# Selling Short: Fruit 'n' Finance

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***Equilibria* #6, 1998/99**

Selling a stock short reverses the usual relationship between company performance and investment return. If you buy one share of WXYZCorp (this is called a "long position"), a $1 rise in the share price makes you $1 richer. If you sell short one share (a "short position"), a $1 rise in WXYZCorp stock makes you $1 poorer.

Textbooks sometimes define shorting as "selling a stock you don't own." This definition is a bit misleading and may make the practice sound menacing, reckless, or immoral. In fact, short selling helps the stock market to function efficiently and encourages sensible, productive economic activity that might otherwise never occur.

Let's substitute a better definition: "A short seller promises to provide a buyer with something of value in the future at a given price. The seller pledges to spend whatever necessary at that time to fulfill the promise." An investor who sells WXYZCorp short at $100 promises the buyer, "Sometime in the future, I will buy a share of WXYZCorp at the going rate and will sell it to you for $100."

Everyday transactions are filled with the equivalent of short sales, and they can help us understand why the practice is important to the stock market. When a McDonald's gift certificate promises to sell the holder one Big Mac for $1 in the future, it has sold Big Macs short. When a caterer promises to feed 100 guests for $3,000 next November, he or she has sold catering services short.

**The Value of Short Selling**

Let's let the caterer illustrate the logic behind short selling. Ralph is planning a mammoth party six months from now, and he wants to serve mountains of citrus fruit to his guests. He hires GourmetCo to provide the food, which we'll assume is GourmetCo's only expense. If the party were today, GourmetCo could provide the fruit for $10,000. But this job is six months from now, and food prices can change with supply conditions. If there's a drought or a frost down south, citrus fruits will be in short supply and this order might cost $20,000. If the Florida weather is good, the citrus farmers will be begging people to buy their fruit, and GourmetCo might get fruit for $5,000.

Suppose GourmetCo offers Ralph the following contract: "We'll provide the fruit for between $5,000 and $20,000, depending on market conditions." Ralph will say, "Forget it. I can't take that kind of risk—give me a set price or there's no deal."

GourmetCo then offers to do the job for a guaranteed price of $13,000, and Ralph signs on the dotted line. GourmetCo has now sold short in the citrus fruit market. It has promised to pay whatever it takes to buy the fruit and has promised to sell it to Ralph for $13,000.

The value of the fruit is like the value of a share of stock. If frost hits the orchards,GourmetCo will have to pay $20,000 for fruit that will only yield $13,000—a $7,000 loss. If the weather is beautiful, GourmetCo will have to pay only $5,000 for fruit that it will sell for $13,000; GourmetCo will pocket the

$8,000 windfall. Ralph prudently refuses to bear this price risk, but GourmetCo may have very good reasons for accepting it, including:

- GourmetCo's risks may cancel out over time. They might lose $7,000 on this contract but reap an $8,000 windfall on another contract.
- GourmetCo may be able to offset this risk by locking in fruit costs. Some fruit farmer, worried that prices might drop, might be happy to lock GourmetCo into an agreement at today's prices. If prices rise, the farmer will be sorry he signed the contract rather than waiting. If prices drop, he'll be thankful he didn't take chances. Here, GourmetCo takes a short position with Ralph but a long position with the farmer, and the two risks exactly cancel one another.
- Maybe GourmetCo, typical of entrepreneurs, is simply more of a risk-taker than Ralph—willing to take heavy risks in exchange for high returns.

GourmetCo might also feel that it has a better-than-average feel for the citrus market. If it believes strongly that prices are heading for a slump, then this risk seems like a good, solid bet—an educated gamble.

This last point illustrates one of the most valuable services that short sellers provide—they provide valuable information to consumers, vendors, and competitors. If GourmetCo bids $8,000 on the job while its competitors all bid $12,000, the other firms have received GourmetCo's citrus market forecast free-of-charge.

The above bullet points explain GourmetCo's reasons for selling short. Each of these points has its analog in the stock market. Some investors sell WXYZCorp stock short because the risks of doing so cancel out other risks over time. Some do because they believe (rightly or wrongly) that WXYZCorp will not do well in the future. Some sell WXYZCorp short to cancel out other risks that they bear. And some sell short because they are risk-takers.

**What if We Ban Shorting?**

What if the law prohibits GourmetCo from selling short its services? In other words, what if GourmetCo can't promise in advance to sell Ralph the fruit for $13,000?

- Ralph either has to sign the contract without a specified price (leaving him vulnerable to price rises) or he has to cancel the party. Either decision makes him worse off.
- If Ralph cancels the party, then GourmetCo is worse off. If Ralph agrees to hold the party and to accept the price risk, then GourmetCo loses the chance to take its desired entrepreneurial gamble.
- If Ralph cancels the party, then GourmetCo will have no need of the fruit, and the farmers, too, will be worse off.
- If GourmetCo can't bid a fixed price, other contractors, laborers, and customers will not learn about GourmetCo's forecast of future fruit prices.

The above effects may make some customers, contractors, and laborers sufficiently worse off that they withdraw permanently from throwing or servicing parties.

An absence of short selling in the stock market would have similar negative impacts on the stock market and on the economy as a whole. Here are some transactions that are facilitated by short selling:

- Suppose a pension fund owns WXYZCorp shares, fears that the share price will drop, but doesn't wish to sell the shares for six months (perhaps for tax reasons). The fund can instead sell short an equal number of shares. Now, it has a long position and a short position and the risks of one exactly offset the risks of the other.
- Suppose some high-tech company's cost base is volatile. Today a piece of equipment costs $100; six months from now, it might cost $200 or $50. This makes the company's budget risky. Suppose, too, that the price of this equipment tends to move opposite to the price of WXYZCorp stock. Then, the company can use WXYZCorp stock to partially offset the risk in its equipment costs. So, if the equipment rises to $200, WXYZCorp stock will have dropped and a short position in WXYZCorp will reap gains to pay for the higher-priced equipment.
- Suppose an expert in the computer industry has good reason to believe that WXYZCorp's stock will drop in the next six months. She can use this information to short the stock, thereby putting her money where her mind is. In doing so, her transaction will signal others that WXYZCorp may be in for some trouble. Others, who have less knowledge of the industry, can piggyback on the expert's brains—free-of-charge. (Of course, they might be piggybacking on some expert's incorrect information, though that's always a risk where markets are concerned.)
- Finally, just as in the citrus example, an inability to conduct these types of transactions might discourage investors, workers, and customers from a variety of productive endeavors.