Ugly Ducklings Beautiful Profits

How To Make Money Shorting Stocks

Ugly Ducklings, Beautiful Profits: How To Make Money Shorting Stocks

It's as true as the day is long. Investors are conditioned to believe the only way to make profits in the financial markets is by establishing bullish positions, whether it be through owning individual stocks or ETFs outright or by rolling the dice on call options. Oddly enough, most investors arrive at the "long only" mentality by no fault of their own.

It's ingrained in our subconscious from the very first time we decide to participate in the financial markets. Put it this way, it has been documented time and time again that in bear markets, CNBC's ratings decline and folks read the *Wall Street Journal* a lot less. Bear markets are bad for business when it comes to the mainstream financial press. They're also bad for business at the big brokerage firms, which make a lot more money when investors are feeling ebullient and pouring money into stocks from the long side.

So even though short sellers play a necessary and useful role in the financial markets, they're often vilified for being disruptive doom and gloomers that are somehow less than patriotic. That's all a matter of conjecture. The so-called experts that only extol the virtues of long only investing while excoriating bears and short sellers are entitled to their own opinions. What they are not entitled to is their own facts.

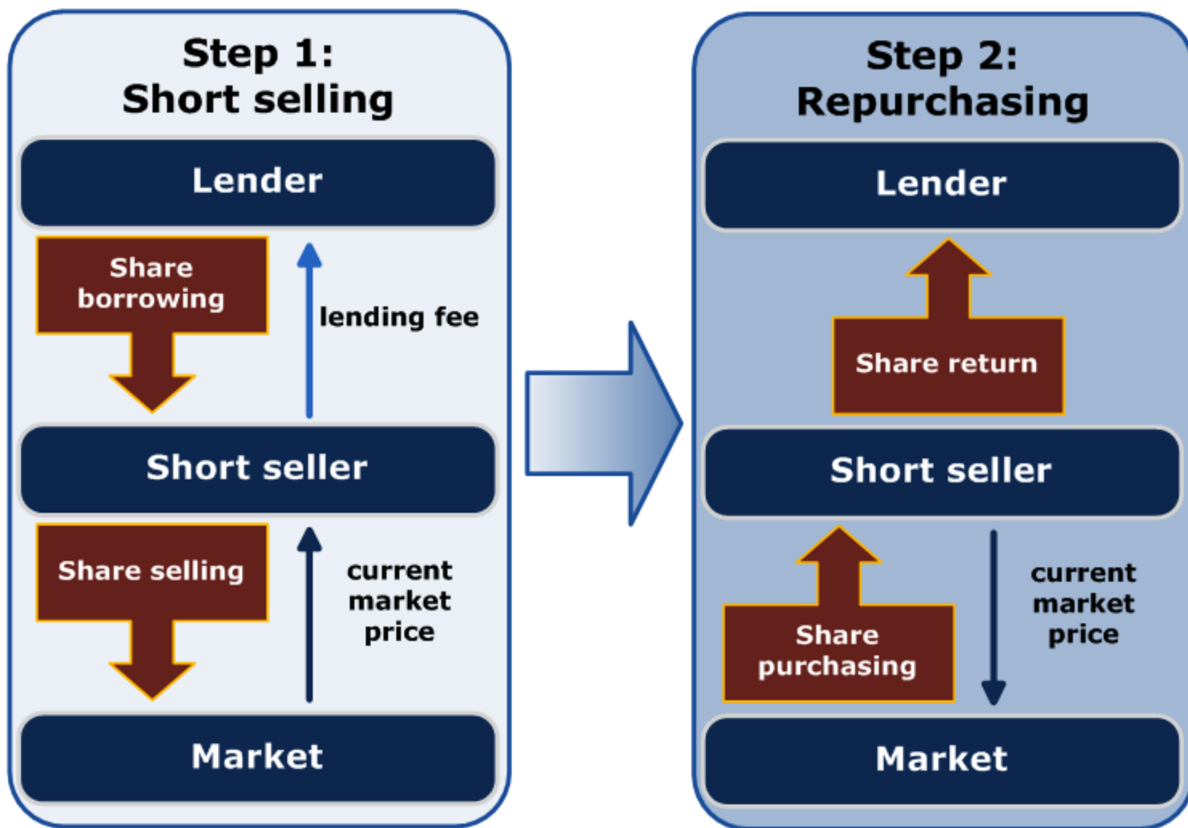
And the facts are crystal clear. There are profits to be had on the downside. Plenty of them. They say the market is a zero-sum game and for every winner there's a loser on the other side. That's true on the upside and it's especially true on the downside. Look, the reality is markets fall much faster than they rise and that speeds up the potential for profits from short selling.

Just look at what happened during the financial crisis. The SPDR S&P 500 (NYSE: SPY), the ETF that tracks the S&P 500, topped out in October 2007 at just over $156, meaning the index itself was trading around 1,560. It took just 17 months to get to the 666 intraday bottom in March 2009. Here we are more than three years removed from the March 2009 bottom and the S&P 500 has failed to even come

within 100 points of its 2007 high. If that doesn't convince you that markets tumble faster than they rise and that there are amazing profits to be made from short selling, than we're not sure what will.

Even with all that compelling evidence, a lot of investors still aren't intimately familiar with short selling or how to do it. Here's the Investopedia definition of short selling: *The selling of a security that the seller does not own, or any sale that is completed by the delivery of a security borrowed by the seller. Short sellers assume that they will be able to buy the stock at a lower amount than the price at which they sold short.*

For those that prefer pictures, here's an illustration of what a run-of-the-mill short sale transaction looks like. We think you'll agree it's neither complicated nor intimidating.



There's more to consider. First, being able to effectively profit from the topsy-turvy market environment we've seen over the past few years is vital and accomplishing that objective will not happen with a long only strategy. Like it or not market volatility isn't a passing phenomenon. It's going to be with us for a while and the investors that know how to profit on the upside AND the downside will find themselves with larger accounts than their long only counterparts.

Second, you've probably heard the expression "This is a stock-picker's market" countless times over the past few years. And it has been a stock-picker's market for two or three years, but the rub is that it's hard to pick the stocks that are likely to deliver substantial returns from the long side. Since there are only so many blue chips and star growth stocks to go around, that leaves a lot of mediocre to really bad stocks that are just screaming to be shorted.

It may seem unfair. Not only will you make more money faster by shorting stocks, but it's also easier to identify those names that are poised for problems.

For those that are short selling rookies, follow this advice: Do yourself a huge favor and dismiss your preconceived notions and stereotypes, most of which are negative, about trading from the short side. This is archaic, inside the box thinking that will not fatten your account. Short selling is not only a necessary aspect of an efficient market, all traders can benefit from short sellers and what the information they bring to the table.

From TradeKing: "*Often times short sellers are the black sheep of the investor community and many wish short sellers simply did not exist. In actuality, however, short sellers aid in creating a healthy and efficient market in many ways. Several benefits include improving the price discovery mechanism, allowing for the expression of a contrarian view, and bringing additional liquidity and activity to sometimes illiquid and inactive markers. Bullish traders and investors may actually learn about new investment opportunities from short-selling analytics, like short interest and days-to-cover.*"

Imagine where investors would have been with Enron, WorldCom, Lehman Brothers and other

notorious companies that went down in flames. Think of just about any major corporate bankruptcy or any company that destroyed shareholder value through malfeasance such as accounting issues, and chances are shorter sellers brought those issues to light.

Still, the media, and worse, Uncle Sam, keep looking for ways to punish short-selling. Perhaps you've heard of the uptick rule. That was an old Securities and Exchange Commission (SEC) rule that dictated traders could only short stocks that were moving higher in price. That rule was done away with, but the SEC brought a new version of it back to life in 2010 and it wasn't a good idea.

The "alternative uptick rule is designed to restrict short selling from further driving down the price of a stock that has dropped more than 10 percent in one day. It will enable long sellers to stand in the front of the line and sell their shares before any short sellers once the circuit breaker is triggered," the SEC said at the time.

Basically, that rule imposed new restrictions on short selling, allowing for it "only when a stock has triggered a circuit breaker by experiencing a price decline of at least 10 percent in one day. At that point, short selling would be permitted if the price of the security is above the current national best bid," according to the SEC language.

There are other issues you need to be aware of when it comes to short-selling. For example, short sellers are subject to the margin rules, meaning should a short position move against you in a big way, your broker could make margin call forcing you to close the position or to put up some cash to protect your trade. Additionally, be advised that if you short a stock that is paying a dividend while your short it, you will responsible for paying the dividend to the person or firm making the loan.

For more on short-selling issues and how you can avoid being caught off-guard, we strongly recommend doing some quick homework on the SEC Web site where there's special section devoted to short-selling. http://www.sec.gov/answers/shortsale.htm

Finding The Best Stocks To Short

At ***Consensus Picks*** we limit our activities to finding the market's best stocks. When it comes to finding truly ugly stocks to short, you've been on your own. Until now, that is. The stocks that emerge from our grueling final screening process are among the most profitable you'll find anywhere. That said, there is a proper method to the madness of finding the very best opportunities from the short side. While it's not as difficult as some so-called experts would like you to believe it is, there's no such thing as a freelance lunch in the financial markets.

Since there are multiple red flags that we can use to find excellent short candidates and not all of those red flags are seen in all cases, let's start with technical analysis. Don't worry if you're not a technical analysis expert because some of the best stocks to short overtly advertise their vulnerability on their charts, so there's no need to jump through a series of complex hoops to find a stock primed for a tumble.

A great place to start is with moving averages. Many traders and money managers will never buy a stock that is trading below its 200-day moving average because they believe the stock may be in its own bear market until it reclaims the 200-day line. To add some confirmation to the bearish thesis and possibly some juice to the returns of a short trade, traders will often look for securities that are below both their 50- and 200-day moving averages.

In fact using the 50- and 200-day lines is important both on the upside and the downside. On the upside, when a security's 50-day line rises above the 200-day line, that's called a golden cross and it's usually a harbinger of bigger gains to come. For bearish trades, a great signal to look for is a longer term moving average, such as the 200-day, crossing below a shorter term line, like the 50- or 100-day. That's what's known as a death cross, but playing death crosses can bring plenty of life to your portfolio.

Here's a great illustration using the U.S.-listed shares of Swiss banking giant Credit Suisse (NYSE: CS). Notice that the stock was trading over $28 when the death cross was first spotted. In a matter of weeks, the shares had tumbled 10%.

Alright, so perhaps you don't have time to be looking for death crosses everyday. Admittedly, the task can be a bit tedious and death crosses don't occur all day every trading day. With that in mind, you can still find perfect short set ups just by looking for stocks that are are residing well below their key moving averages and/or haven't been above their 200-day lines for an extended time frame.

How important is it for a stock that falls below its 200-day moving average to regain that level quickly? Well, let's just say it's VERY important, because the longer it labors below the 200-day line, the more invitations to short-sellers the stock is sending out. Just look at this chart of Arch Coal (NYSE: ACI). It's been almost a year since it traded above its 200-day simple moving average. Then it wasn't long before the stock violated its 50-day line. From there the selling pressure intensified.

All that was left was for Arch to drop an important short-term moving average in earnest an it did that earlier this year, falling below the 20-day line. That led to a tumble from $14 to just over $9 in a matter

of weeks, but none of these monster declines would have been possible without the stock falling below the 200-day SMA.

Active traders can employ another strategy and it's one you're probably already familiar by virtue of buying stocks. Just as it is wise to look for support areas and stocks honoring those support levels, it's equally as efficacious to look for stocks that are being turned back at price levels that have become obvious resistance zones.

The simple patterns to spot in terms of stocks that are faltering in the same area on the upside over and over again are the double top, the triple top and the multiple top. Fortunately, all it takes is some common sense to protect yourself when shorting stocks. Just place a stop 3%-5% to above the resistance price. That way if the stock legitimately wants to make a new high, you'll be protected and your loss will be small.

Just look at this chart of Amgen (Nasdaq: AMGN). The stock has tried to find its way above $69 several times in 2012. It was only successful once, but that move occurred on low volume so there was confirmation the buyers were really ready to send this stock into the $70s. Every time Amgen has

flirted with $69, it has been sent back.

In this case, the pullbacks haven't been too deep because we're using an example where the stock is more bullish than bearish, underscoring the notion that shorting based on resistance rejection is a quick-strike trade. Eventually, the bulls will throw in the towel if they can't crack $69 and when they do, the declines will be larger than what has been seen to this point. All you'd need to do is set a sell stop order around $69 to get into the trade and a buy stop just over $70 (so the trade has some room to breathe) as protection. Anyone can do this and do it repeatedly for consistent profits.

Of course, there are other ways beyond technical analyst to spot those stocks that are begging to be shorted. Let's get into some of them right now by looking at some of the fundamental red flags that alert us to amazing short opportunities.

Fundamental Flaws: Profits And Perils

One way to go about shorting stocks on a fundamental basis, sort of, is to look for names that have made large percentage gains in short amounts of time. Yes, this strategy works, but it is extremely risky

if for no other reason that a stock that screens as overbought using indicators such as RSI or stochastics can stay overbought for days, weeks and months.

In other words, calling a top in a momentum stock is risky and shorting a stock just because it has jumped say 20% in the past two weeks isn't a commentary on the stock's fundamentals. It's merely an expression of the view that the stock is "overbought" or "expensive." Who are we to determine that? That market does that and if the market wants the stock to be overbought for three months, then that stock will be overbought for three months.

Again, there is money to be made shorting stocks that have rapidly risen in short amounts of time. However, there's more luck than skill involved in this gambit. A little company called Apple (Nasdaq: AAPL) confirms. Just look at this chart.

How many times between December 2011 and early April 2012 did Apple notch a large percentage move in just a few days or a couple of weeks? Too many to count! The reason why Apple serves as a fine example for not shorting based on rapid price gains is because a lot of folks said the stock was too expensive/overbought at $250 a share. They said the same thing at $300 and $400. If they expressed

those ill-fated views in the form of shorting Apple directly, they would have lunches eaten.

Bottom line: If you're going to short a stock because it has appreciated rapidly, be sure to allow the stock to confirm to you that is poised for a near-term pullback and use a tight buy stop to minimize any potential damage.

Let's consider more exact fundamental factors. One metric that traders like to look at before shorting a stock is its price/earnings, or P/E, ratio. A stock's P/E ratio is merely the price it trades at divided by its trailing or expected forward earnings. If ABC Inc. trades at $50 and is expected to earn $2 per share over the coming year, it has a forward P/E of 25.

Again, the risk with shorting a stock based on a high valuation is that some stocks can command high P/E multiples for extended periods of time. Some growth stocks can sport high P/E ratios for years, Amazon (Nasdaq: AMZN) is a good example of one. As long as a company can keep delivering the earnings and revenue growth necessary to command what appears to be an excessive valuation, it's showing its fundamentals are strong and that it's a risky short.

What's also critical to remember about shorting a stock on the basis of P/E ratios is that "expensive" isn't universal between sectors. A forward P/E of 20 for a consumer staples stock is probably a tad too rich, but that same forward P/E in the tech sector might be viewed as cheap.

A high forward P/E is instructive for the purposes of short selling because tells us that the stock is vulnerable to even a slight misstep regarding a new product introduction or its next earnings report. Look at this chart of Amazon and the struggles it has had since late 2011.

The stock's P/E was excessive, arguably it still is, and those nasty declines (aka great shorting opportunities) came by virtue of the market's perceived displeasure with the Kindle Fire's inability to compete with Apple's iPad and the risks that presents to Amazon going forward. Amazon may still deliver great returns from the long side in the future, but in order for it trade at a valuation the market is

more comfortable with, the share price has to retreat more and that means shorting opportunities galore.

Another indicator you can use to help you look at future earnings growth is the PEG ratio, or Price/Earnings to Growth. PEG is calculated by taking the P/E and dividing it by the projected growth in earnings. The formula looks like this PEG = P/E / (projected growth in earnings).

For example, a stock with a P/E of 50 and projected forward earnings growth of 25% would have a PEG of 2 (50/25=2). The good thing about using PEG when it comes to finding stocks to short is that PEG ratios are more universally applied over the broader market then PE ratios are. A PEG level of 1-2 is generally accepted as fair, below 1 and you might have stumbled upon a nice value play. A PEG number well above 2 and you might have found a potential short.

Want to know what Amazon's current PEG is? A whopping 5.34. Another advantage of PEG is that it is most useful when applied to high momentum, high growth companies. Put another way, PEG might work well when applied to a boring stock like Procter & Gamble (NYSE: PG), but the metric is most efficacious with high trajectory, volatile stocks such as Amazon and Apple.

Remember, PEG places a value on the expected growth in earnings of a company. The metric can indicate, better than PE, that a company's share price is too rich relative to the earnings growth it can actually deliver for investors. Bottom line: Valuation tools such as P/E and PEG can be as helpful on the downside as they are on the upside and should be used for both scenarios.

Fundamental Flaws II: On A Silver Platter

Earlier, we made it quite clear financial markets don't hand out free lunches. Let's clarify and say RARELY does the market hand investors a free lunch, but when it does, the returns can be staggering, especially from the short side.

What we mean by "free lunch" is a signal so obvious that even a poorly trained monkey could spot it and act on it for big-time gains. We've detailed how you can do that with technical analysis and valuation tools. Now let's explore the easiest to spot of all flaws: Wide-ranging fundamental carnage. This is when a particular investment theme or sector falls out of favor in such a dramatic way that you'd have to be living under a rock to miss it because it's all over the mainstream financial media.

Wide-ranging fundamental issues essentially mean that there is literally no safe haven within a sector. Take the solar industry over the past 12-18 months. This is simply a sector where none of the publicly traded companies can get their acts together.

The Chinese companies have essentially cannibalized each other and the rest of the sector by slashing prices for solar panels and wafers. The U.S. solar companies have not benefited from a presidential administration that should have been a boon for them. President Obama has pushed an alternative energy like none of his predecessors have and this should have been the best thing to happen to solar stocks since the sun. Things haven't worked out that.

So we're up to two fundamental strikes against solar stocks, the U.S. and China. Making matters worse

for solar stocks but great for those shorting them is the European sovereign debt crisis. European countries such as Germany and Italy, among many others, are among the biggest consumers of solar power in the world. With the euro on the brink of collapse and likes of Italy and Spain staring at sovereign debt defaults, European solar subsidies have been slashed.

Combine all those factors and it's no wonder the chart of the Guggenheim Solar ETF (NYSE: TAN) looks like this. That's one of the easiest shorts you could ever find and TAN gave investors another signal earlier this year it was an ideal short: A reverse split. Even without the reverse split, solar stocks and ETFs have been damaged goods and some of the best shorting opportunities on the market.

Another example of broken fundamental theme turned incredible short has been natural gas. Right before the commodities bubble burst in 2008, natural gas traded on the NYMEX went for $14 per million cubic feet. Predictably, that price plunged during the global credit crisis, so it may seem like the easy money shorting natural gas has already been made, right?

Maybe, maybe not because the price of natural gas these days knows only one direction: Lower. As is the case with any commodity, natural gas prices are driven by supply and demand. Due to the shale

boom, the U.S. is the world's largest producer of the fuel. Problem is that also means the U.S. is producing too much natural gas because demand here is nowhere on par with supply. At least not yet.

With the deepest fundamental flaw any commodity could ever deal with exposed, the price of natural gas has continued to tumble, giving savvy investors an easy short over an extended time period with the U.S. Natural Gas Fund (NYSE: UNG). One of the most hated and shorted ETFs on the market, UNG actually does what it's supposed to do and that is front-month natural gas futures contracts.

The good thing for the shorts is natural gas futures of any kind are to be avoided like the plague these days. In April 2012, UNG "celebrated" its fifth birthday, but its unlikely anyone that has ever been long this fund wanted to throw party. Since debuting in April 2007, UNG has lost an astounding 96%. The other sign that UNG has made for and could continue to be a great short? Not one, but two reverse splits since March 2011. In other words, if not for the reverse splits, UNG probably would have gone to zero long ago.

Bottom line: No matter how strong a bull market is and no matter how intimate equity correlations are, there will ALWAYS be laggards that make for great short-selling opportunities. One famous market

guru likes to say "There's always a bull market somewhere." He might be right, but believe us when we tell you that there are definitely always bear markets somewhere.

Bear markets for individual themes or securities within broader bull markets are what as known as secular bear markets. In fact, some analysts and traders have already said Amazon will be the "secular short of 2012." Meaning that while the Internet space and broader market are expected to move higher, Amazon has company-specific issues that investors and traders are not willing to overlook, particularly with the stock's bloated valuation.

Another example of a secular bear market that fans of market history might remember is that of gold in the 1980s through the end of the 20th century. Starting in the mid-1980s, U.S. equities began an unprecedented bull market that last nearly two decades. Yes, there were hiccups and pullbacks along the way, but the overarching trend for stocks was higher for about 15 or 16 years.

That was not the case with gold. The nominal gold price fell from a high of $850 an ounce to around $250 an ounce all while stocks were in rally mode. Remember: A bull market somewhere does NOT mean a bull market everywhere.

More Red Flags To Look For

As we've been mentioning throughout this report, finding the best stocks to short can often times be far easier than finding the best ones to trade from the long side. We've highlighted easy to spot technical trends that can tip you off to short trades as well as valuation tools and fundamental issues that, once mastered, can help make you a mint shorting stocks.

There are even more easy-to-spot red flags that will tip you off that a stock is ready to tumble. Let's have a look at some here.

Lack of Institutional Support: Assume you find a stock that has rallied hard and fast in a relatively short amount of time. That might make for a good short, but it makes for an even better short if there is little or no positive change in the stock's institutional ownership. Retail investors on their own can only support a rally for so long, if for no other reason than that they don't have the ammunition that large asset management firms and mutual fund companies have. Simply put, a stock that is rallying with out institutional support is vulnerable to a nasty sell-off.

Insider Selling: Be careful with this one because company insiders do sell their stock for more reasons than just the belief that the share price is ready to decline. However, a lot of insider selling in a condensed period of time following a rally could be a tip that the stock could be in near-term trouble. Also look for a lack of insider buying.

Deteriorating Earnings Quality: One of the best ways to spot a stock to buy is to look for improving earnings and revenue. A stock that has improved both metrics by say 20%-30% in consecutive quarters is screaming to be bought. On the other hand, a company that consistently misses estimates and/or guides lower is asking to be shorted. Just look at BlackBerry maker Research In Motion (Nasdaq: RIMM) over the past 12-18 months.

Overly Complex Financial Statements: Company financial statements such as 10-Qs, 10-Ks and related fare don't usually make for stimulating reading, but most aren't too hard to understand. However, once an investor becomes proficient in reading company balance sheets, the red flags begin to really stand out.

Increased use of partnerships, off balance sheet transactions**,** pending lawsuits or other contingent liabilities, declining margins, increasing debt/equity ratios, increased number of shares outstanding, rising accounts receivable and/or inventories, as a percentage of sales, an above-average amount of non-operating or one-time charges, poor return on capital/too much goodwill and decreasing cash flow are all signs that stock has potential problems. Find several or all of these issues together with one stock and you've got a stellar short candidate.

Accounting Issues: Nothing makes for a great short quite like a company that is believe to be home to accounting issues and irregularities. Accounting issues that are easy to spot include lots of footnotes in filings and corporate reports, frequent changes in auditors, inclusion of a qualified opinion or a company that has no audit committee or one that has a relationship that is too close for comfort with CEO and CFO.

10 Ways to TAKE CONTROL OF YOUR FINANCIAL DESTINY

As an investor, your goal is to make money. And no matter your personal investing style, Wealthpire can help. Simply try any of our market-beating investment services RISK FREE for 30 days. Learn more by visiting www.Wealthpire.com/GetStarted

LEARN MORE

Arm yourself with the "killer move" technique for picking winning stocks. If you have 15 minutes per day and a few hundred bucks, you could get started using this technique to grab consistent double-digit gains on a monthly basis.

LEARN MORE

Learn how to pull life-changing gains from the stock market, starting as early as tomorrow morning. This service teaches you a strategy that will allow you to make massive all in the very first hour of the trading day

MorningHoursTrading.com

LEARN MORE

No work. No research. No guesswork. Get a leg up by copying these trades first thing in the morning, and you'll be light-years ahead of other folks who are still trying to figure out the best stocks to buy.

OPTIONSINSIDER.COM

LEARN MORE

Uncovers the best options plays in the world and shows you how to make the kind of explosive gains insiders rake in on a daily basis. Whether stocks go up or down, you'll have the tools to excessively pad your bank account in just minutes per day.

LastHourTrading

LEARN MORE

Turn your trading account into a daily income machine by banking consistent double-digit returns. By this time tomorrow you could be one of a handful of folks who are locking in profits twice on each trade they make.

ICHIMOKU SWING TRADING

LEARN MORE

This investment strategy is virtually unknown in the Western hemisphere, yet it can hand you $1,000 per week once you master it. Follow Ichimoku guru Bob Joiner as he lays out step-by-step instructions that will give you detailed knowledge of this incredible system.

PennyStocksGuru.com

LEARN MORE

You may have heard of penny stocks, but I'm sure you've never heard about penny stocks like these. Learn how to get in on the ground floor of tomorrow's elite businesses… and multiply your wealth with dynamic gains.

LEARN MORE

This unique, minutes-per-day system transforms even the most novice investor into a master day trader. The thing is, since you buy today and trade tomorrow, you'll experience a freedom day-trading rarely affords you.

TRADE For A LIVING

LEARN MORE

Only 2-3% of investors actually make enough money to earn a living without working a regular job. If your goal is to pad your retirement account without going into the office every day, this is all the information you'll ever need.

CONSENSUS PICKS

LEARN MORE

Gain access to multi-sourced and multi-verified stock picks from the most accurate alert services in the world. This breakthrough technology is finding winners up to 92.75% of the time. Here's your secret weapon to making consistent profit-rich trades in any market conditions.