FUNDAMENTALLY SPEAKING

A simple explanation of the finance terms we all hear about but don't really understand

Don't get caught short if shares take positive turn

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January was a very ordinary time for share market investors.

The ASX was down more than 6 per cent, while in the US, technology companies fared even worse and the Nasdaq fell nearly 9 per cent. With these returns in mind, it's hard to believe that some of the managed funds we use actually generated a positive return for the month.

The funds that managed to eke out a positive return had one thing in common — for part of their portfolio they implement a strategy known as short selling, or "shorting". The aim of shorting is to make money when a company's share price falls.

To explain how it's possible to profit from a falling share price, let's consider an example. You think ABC Ltd is overvalued. For this reason you don't own any of their shares. The next step is to approach an owner of ABC shares and borrow them. In return, you pay the owner a fee — a bit like an interest cost. In this example let's assume you borrow 100,000 shares.

Once you have borrowed them you're free to sell them on the share market. Let's assume you sell the shares for $1 each, which means you receive $100,000 in sale proceeds. From here, whether you profit or not depends on what ABC Ltd's share price does.

If it falls, say to 50¢, you make money. You do this by buying back the 100,000 shares at a cost of $50,000. The 100,000 shares are then returned to the original owner and you are free to pocket the difference as profit, in this case $50,000.

But it's not always a one-way street. If the share price rises you can lose money. The loss comes about because it's going to cost you more to buy the shares back than you originally received in sale proceeds.

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Illustration: Don Lindsay