

## BOOSTING MARKET ACTIVITY ON SHORT SELLING

The stock market in Nigeria is obviously making a steady and very interesting progress towards becoming very functional and vibrant. Few developments points to this. First is the introduction of the categorised and sectoral indices aimed at tracking the performance of leading stocks as well as the performance of the major sectors of the market. Secondly, the introduction and development of the over-the-counter (OTC) market as well as other products such as reits instruments are pointers to increasing the transaction space. It is equally expected that as the mortgage industry comes alive following the launch of the Nigerian Mortgage Refinancing Company (NMRC), new exchange traded mortgage backed instruments and asset backed instruments will be released into the market.

A functional stock market is the one that is active. And market activity on the other hand is a function of its width and depth. And by extension, this is measured by a number of factors key of which include availability of products, investors, and market strategies by which these products are delivered on the bases of closed transactions. The implication of this is that as the Nigerian stock market advances, new trading strategies will naturally evolve to facilitate the delivery of these new products. For a start short selling is one the trading strategies impacts on market activity.

### Short Selling

In short selling, also known as **shorting** or **going short**, an investor borrows and sells what he does not have or own. Specifically, it is the practice of selling securities or other financial instruments that are not currently owned. However, this is done with the aim of subsequently repurchasing replacing the instrument from the borrowed account. In the event of an interim price decline, the short seller will profit, since the cost of repurchase will be less than the proceeds which were received upon the initial short sale. Conversely, the short position will be closed out at a loss in the event that the price of a sold or shorted instrument should rise prior to repurchase. The potential loss on a short sale is said to be unlimited in the event of a continued rise in the price of the instrument.

Short selling is most commonly done with instruments traded in public securities, futures or currency markets due to the liquidity and real-time price dissemination characteristic of such markets and because the instruments defined within each class have high liquidity rating.

However, the short seller will be required to post margin or collateral to cover losses, and any inability to do so on a timely basis would cause his broker or counterparty to liquidate the position. In the securities markets, the seller generally must borrow the securities in order to effect delivery in the short sale. In some cases, the short seller must pay a fee to borrow the securities and must additionally reimburse the lender for cash returns the lender would have received had the securities not been loaned out.

### How Does it Work Concept?

The following example describes the short sale of a security. In order to profit from a decrease in the price of a security, a short seller can borrow the security and sell it expecting that it will be cheaper to repurchase in the future. When the seller decides that the time is right or when the lender recalls the securities, the seller buys equivalent securities and returns them to the lender. The process relies on the fact that the securities or the other assets being sold short are fungible; in other words, the term "borrowing" is therefore used in the sense of borrowing N10, where a different N10 note can be returned to the lender as opposed to borrowing a car, where the same car must be returned.

A short seller typically borrows through a broker,

## MARKET UPDATE

	15/01/13	15/12/13	25/04/14
Naira/US\$	154.1	155.2	155.75
Brent,US\$/BBL	109.78	107.84	109.9
COCOA, US\$	1487.82	2685.47	2760.56
MPR%	12.00	12.00	12.00
INFLATION RATE %	10.3	7.9	7.7
MORTGAGE RATE %	22.0	23.0	23.0

## STOCKS CONSTITUTING GMA INDEX

STOCKS	31/12/13 Price (N)	25/04/14 Price (N)	%Change in Price
OANDO	24.25	15.99	-34.06
GTBANK	27.02	27.30	1.04
OKOMU	44.00	35.03	-20.39
STANBIC	21.35	23.00	7.73
DANGSUGAR	11.70	9.35	-20.09
FIDSON	2.79	2.88	3.23
TRANSCORP	4.35	3.64	-16.32
CCNN	11.75	8.81	-25.02

	PRICE(N) 31/01/14	NAV (N) 25/04/14
UHOREIT	50.00	55.58
UPDCREIT	10.00	10.17

Index	31/12/13	25/04/14	% Change
NSE ASI	41,329.19	38,898.14	-5.88
GMA Index	1.50	1.41	-6.44

### Source: CBN, SEC and NSE

who is usually holding the securities for another investor who owns the securities; the broker himself seldom purchases the securities to lend to the short seller. The lender does not lose the right to sell the securities while they have been lent, as the broker will usually hold a large pool of such securities for a number of investors which, as such securities are fungible, can instead be transferred to any buyer. In most market conditions there is a ready supply of securities to be borrowed, held by pension funds, mutual funds and other investors.

Buying back the securities that were sold short is called "covering the short" or "covering the position". A short position can be covered at any time before the securities are due to be returned. Once the position is covered, the short seller will not be affected by any subsequent rises or falls in the price of the securities, as he already holds the securities required to repay the lender.

Short selling refers broadly to any transaction used by an investor to profit from the decline in price of a borrowed asset or financial instrument. However some

short positions, for example those undertaken by means of derivatives contracts, are not technically short sales because no underlying asset is actually delivered upon the initiation of the position.

### Short Selling in the US

In the U.S., the seller must arrange for a broker-dealer to confirm that it is able to make delivery of the shorted securities. The vast majority of stocks borrowed by brokers come from loans made by the leading custody banks and fund management companies. Institutions often lend out their shares in order to earn a little extra money on their investments. These institutional loans are usually arranged by the custodian who holds the securities for the institution. In an institutional stock loan, the borrower puts up cash collateral, typically 102% of the value of the stock. The cash collateral is then invested by the lender, who often rebates part of the interest to the borrower. The interest that is kept by the lender is the compensation to the lender for the stock loan.

Brokerage firms can also borrow stocks from the accounts of their own customers. Typical margin account agreements give brokerage firms the right to borrow customer shares without notifying the customer. In general, brokerage accounts are only allowed to lend shares from accounts for which customers have "debit balances", meaning they have borrowed from the account.

### Dividends and Voting Rights

Where shares have been shorted and the company which issues the shares distributes a dividend, the question arises as to who receives the dividend. The new buyer of the shares, who is the "holder of record" and holds the shares outright, will receive the dividend from the company. However, the lender, who may hold its shares in a margin account with a prime broker and is unlikely to be aware that these particular shares are being lent out for shorting, also expects to receive a dividend. The short seller will therefore pay to the lender an amount equal to the dividend in order to compensate, though as this payment does not come from the company it is not technically a dividend as such. The short seller is therefore said to be "short the dividend".

A similar issue comes up with the voting rights attached to the shorted shares. Unlike a dividend, voting rights cannot legally be synthesized and so the buyer of the shorted share, as the holder of record, controls the voting rights. The owner of a margin account from which the shares were lent will have agreed in advance to relinquish voting rights to shares during the period of any short sale.

### Short Selling Futures and Options Contracts

When trading futures contracts, being 'short' means having the legal obligation to deliver something at the expiration of the contract, although the holder of the short position may alternately buy back the contract prior to expiration instead of making delivery. Short futures transactions are often used by producers of a commodity to fix the future price of goods they have not yet produced. Shorting a futures contract is sometimes also used by those holding the underlying asset as a temporary hedge against price declines. Shorting futures may also be used for speculative trades, in which case the investor is looking to profit from any decline in the price of the futures contract prior to expiration.

An investor can also purchase a put option, giving that investor the right (but not the obligation) to sell the underlying asset such as shares of stock at a fixed price. In the event of a market decline, the option holder may exercise these put options, obliging the counterparty to buy the underlying asset at the agreed upon price, which would then be higher than the current quoted spot price of the asset.

### Conclusion

Short selling is sometimes referred to as a "negative income investment strategy" because there is no potential for dividend income or interest income. Stock is held only long enough to be sold pursuant to the contract, and one's return is therefore limited to short term capital gains, which are taxed as ordinary income.

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