed stock to a buyer at \$48 who believes LEN's price will increase.

The speculator sold 100 shares he does not own, so this transaction is called a "short sale." Now this short sale at \$48 creates a credit balance in his brokerage account of \$4,800 and he's "short" 100 shares, which must be returned at some time in the future.

It's six months later. Behold and lo, LEN reports significantly lower revenues and earnings and its share price declines to \$38. At this point, the speculator decides to buy back the 100 shares of LEN (this is called "covering" the short sale.). He uses \$3,800 of the \$4,800 credited to his account from the short sale six months ago, and returns the 100 borrowed shares to his brokerage. Since the speculator sold the borrowed share at \$4,800 and covered (bought them back) them with a purchase at \$3,800, his net profit is (\$4,800 less \$3,800) \$1,000. It's a big easy, straight as an arrow and sweet as a kiss.

There is an important caveat though. If the speculator is wrong and LEN posts strong revenues and earnings its stock could rise dramatically to, say, \$68. At this point the speculator might wish to cover his short sale and buy back LEN at \$68. Because the speculator only has a \$4,800 credit from the short sale of LEN in his brokerage account, he has to come up with \$2,000 more to cover this short. And that's a \$2,000 loss. If he covers at \$78 he's lost \$3,000 and if he covers at \$108, that's a \$6,000 loss. The upside loss is unlimited. Wow!

Meanwhile, unless you're a seasoned speculator and have beaucoup bucks, it's rather unwise to pick individual issues on your own. If you wish to do this, I suggest the following open-end and closed-end funds that specialize in short sales. I'm not recommending them, rather giving you a safer and more efficient alternative.

Short SmallCap600 ProShares (SBB-\$65.03), Ultrashort Russell2000 Value Pro (SJH-\$70.84), ProFunds Short Real Estate Investor (SRPIX-\$23.96), PIMCO Stock Plus Short Strategy (PSSDX-\$7.75), UltraShort Financials ProShares (SKF-\$73.69) UltraShort Real Estate ProShares (SRS-\$88.87) and Prudent Bear Fund (BEARX-\$6.58). And please don't take it personally if I do not wish you good luck.

Please address your financial questions to Malcolm Berko, P.O. Box 1416, Boca Raton, FL 33429 or e-mail him at malber@comcast.net.

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