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Short selling, the strategic weapon for bearish market trend: strategies, risk and regulations in India

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Abstract: Indian stock market is well known for its high volatility. In securities market higher the volatility higher the risk. To minimize the risk particularly in bearish market (falling market trend), when market is not working properly and equity prices are falling short selling is one of the best investment practices. Short selling is the sale of security (Equity, Future & Options Segment) on which seller does not have any ownership. In this paper the aim is to provide a brief overview of short selling and different strategies for short selling in Indian securities market. The paper also comprises meaning of short selling, short selling process, strategy to short selling, top short sold securities in last 24 month, risk associate with short selling and SEBI regulation regarding short selling in Indian securities market.

Key words: Short selling, Bearish market strategies, Investment and India

Introduction

Short selling is the sale of security (Equity, F&O) on which seller does not have any ownership. In simple term, short selling refers to the sale of securities which are borrowed by the sellers from the intermediaries. The strong motivation behind short selling is believes of borrower, the price of security will decline further after the sale, enabling it to be brought back at a lower price to make profit. Investors borrow the security and sales it when it has high price and buy it back when price is declined to make profit and return the security to the lender. In this paper we will discuss how an individual investor can be benefited from bearish market, perfect timing to short selling, top short sold securities and risk involved in short selling along with various SEBI regulations.

Literature of review

The research paper is mainly based on "Discussion paper on Short Selling and securities Lending and Borrowing" presented by SEBI. On 20 December 2007 SEBI- Market Regulation Department has issued a guideline regarding short selling and securities lending and borrowing. Pursuant to the recommendation of Secondary Market Advisory Committee (SMAC) of SEBI and the decision of SEBI Board, SEBI permit short selling to all class of investor but they decided to impose ban on naked short selling.

In 2002 discussion paper on short selling, the "UK Financial Services Authority" conducted that short selling is a "legitimate investment activity which play an important role in supporting efficient market. NSE India and BSE India website is the main source of information for this Research paper.

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Objectives of study

- Short selling meaning and process with practical example
- Risk involve in short selling
- Top short sold script on NSE in last 24 month (Volume wise)
- When to do short sell?
- Stock selection for short selling
- SEBI guidelines and regulation on crowd funding in India

Methodology

Meaning of short selling

Short selling is the sale of security (Equity, F&O) on which seller does not have any ownership. In simple term, short selling refers to the sale of securities which are borrowed by the sellers from the intermediaries. The strong motivation behind short selling is believes of borrower, the price of security will decline further after the sale, enabling it to be brought back at a lower price to make profit. Investors borrow the security and sales it when it has high price and buy it back when price is declined to make profit and return the security to the lender.

It is mandatory to distinguish short selling from Naked short selling. Naked short selling is the selling of shares that does not exist in really. A naked selling may manipulate the market by selling the fictitious security and it may also impact the price of stock by creating the artificial supply of stock. Perhaps this is why, A Naked short selling is restricted in Indian Security Market.

Example:-

Case- 1 (When security price fall)

Mr. Himanshu Goyal borrows 75 share of Nifty (having price of 8500 per share) from Ms. Nilam at borrowing charge of 0.5% of value of share. Mr. Himanshu Goyal sold these shares to Ms. Komal Tyagi at market price (8500 per share). After sometimes Mr. Himanshu Goyal buy back these share again @Rs. 8000/ share from open market. In this transaction profit / loss of Mr. Himanshu Goyal are shown in below:-

Particular	Amount
Sales proceeds of script (75 shares * 8500)	+637500
Less:- Purchase price of Script (75 share * 8000 per share)	-600000
Less: - Borrowing Fees (637500 * 0.5%)	-3100
Profit	**34312**

Case- 2 (when security price rise after short sell)

Mr. "Himanshu Goyal" borrows 75 share of Nifty (having price of 8500 per share) from Ms. "Nilam" at borrowing charge of 0.5% of value of share. Mr. Himanshu Goyal sold these shares to Ms. Komal Tyagi at market price (8500 per share). After sometimes market price of Nifty Index start rising, to minimize the loss Mr. Himanshu Goyal buy back these share again @Rs. 9000/ share from open market. In this transaction profit / loss of Mr. Himanshu Goyal are shown in below:-

Particular	Amount
Sales proceeds of script (75 shares * 8500)	+637500
Less:- Purchase price of Script (75 share * 9000 per share)	-675000
Less: - Borrowing Fees (637500 * 0.5%)	-3100
Loss	**-40600**

Above examples clearly state that, short sell is just opposed to long position as a short seller will make profit when price of stock decline while a long position investor earn profit when price of security rise.

Process of short selling

Following steps are involved in short selling:

1. Borrow the security from broker
2. Sell it immediately

Wait till the security price is expected to fall

3. When price declined purchase the security as it has to return.
4. Return the security to lender on the purchasing day (settlement day).

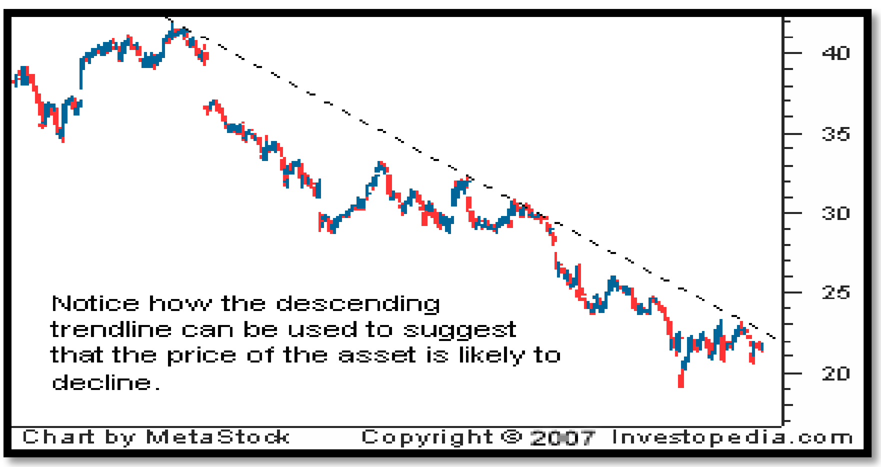
Risk involved in short selling

- **High borrowing cost:** since a short seller sells the borrowed security through intermediate so the borrower has to pay borrowing charge. Borrowing fees on short selling is generally charged at high rate.
- **Loss can be unlimited:** in the short sell, loss can be infinite. A short seller faces loss when stock prices in rise and there is no limit in how high it can go. On the other hand a stock price cannot fall below zero (0). So profit is limited and loss is unlimited.
- **High uncertainty:** short selling is motivated by believe that stock price will decline in near future. This prediction is done only on the basis of market analysis and technical analysis. But this prediction may not be always right. If prediction prove wrong and stock price go up, the short seller has to purchase security at high price to return to security to the lender, (**Case-2 in above example**)
- **Regulatory Risk:** Some times SEBI also impose ban on short selling in order to get price stability in market. In the year 2001 SEBI imposed a partial ban on short selling after a crush in stock price with the reference of insider trading in B.S.E (Anand Rathi Vs SEBI).

Strategic time for short selling

We all know stock typically decline very fast than they increase. A recognizable gain in stock price earn in several year may be wiped out in a couple of week or even a day. So a short seller must choose proper timing for short selling, because a late mover may lost the opportunity of big part of stock's decline. In other side, being too early may make it difficult to hold on to the short position. An investor may find following situation favorable for short selling:-

- **Declining sector Trends: -** In the bearish market tend to decline. If an investor perceive there will further decline in market, then there may be better chance of making profit through short selling. Global slowdown of 2008-09 was the most favorable time for short seller.
- **In fundamental deteriorating Market :-** For the broad market, worsening fundamentals could mean a series of weaker economic data that indicate a possible slowdown, or bearish technical signals like reaching new highs on decreasing volume, deteriorating market breadth, etc. Experienced short sellers may prefer to wait until the bearish trend is confirmed before putting on short trades, rather than doing so in anticipation of a downward move. This is because of the risk that a stock or market may trend higher for weeks or months in the face of deteriorating fundamentals, as is typically the case in the final stages of a bull market.
- **During off season of a particular sector:-** some seasonal sector perform well in particular season with higher demand and supply but they have worse demand or supply in some particular season of time. So a short seller should short sell in off season. For example after the rainy season the mining sector in India mainly decline.
- **Technical trends:** - For short term price prediction technical analysis is the best tool. Looking at the chart the investor can easily think about, what is the general trend?
  Most of the time we see that a stock that has been in a downtrend continued to trade in same pattern of near extended future.



In the graph it is clear that there is a decaling trend in stock price, so it difficult for an investor to make capital appreciation. So this is the best time and stock for short selling. Other technical tools that may be used are moving average and support and resistance line etc.

Stock / company selection for short sell

- Company with very high price earning ratio and much higher p.e.g. ratio.
- Company with useless product or services.
- Company with very weak financial position.
- Company with very high closing stock and trade receivable.

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Short selling and India

India has mixed experience of short selling in March, 2001 the Securities and Exchange Board of India banned short selling in Indian market. It was banned after stock market crashed due to unethical practice by Anand Rathi, the then-president of Bombay Stock Exchange (Mr. Rathi was later absolved of any unethical practice by Securities Exchange Board of India). However shortly after the ban, only retail investors were allowed to short sell. In 2005, SEBI allowed short selling to institutional investors as well. On 20 December 2007 SEBI- Market Regulation Department has issued a guideline regarding short selling and securities lending and borrowing, in which all classes of investor, viz., retail, and institutional investors are allowed to do short selling in India.

Some Top Short Sold Stock in last 24 month

Stock Name	Number of Shares short sold
Idea cellular limited	2439045 shares
BHEL	906694 shares
Kotak Mahindra Bank	652473 shares
Yes Bank Ltd.	419300 shares
Bharat petroleum ltd	382866 shares
Axis Bank Ltd.	151200 shares

- Source: - (www.nseindia.com)

SEBI Guidelines for short selling

On 20 December 2007 SEBI- Market Regulation Department has issued a guideline regarding short selling and securities lending and borrowing. Pursuant to the recommendation of Secondary Market Advisory Committee (SMAC) of SEBI and the decision of SEBI Board, it has been decided:

- All classes of investor, viz., retail, and institutional investors, shall be permitted to short sell.
- Naked short selling shall not be permitted in Indian Security market.
- An institutional investor shall not be allowed to do **day trading,** that mean they cannot do intraday short selling.
- The securities traded in F&O segment shall be eligible for short selling.
- The institutional investors shall disclose whether the transaction is short sell at the time of placing an order. However, the retailer would disclose by the end of trading hour on transaction date.

Conclusion

Short selling is an important activity in bearish securities market. It acts as an energizer for investors in bearish market. Although we examine that investors are not fully aware about short selling in India. As data driven from NSE clearly states that volume wise short selling is very low on National stock exchange since last 2 year. To prevent any manipulation in stock market by selling the fictitious security naked short selling is not permitted in India. All investors are required to mandatorily honor their obligation of delivering the securities at the time of settlement. Short selling may prove as a wonderful technique of profit making in the deckling market despite risk element, if it done in a disciplined way after doing proper technical and market analysis. On the other hand it may also

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contribute positively in economy. As data driven from NSE clearly states that the investor are not fully aware about short sell due to the lack of knowledge, so it may prove as an opportunity for a short seller. However a short seller must remember it may provide unlimited loss and limited profit (100% of the stock price).

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