Understanding the differences between long and short investing

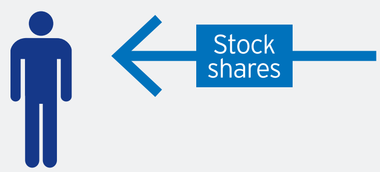
Traditional investing in the stock market is based on the concept of buying low and selling high: An investor purchases a stock hoping the price will rise. But what if you think the company's stock price is higher than it should be? Can you still profit? By using an investment strategy called short-selling, investors can "short" a stock in hopes that the price will drop. Investors can short-sell individual stocks themselves, or they can purchase a mutual fund that uses this technique.

How short-selling works

Investors take a short position when they expect the value of the stock to decrease. They do this by borrowing the stock, selling it at what they hope is the high price, then buying the same number of shares once the price has dropped. There are risks involved – including the potential of unlimited losses. Short positions lose money when a stock price rises, and there is no limit to how high the price of any given stock can go.

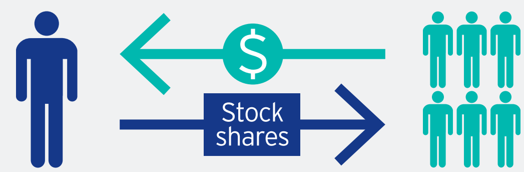
In traditional investing, you make money by buying low and selling high. Short-selling does the exact same thing in reverse: Selling high and buying low.

Example of a short-selling strategy



Step 1: Borrow the stock

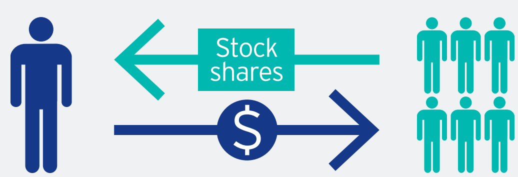
To short-sell, investors must borrow shares from someone who owns them, such as a broker.



Step 2: Sell the stock

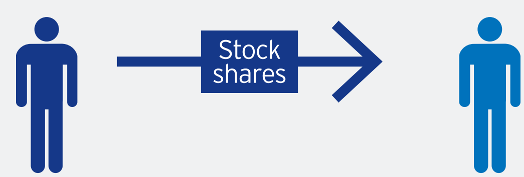
The investor then sells the borrowed shares on the open market.

Wait for the stock price to decline or specified time period



Step 3: Buy back the stock

Within a specified time period, the investor must buy back the borrowed shares on the open market and return them to the broker.



Step 4: Profit or loss?

If the shares are repurchased at a lower price, the investor profits. If the shares must be repurchased at a higher price, the investor loses money.

For illustrative purposes only

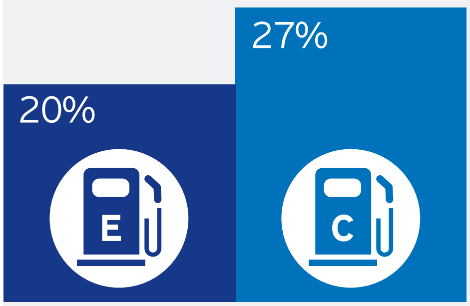
How some long/short strategies work in a portfolio

There are a number of long/short strategies investors can use to achieve their portfolio objectives. One approach is called "market neutral."

Sometimes sweeping movements in the stock markets will move most stocks up or down, regardless of each company's true value. Market neutral strategies seek to eliminate the impact of broad market movements by trading related stocks (for instance, two stocks from the same industry) on a long and short basis. The key to generating a positive return is to identify the appropriate stocks to go long and short.

Below is an example of the type of long/short pairing that a market neutral strategy might use – taking a long position in one major energy company and a short position in another. In this hypothetical example, the investor believes Chevron looks cheap relative to ExxonMobil, so she buys $100,000 of Chevron stock and shorts $100,000 of ExxonMobil stock.

Experienced investors may use market neutral strategies to neutralize moves in the market from companies in the same industry

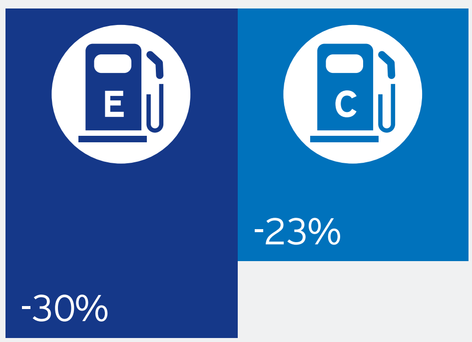


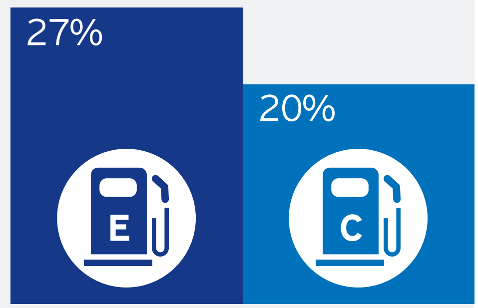
Investor makes money

Suppose ExxonMobil rises 20% and Chevron rises 27%; the investor sells Chevron for $127,000, covers the ExxonMobil short for $120,000 and pockets $7,000.

Investor makes money

If ExxonMobil falls 30% and Chevron falls 23%, the investor sells Chevron for $77,000, covers the ExxonMobil short for $70,000 and still pockets $7,000.





Investor loses money

If the investor is wrong and ExxonMobil rises 27% and Chevron only rises 20%, she will lose $7,000 on the investment.

Hypothetical example is for illustrative purposes only and is not a recommendation to buy/sell any securities. Long/short strategies may cause an investor to repurchase a security at a loss as there is no limit to how much the price of a security can fall or increase. Exposure to potential loss in unlimited. These are not actual holdings.

Talk to your financial professional

Many investors are employing these strategies to help them meet their goals. If you're considering adding a short-sell strategy to your portfolio, a financial professional can help you understand the nuances of the techniques, including their risks and benefits.