Shorting the Market

The Australian stock market has fallen nearly 500 points (10%) in less than a month from the beginning of September. Six months of growth has been eliminated in 28 days. It was not out of the blue. Gold and Oil have fallen to four year lows and have been in steady decline, leading major commodities down since 2012. This has seen the downturn in the $AUD returning to 2010 levels and pointing towards the twenty year average of $0.80 USD.

Realistically, our market has lost contact with the US and German markets that have experienced significant quantative easing. If we look towards the London market (FTSE 100) we see an alarming long-term pattern – the FTSE has failed for the third time to defeat the magic 6900 marker in fifteen years and is currently falling – and with it heavily weighted stocks such as BHP, RIO, NCM and a host of small stocks that have duel listings in our Top 200 index.

Further consideration can be given to the fact that the long-term uptrend has been broken. There is support above 5000 but if this level is broken, the next level of support is down near 4500 – another 12 % lower than our current position.

B.H.P. Investing

The old method of investment relies on picking good stocks with good yields and holding on. It is known as Buy Hold & Pray (B.H.P.) Investing. If the market is in for a relatively mild correction then this methodology has been successful. However, like all investing it is heavily dependent on timing. If you invested heavily in 2002 then the recent years have been a joy of profit. If you commenced this strategy in 2007, you are yet to recover from the GFC and things do not look so rosy.

30 Degrees Up – 60 Degrees Down

The problem is that stocks do not rise and fall in the same manor. Going up the stairs takes a long time and falling down the lift well takes a short time. Consequently we can think about stocks rising at 30 degrees but falling at 60 degrees. As volatility comes back to the market, the down side tends to be substantially higher than the upside.

An important component of market direction is that "Markets crash down – they do not crash up". This also has an effect on investment recovery – the time taken to recover lost value for market investments. This means that shorting the market or making money on a market fall is often a more effective means of investing than making money on a rise. This is relatively simple but because it is unfamiliar, less than 10% of investors take advantage of shorting strategies.

Short Selling

Short selling or "shorting" means that you are making money on the fall in value of the market. This is achieved by obtaining a "guaranteed" current value of a stock against the potential lessor future value of the stock. There are a number of instruments that allow you access to this. Each has its strengths and weaknesses.

Put Options

Put Options are available on 76 stocks in the Australian market. They are moderately effective on the Top 50 stocks. They are very effective on the top 20 stocks where they are thickly traded and have multiple underwriters.

An Option is the right but not the obligation to buy a stock at a lower price than the current market value. If we purchase a $32.50 PUT options on BHP, we have a guaranteed sale price of $32.50 for BHP. If the market falls below $32.50 to $32.00, the profit for the PUT becomes $0.50 – the difference between the PUT value and the current price.

Option Advantages:

1) They are inexpensive
2) Risk is limited to 100% of the investment. You cannot lose more than the cost of the option.

Option Disadvantages:

1) They are not applicable to a large number of instruments
2) They have an expiry time (1 to 3 months)
3) More than 70% of PUT options expire worthless

Futures

Futures work in a similar way to options. They insure a current value against a future value of an instrument. Whilst they are available on top 20 stocks, they are not regarded as effective in this area and are thinly traded. However, they are ideal for insuring an index. Index insurance is ideal for a diversified portfolio of Top 200 stocks.

Futures Advantages:

1) They are cost effective on large portfolio's
2) They are ideal for Index movements
3) Highly leveraged

Futures Disadvantages:

1) You can lose more than you invest – losses are not limited to your investment cost
2) Specific shares are not easily insured and the level of insurance is general
3) Futures contracts expire every 3 months

Contracts for Difference (CFD's)

CFD's work very well for shorting an individual stock. They are sold at the current price and bought back at a future date as the participant decides – there is no expiry date. They are individual and so they are ideal for shorting odd parcels such as 454 BHP shares. The concept is to sell BHP today and buy it back at a lower price in the future and make a profit. To take control of these shares we offer a "margin" as security bond. A common "margin" for top 200 shares is 10% of the underlying value.

We are used to the equation for buying something and then selling it at a profit:

+1 (buy it) – 1 (sell it) = $profit/loss

Shorting equation is simple:

-1 (sell it) + 1 (buy it back) = $profit/loss

This means if we sell BHP for $32.50 and we buy it back for $32.00 in the future, we make $0.50 per CFD. Hence the Contract for Difference – which is the difference in the price from time of sale to time of purchase.

CFD's are an unregulated market. That means that they are not governed by a common set of standards and so CFD's providers vary dramatically from one to another. The following is true for CITY INDEX

CFD Advantages:

1) You get PAID to be short. Because you are effectively lending money to your provider, you earn a small amount for going short.
2) Stop loss and money management rules are applicable – guaranteed stops are available.
3) CFD's can be tailored to any size portfolio and are applicable to the index, commodities, or any top 200 stock.
4) Forcible Close Out legislation (FCO) means you cannot lose more than your account balance.
5) CFD's do not expire and positions can be opened and closed at will.
6) CFD's are highly leveraged and so you get significant "bang for your bucks".

CFD Disadvantages:

1) You can lose more than your initial investment “margin”.
2) CFD’s draw down errors because they are leveraged.

Shorting & Timing

The critical component of Selling Short is to know WHEN to sell short. This is easily achieved using a myriad of technical tools. We can use these tools on either a top 200 stock or an Index.

A common tool is a simple 30 day moving average. Where the LOW price of the day is above the 30 day moving average, you can buy/hold the stock. Where the HIGH price is below the 30 day moving average you can Sell Short.

If we apply this to BHP we can see below:

Advantages:

1) Gives a clinical and technical approach to shorting
2) Provides and effective money management strategy
3) Is highly effective in long trends
4) Easily calculated

Disadvantage:

1) Is about 50% accurate
2) Sideways movements in the market will be expensive.
3) Different values are effective for different stocks/indexes – performance will vary drastically from instrument to instrument.

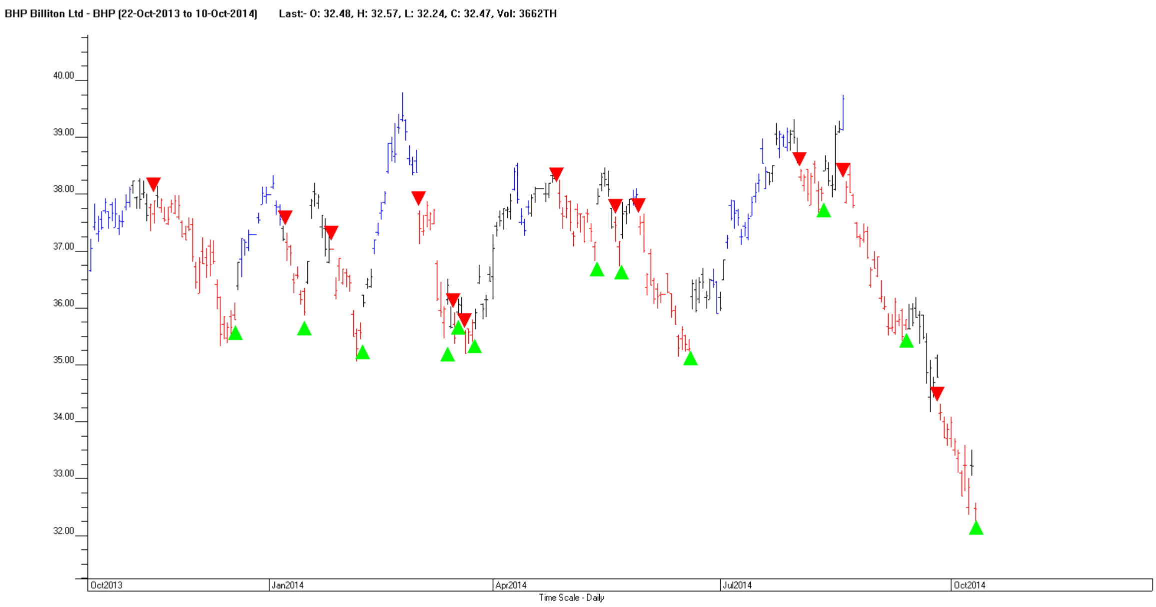
Profiling an Instrument (Portfolio Defender)

If we look at BHP, we can construct a complex profile of behaviour based on such things as direction of the Australian Index, US Index (BHP is listed in NYSE), UK Index (BHP is listed in LSE), value of the $AUD (BHP as an exporter), value of commodities (Gold, Copper, Iron) etc. we will gain a very deep understanding of BHP price behaviour.

Portfolio Defender is specifically designed to individually profile every instrument from ANZ to WBC for specific "shorting" profiles. This makes the Portfolio Defender the most advanced investing tool on the market. It can be deployed in two ways:

1) Shorting stocks, indexes, and commodities for profit.
2) Insuring long-term positions with a negative position to neutralise downside risk – this strategy involves holding the underlying stock for long-term growth and dividend income and then shorting the stock with a CFD when the market indicates. Your tax position on the underlying share does not change but any capital value reduction is returned to you as cash.

Portfolio Defender colour codes the chart to indicate a defensive position is required. If the chart turns RED – then a defensive position is required. The portfolio Defender is the ultimate way to manage short positions in the Australian market. It is also effective for long trading – indicating when a stock or instrument is likely to rise. Because it is a profiling instrument it is effective on the majority of instruments in the majority of market conditions.



Advantages:

1) Ideal for Shorting and constructs an individual profile for individual top 200 stocks
2) Can be used on commodities and indexes
3) Automatically manages risk
4) Requires no skill or experience to operate
5) Used in conjunction with stock for insurance (method 2) profits can be huge and losses tend towards $0
6) More than 70% accurate on most Top 200 stocks

Disadvantages:

1) Puts professional fund managers out of business

What next?

To download a free demonstration version of the IC-Investor Software click here

If you are interested in receiving a FREE trial of the Portfolio Defender eNewsletter click here. The eNewsletter is issued every Friday and contains the results for the top 200 stocks.

If you are interested in learning how to short the market we run a Course – Shorting 101 that is designed to teach beginner and intermediate shorting for profit and insurance. Click here to register your interest in attending a course in a city near you.

If you are interested in the Professional Portfolio Defender software – please enquire and we will arrange for a demonstration of the software.

If you are interested in our broker team to handle professional insurance for an existing portfolio for you – click here to receive more information.

Alternatively you may contact one of our friendly staff via email; sales@investorcentre.com.auOR telephone 1300 132 999

Now it's up to you – are you going to Buy, Hold, and Pray - or are you going to participate in the next volatility move in our markets?