**How to Short Sell Stocks**

**Abstract**

The Shanghi Composite Index is at 2722.55 on January 27, 2016, down 17.64% for the past year. The Federal Reserve might raise The Federal Funds Interest rate in March 2016. Crude Oil WTI (NYMEX) closed at $32.80 per barrel on January 27, 2016 down from $37.34 on January 4, 2016. The bear is at the door! What to do? Short selling stocks has proven to be a viable strategy in a bear market.

**Contents**

Title Page p. 1.

Abstract p. 2.

Contents p. 3.

Introduction p. 4.

Literature Review p. 5-6.

Methodology p.7.

Review of Data pp. 8-26.

Discussion pp. 27-34.

References p. 35-36.

Appendices p. 37-47.

**Introduction**

 The Dow Jones Industrial Average, S&P 500, and NASDAQ Composite Indexes all formed a head and shoulders chart patterns December 2015 thru January 2016. This was followed by a sharp decline that broke thru the 200 and 50 day moving averages in January 2016. This ushered in the current bear market. A bear market is the best time to short sell stocks. Most stock prices decline in a bear market.

**Literature Review**

 It is preferred to short sell stocks during a bear market. A bear market is more than a 20% drop in the Dow Jones, S&P 500, and NASDAQ etc. in a short period of time usually less than three months. The chart pattern in these indexes is a head and shoulders top that is followed by a drop below the 50 & 200 day moving averages. The head and shoulder patterns have wide and loose base formation that is different from a W pattern which has narrow well defined base. William J. O’Neil author of How to Make Money Selling Stocks Short, provides many years of experience evaluating what stocks to short sell. The short seller sells shares of a stock that they don’t own. The brokerage firm must have the shares available in the inventory. When the short sale is done correctly, the stock price will decline. The investor would cover the short sale by buying the shares at a lower price than the original sale of the shares. The difference between the lower market price the shares declined to and the strike price is the capital gain. The net capital gain is determined when the commission from the short sale transaction are deducted. Short sell candidates are companies with top management exiting the corporation, declined sales, net income, earnings per share, and retained earnings. Other clues are companies that reduce their dividends. However, it is usually better to short sell companies that don’t pay dividends. This is because dividends reduces the capital gain and adds to a capital loss. Companies that have narrow products lines and service are good short sell candidates. The company would have difficulty producing consistent sales in both good and poor markets. Finally, companies with out of date technology will fail to have effective internal control. This will lead to declining earnings per share.

**Methodology**

 Secondary resources are utilized in this research paper. It takes many years to perfect a trading system of how to short sell stocks. “Secondary sources are interpretations of primary data.” “Encyclopedias, textbooks, hand books, magazine, and newspaper articles, and most news casts are considered secondary information sources.” “From the beginning, it is important to remember that all information is not of equal value.” “As the source levels indicate, primary sources have more value than secondary sources, and secondary sources have more value than tertiary sources” (Cooper, Schindler, 2014, pp. 95-96).

 “The exploratory phase search strategy usually comprises one or more of the following: Discovery and analysis of secondary sources.” Published studies (usually focused on the results of surveys or on case studies fearturing one or a few incidents).” “Document analysis.” “Retrieval of information from organization’s databases.” “Interviews with those knowledgable about the problem or its possible solutions (called expert interviews).” “Interviews with those knowledgable about the problem or its possible solutions (called expert interviews).” “Interviews with individuals involved with the problem (called individual depth interviews, or IDIs).” “Group discussions with individuals involved with the problem or its possible solutions (including informal groups, as well as formal techniques such as focus groups or brainstorming)” (Cooper, Schindler, 2014, p. 94).

**Review of Data**

 “The general market should be in a bear trend, and preferably in a position that is relatively early in the bear trend.” “Shorting stocks in a bull market does not offer a high probability of success, and shorting stocks very late in a bear period can be dangerous, if the market suddenly turns to the upside and begins a new bull phase” (O’Neil, 2005, p. 32).

 “Stocks that the would-be seller has identified as candidates for short sales should be very liquid.” “They should have sufficient daily trading volume so as not to be subject to rapid upward price movement if the stock experiences a sudden rush of buyers that can result in a significant short squeeze.” “A general rule of one million shares of more traded per day on average is a reasonable liquidity requirement” (O’Neil, 2005, p. 33).

 “Look to short former leaders from the prior bull cycle.” “Stocks that offer the best short sale opportunities in a bear market tend to be the very same stocks that led the prior bull phase and had huge price run-ups during the bull market” (O’Neil, 2005, p. 33).

 “Watch for head and shoulders top formations and late-stage, wide, loose, improper bases that then fail.” “These are the optimal short sale chart patterns.” “Look to short former leaders five to seven months or more after the stock’s absolute price peak.” “Often, the optimal shorting point will occur after the 50-day moving average has crossed below the 200-day moving average, a so called black cross, and this may take several months to develop.” “Once a former leading stock has topped, monitor it closely and be prepared to take action when it signals an optimal shorting point.” “Set 15-30% profit objectives, and take profits often” (O’Neil, 2005, p. 33).

 “Wedging, or a rally that trades on successively lighter and lighter volume as the stock moves, higher, is a sign that there is a lack of buying demand for the stock.” “Railroad tracks occur when a stock trades up sharply one week and then the next week completely retraces the price range of the previous up-week, closing near the peak for the week on high volume.” “Stalling, or price action that occurs when a stock is rallying but closes below the midpoint of its weekly price range for one to three weeks on the way up, can be a clue that a rally is being met by systematic selling which will soon overcome the rally and send the stock down again.” “Island tops, which are characterized by a stock that has a final gap after a rally of two to three weeks or more, and then trades in a tight range for the gap week.” “Watch for breakouts from late stage bases that occur on low volume.” “If a stock, after a long price run, forms a wide loose, and improper late stage base, be alert for a low volume breakout attempt from this base.” “A low volume breakout attempt that reverses on sharply increasing volume can offer an early short sale point.” “Sometimes this type of low-volume breakout from a late-stage, important base occurs after a stock has had a climax top.” “Following a climax top, a stock may turn up and build a big, wide and loose base and attempt to break out again.” “If this breakout occurs on very little volume, it very likely will fail and signal that the stock has topped for good” (O’Neil, 2005, pp. 42-43).

 “Be alert to price areas that may represent prior support, as many chartists will short a stock once it breaks a support level, only to see the stock undercut the support level and then turn and rally sharply higher, running in the premature short sellers.” “Part of the reason this occurs is because technical analysis and the use of charts to interpret stock price action has such a wide following that many individuals act upon the same information at the same time.” “Since a breach of a support area is considered a bearish signal in the mainstream of technical analysis, everyone on the plant who is reading charts gets short, creating all at once a mass of short sellers at that point.” “Once they are all short, they effectively create a near-term floor for the stock in that they are now would be buyers in the event they have to cover their short position.” “When everyone is leaning one way on a stock on the short side, they will invariably get run in.” “Often the best place to cover a short position is right as the stock is undercutting a prior low or area of support, because the stock will often turn and rally from that point, enabling the investor to wait and watch for another opportunity to short the stock” (O’Neil, 2005, p. 43).

 “It is important to understand that successful short selling requires relentless determination and persistence.” “There will be many times when the investor will be stopped out of the short position, and when the short seller must cut losses quickly and decisively.” “The investor must continue to monitor those same stocks that he was stopped out of and which continue to fit our short selling templates, because eventually the proper selling point will present itself, and the investor must be alert to catch it as it unfolds.” “This means the short seller may get stopped out of a short sale several times on the same stock before finally hitting the sweet spot and catch a stock just before it cascades to the downside and yields a 15-30% Capital Gain” (O’Neil, 2005, p. 43).

 Cisco Systems formed a head and shoulders top chart pattern from March 2000 thru June 2000. The pattern was followed by four rally attempts above the 50 day moving average line. The stock traded at $70 per share September 2000 and declined to $11 per share September 2001. Lucent Technology had a wide loose head and shoulders top form from June 1999 to March 2000. This was followed by four rally attempts. The optimal short position was September 2000 where Lucent traded at $60 per share. The stock decline to $5.35 per share in April 2001.

 Calpine Corporation formed a wide loose cup with handle chart pattern form September 2000 to December 2001. This was followed by a head and shoulder top from January 2001 to July 2001. Stalling action occurred in July 2001. The optimal short sell point was September 2001 the stock traded for $40 per share and decline to $2 per share in December 2002. Yahoo Incorporated formed a wide loose cup with handle pattern December 1999 to March 2000. This was followed by four rallies above the 50 day moving average line. The correct short sell point was on December 2000 at $222 per share. Yahoo declined to $21 per share in June 2001. Broadcom Corporation formed a railroad tracks chart pattern in February 2000. This was followed by a loose sideways cup with handle pattern January 2000 to September 2000. The short sell point was December 2000 at $220 per share. Broadcom Corporation decline to $22 per share in June 2001.

 Lowes Corporation had the head and shoulders top chart pattern from October 1968 to June 1969. The stock rallied three times above its 50 day moving average October 1969 to February March 1970. The short point sell was $34 per share Lowes Corporation stock price declined to $16 per share in June 1970. Redman Industries formed the head and should top with wide and loose cup with handle bases September 1968 to August 1969. Redman rallied four times and the short sell entry point was November 1969 at $45 per share. The stock declined to $15 per share in June 1970. Skyline Corporation formed two late stage improper sideways double bottom bases January 1969 to August 1969. Skyway had spiked volume four times August through December 1969. The short sell point was at $25 per share March 1970. The stock decline to $14 per share in June 1970.

 Boeing Company formed a sideways head and shoulders top in high volume February 1966 to September 1966. The short sell point was $71 per share March 1966 and the stock price declined to $44 per share December 1966. Motorola Incorporated formed a head and shoulders top in high volume November 1966 to September 1966. The short sell point was $175 per share in November 196 and declined to $91 per share in December 1966. Solitron Devices Incorporated formed a high volume head and shoulders top February thru August 1966. The stock rallied three times above the 50 day moving average line in lower volume. The stock price declined in high volume to $60 per share in November 1966. Williams Companies formed a head and shoulders top in high volume November 1965 to May 1966. The stock rallied once in low volume. The short sale entry point was $60 per share in August 1966. Williams and Companies declined to $35 per share in October 1966.

 Allied Products Corporation formed a head and shoulders top with two sets of railroad tracks in high volume February 1966 thru May 1966. The short sell entry point was July 1966 at $51 per share. Allied Products Corporation declined to $25 per share in December 1966. DynCorp formed a head and shoulders top in massive volume September 1967 thru February 1967. This was followed by stalling rallies above the 50 day moving average. The short sell entry point was $24 per share in February 1968. It took the stock more than two years to decline to $8 per share in July 1969. Monogram Industries formed twin wide loose cup with handle chart patterns form January 1968 to February 1969. This was followed by a low volume rally above the 50 day moving average. The short sell point was $59 per share February 1969 during upside volume wanes. The stock declined to $25 per share in November 1969. Sunstrand Corporation Formed a head and shoulders top from October 1967 to July 1969. This included a wide loose sideways cup with handle chart pattern. The short sell point fell within the right shoulder of the head and shoulder top at $62 per share May 1969. The stock declined to $26 per share in November 1969.

 Levitz Corporation Formed a head and shoulder top from February 1972 to October 1972. The chart formation included a ladle with handle in heavy downside volume of a downward price. The short sell point was November 1972 at $46 per share. The stock declined to $7 per share in June 1973. Winnebago Industries Incorporated formed a head and shoulders top January 1972 to October 1972. The included the black cross of the 50 day moving average crossing the 200 day moving average. The short sell point occurred January 1973 when the stock price broke below the 50 day moving average at $23 per share. The stock price declined to $3.60 per share in November 1973. Knight Ridder Incorporated had a head and shoulders top November 1972 to May 1973. The chart pattern included a wide loose cup with handle base. The short sell point was at $52 per share in May 1973. The stock declined to $28 per share November 1973.

 The Walt Disney Company formed a head and shoulders top December 1972 to March 1973. Earlier a wide loose cup with handle pattern formed August 1972 to November 1972. The head and shoulders top was followed by four rallies above the 50 day moving average May 1973 to October 1973. The short sell point was October 1973 at $85 per share. Walt Disney declined to $44 per share in December 1973. Brunswick Corporation formed a double bottom base that didn’t drop thru the 50 moving average April 1972 to August 1972. The short sell point was September 1972 at $45 per share. The stock declined to $13 per share in December 1973. Kaufman & Board Incorporated had a cup without a handle base in May 1972. This was followed by three rallies above the 50 day moving average August 1972 to January 1973. The short sell point was at a black cross formation in January 1973 at $20 per share. The stock declined to $5.50 per share in November 1973.

 Rite Aid Corporation formed a wide head and shoulders top from May 1972 to August 1973. This included a black cross in May 1973 and was followed by three rallies above the 50 day moving average. The short sell point was October 1973 at $32 per share. Rite Aid declined to $4.50 on May 1974. Transworld Airlines formed a head and shoulders top January 1972 to October 1972. The head and shoulder top included a black cross in August 1972. Two short sell points occurred when the stock price touched the 200 day moving average in October 1972 $21 per share and May 1973 $18 per share. The stock price dropped below both moving averages in June 1973 and declined to $4.25 per share in May 1974. Bank of America formed a head and shoulders top July 1973 to February 1974. The stock had a black cross in December 1973. The stock rallied three times above the 50 day moving average December 1973 to May 1974. The short sell point was $33 per share April 1974. Bank of America declined to $6.90 per share December 1974. Coca Cola formed a general market top in November 1972. The short sell point was at the black cross formed in January 1974 in high volume at $145 per share. Coca Cola declined to $47 per share in December 1974.

 Wendy’s International Incorporated formed a wide loose/sideways cup with handle formation May 1978 to November 1978. This was followed by a failed breakout attempt. A black cross occurred in January 1979. The short sell point was at $35 per share in November 1978. Wendy’s stock declined to $12.50 per share in December 1979. Advanced Micro Devices Incorporated formed a head and shoulders top October 1980 to July 1981. The head and shoulders pattern included a climax top October 1980-December 1980. The short sell point was $29 per share in July 1981. The stock declined to $14.70 per share in September 1981. Harris formed a head and shoulders top November 1980 to October 1981. A black cross occurred in August 1981. The stock had four rallies above the 50 day moving average form October 1981 to January 1982. The short sell point was at $43 per share in January 1982. The stock declined to $21 per share in June 1982. Helmerich & Payne Incorporated formed a head and shoulders top from October 1980 to May 1981. The head and shoulders top included a wide loose W pattern from December 1980 to October 1981. Four rallies above the 50 day moving average occurred June 1981 to September 1981. A black cross occurred in July 1981. The short sell point was at $39 per share October 1981. Helmerich declined to $14.55 per share in September 1982.

 Clorox Company formed a head and shoulders top October 1972 to June 1973. It included a black cross in May 1973. The short sell point was $44 per share. Clorox stock price declined to $5.80 per share in December 1974. Medtronic Incorporated formed a wide loose cup with handle pattern from December 1972 to December 1973. This included two black crosses. Three rallies above the 50 day moving average occurred from February 1974 to July 1974. The short sell point was $46 per share July 1974. The stock declined to $23.81 per share in December 1974. National Semiconductor Corporation formed a head and shoulders top July 1973 to April 1974. This included two black crosses. The short sell point was $20 per share. The stock declined to $9.91 per share in December 1974. Snap on Incorporated formed a wide loose cup with handle pattern from April 1973 to November 1973. This included two black crosses. The short sell point was $57 per share January 1974. Snap On Corporation stock declined to $21.15 per share in November 1974.

 “The cash account is the most basic brokerage account and it is the first one the short seller must establish before short selling.” “After establishing the cash account the brokerage will want a minimum of $1,000-$5,000.” “A margin account allows the investor to borrow funds from the brokerage firm.” “The cash and the securities in the margin account serve as collateral for borrowing.” “Because of risk, margin accounts are highly regulated.” “This means that the process can be complicated.” “The main law for margin accounts is Regulation T, which is part of the Securities and Exchange Act of 1934.” Another important rule for margin accounts is “hypothecation.” “Essentially, this means the investor allows the broker to use the securities in the margin account for loans.” “At the same time, the short seller agrees to repothecation.” “This means that the broker will be able to use securities to get loans from outside lending sources.” “The process of hypothecation and repothecation allows the brokerage firm to facilitate short selling transactions” (Taulli, 2011, pp. 12-15).

 “When the investor decides to short sell, he will need to make sure to find shares to borrow.” “A brokerage firm’s loan department handles this.” “They will either have the shares from existing margin accounts available or will seek them out from other brokerage firms.” “This is known as the “lending shares” market, and it is actually a big source of profits on Wall Street” (Taulli, 2011, p. 15).

 “The equity in a margin account is the difference between the market value and the credit balance and any amounts borrowed to purchase stock.” “The process of ending a short position is called covering the short.” “When this happens, the margin account would no longer have money set aside as collateral.” “Instead, the margin account would only have capital gain or loss from the short sale that was covered.” “If the short seller falls below the minimum maintenance requirement, the brokerage issues a margin call, which demands the investor to put more cash or securities in the margin account.” “Not all the assets in a margin account can be borrowed against.” “Brokerage firms are more comfortable providing margin loans for shares that trade on the main exchanges like the New York Stock Exchange or the NASDAQ” (Taulli, 2011, p. 19).

 “If the investor has a gain in a stock, she could use short selling to lock it in.” “This is known as shorting against the box.” “This is considered a perfect hedge because long and short positions on the stock offset each other.” “However, the IRS may consider the short sale to be a constructive sale of the long position.” “This means the short seller is taxed on the capital gain.” (Taulli, 2011, p. 21).

 “Pay attention to bid and ask spread.” “Google’s stock is traded on the NASDAQ Exchange.” “When short selling the stock, the investor will sell it at the bid price.” “Based on the quote, a market maker is willing to buy shares at $469.92, each.” “This is a financial firm that is a member of the NASDAQ and will take the other side of a trade.” “The profit is the difference between the bid rice and the ask price.” “But this is a cost to the outside investor.” “So when Google is shorted at $469.92, the investor will not break even until the ask price hits this price” (Taulli, 2011, p. 26).

 “What if the brokerage firm fails?” “The short seller is covered by Securities Investor Protection Corporation.” “This is a nonprofit corporation that insures the amounts in the investors brokerage account.” “The maximum coverage is $500,000 per account.” “Of this only $100,000 is in cash.” “Brokerage firms will often get excess insurance coverage.” “Depending on the size and changes in the investors margin account, to make sure the investor is covered.” “The investor can access more information about SIPC at <http://www.sipic.com>.” “All brokers must be licensed and registered with FINRA.” “FINRA protects the public from fraud.” “A short squeeze involves a stock that has a heavy concentration of short sale positions.” “There are tools to help the investor.” “First, there is the short interest ratio.” “This shows the number of days it would take to cover all short positions.” “The formula is: Short interest/ average daily volume.” “Five or more days the stock could be vulnerable to a short squeeze.” “Next the short seller will use the floating percentage indicator.” “The formula is short interest/ float.” “The float is the number of shares that can be sold without restriction.” “The short seller focuses on the float because this indicates liquidity of the stock” (Taulli, 2011, pp. 31-32).

 “Blue chip companies can be short sell candidates.” “They trade in heavy volume which makes them easier to short sell.” “Some income paying stocks are not generating the cash to pay a dividend.” “When they cut down on the dividends their stock price will plunge, thus opening a short sell opportunity.” “Cyclical stocks can fall out of favor and provide short sell opportunity as the stock price falls.” “Speculative stocks are companies in the early stage of development.” “Biotech and alternative energy could take years to catch on.” “This causes long periods of dropping stock prices” (Taulli, 2011, pp. 50-51).

 “A short seller likes to focus on the exponential moving average and use a time period of 150 to 200 days.” “If the exponential moving average falls below the current stock price, this is a bearish indicator.” “This is known as the death cross.” “The double top is the most common bear type chart pattern.” “Oscillators are helpful for technical analysis because they show signs when a stock is overbought or oversold.” “A useful oscillator is the Bolinger Band invented by John Bollinger.” “His oscillator a 21 day moving average.” “Important candlestick formations that short sellers focus on the following: Doji: A Doji shows the momentum of a stock is slowing into a downward trend.” “Engulfing bearish pattern: When a stock is in an uptrend, there will be a sudden shift.” “The real body will turn black and much larger that a prior white body.” “Umbrella: The investor will see two characteristics.” “First, there will be a spinning top at the high end of the trading range.” “This is when the real body is small.” “Next, the candlestick will have a lower shadow that is minimum of twice the size of the real body.” “When an umbrella occurs, the stock is in an uptrend, then expect a fall in price.” “Dark cloud cover: With the stock in an uptrend, the candlestick will go from a large white body to a black body.” “For the black body, the open must be at the high of white candlestick and the close at roughly the white candlestick’s middle area.” “Evening star: several candlesticks patterns involve a star.” “This is located much higher than the preceding candlestick.” “It’s really an indication of a reversal of a pattern.” “It’s really an indication of a reversal of a pattern.” “A bearish one is the evening star, since location is much lower than the previous candlestick.” “Another is the shooting star, which has a small real body and is lower in price range” (Taulli, 2011, pp. 129-130).

 “The following factors have triggered past bear markets: Deflation is a general fall in prices in the economy.” “Consumers hold off on buying goods and services with the expectation of prices falling further.” “High price earnings ratios: This is an indication that valuations are at unsustainable levels.” “This makes it tougher for companies to keep growing to justify the valuations.” “The Inverted Yield Curve: A yield curve is a graph of the yields of short term to long term bonds.” “With an inverted yield curve it is nearly impossible for banks to make money.” “The upshot is that they will pull back on lending and boost their reserves.” “It is the Federal Reserve that creates the inverted yield curve.” “The goal is to reduce economic activity, such as when inflation is getting problematic.” “However, this is not an easy process and a recession can easily be the outcome” (Taulli, 2011, pp. 135-136).

 “Richard Arms developed the TRIN (Trading Index).” “(Number of advancing stocks/Number of declining stocks)/ (Advancing volume/Declining volume).” “For short sellers, they will look for TRIN of 1.20 or higher.” “This is a sign the market is overbought.” “The Volatility Index measures the daily change in implied volatility of the S&P 500.” “This index is useful to predicting the trend the next couple of months.” “The advance decline indicator is the ratio of total advances and declines on the New York Stock Exchange.” “This is a useful indicator of short term (less than a month) of market direction.” “The up volume indicator shows the number of stocks that are up compared to those that are down in volume” (Taulli, 2011, pp. 141-142).

 “Arbitrage is when a trader takes advantage of price discrepencies in two markets.” “Gerry Bamberger invented statistical arbitrage.” “AN example would be buying 10,000 shares of United Airlines and short selling Southwest Airlines.” “The result should lower the volatility in the block of trade.” “Bamburger realized that block trades can create a short term profit opportunity.” “This was because the trade would temporarily throw the price out of whack.” “The tough part of statistical arbitrage is to find two securities that have a high degree of correlation.” “Merger arbitrage is when a trader makes a profit from shorting the acquirer’s stock and buying the target’s shares.” “This is possible because there is usually a gap in the valuation of the target’s current stock price and the buyout price.” “Convertible bonds represent an attractive form of cheap financing for companies: The reason is that there instrument provides investors with the potential upside from stock appreciation.” “Because of this, interest rates tend to be lower, especially in light of a company’s credit rating.” “Debts are subordinate to existing debts.” “So in the event of default, the convertible bond holders will be the last in line to get paid back (for debt securities).” “A convertible bond may be callable: This means that the company has the right to repurchase the security” (Taulli, 2011, pp. 150-151).

 “The general market averages (Dow Jones Industrial, S&P 500, NASDAQ) are important because they represent the most part some of the largest and most well-established companies in the American economy.” “It is best to time short selling with action and movement of general market averages.” “After they show definite signs of weakness, only then does it become a question of the selection and timing of the individual stocks to sell short” (O’Neil, 2005, p. 6).

 “The point of understanding failed follow-through days is that they often coincide with laggard, shortable stocks rallying up into areas of overhead resistance which can offer optimal secondary shorting points.” “The short seller should be alert to follow through days that occur without fundamentally sound stocks staging fresh breakout.” (O’Neil, 2005, p. 6).

 “Bear markets and panics are normally brought on by deteriorating basic conditions or unusual, specific events.” “In normal market cycles, money becomes tight after the third or fourth increase in the Federal Reserve Board Discount Rate.” “Further expansion of business, particularly in the housing sector, is chocked off” (O’Neil, 2005, p. 12).

 “The stocks to sell short should primarily be the big leaders from the preceding bull market.” “That is, stocks that have had a large percentage increase.” “Our studies have shown that more institutions own more shares of former leaders as much as one to two years after they top than they do during the stock’s big run and period of outstanding price performance.” “It is helpful if a stock has recently split, and the larger the split, the better.” “It is even better if it is the stock’s second split during the last couple of years” (O’Neil, 2005, p. 16).

 “Huge institutional sponsorship of a stock can also be a liability for a stock once a bear market sets in.” Normally the investor wants to see strong institutional sponsorship in a stock during a bull market.” “However, in a bear market, stocks that are heavily owned, and in some cases “over owned,” by institutions can suffer if these sources of potential supply decide to unload positions.” “This over-ownership usually occurs in leaders that have long since topped” (O’Neil, 2005, p. 17).

 “It is dangerous to sell short companies with thin capitalization, or with small trading volume.” “When the market suddenly turns up, thin stocks tend to advance rapidly on only a little buying and create quick, large losses” (O’Neil, 2005, p. 19).

“To determine the exact timing of a short sale, analyze a good daily or weekly chart of individual stock’s price and volume movement during the last year.” “A an important and key concept in successfully timing short sales is that the optimal shorting point will, in the majority of cases, present itself five to seven months or more after the absolute peak in the stock price.” “It is not until all premature short sellers and late comers to the stock are worn down that the stock will begin to break significantly.” “A useful was to determine when this has occurred is to watch the 50 day moving average.” “When this 50 day moving average crosses the 200 day moving average and moves below it, a sharp break will often occur within a week or two months, and it is the this moving average cross that can help narrow the timing window for a short sale.” “If the short seller monitors a stock closely after the 50 day moving average crosses the 200 day moving average, the investor should be able to react to the first signs that the stock is now going to break down sharply” (O’Neil, 2005, p. 24).

 .

**Discussion**

The Stop loss order is highly recommended for short sellers. This will limit the capital loss in the event the short seller in wrong about market price of the stock. Mr. O’Neil suggests to limit capital losses to 8% of the strike price. Covering short sells is also highly recommended. This allows the investor to capitalize on capital Gains. Reading charts is critical for success in short selling. Patience is important in interpretation. It can take more than a year for a head and shoulders top pattern followed by a decline of the stock price thru 50 moving average. By comparison, most bullish chart patterns take less than 90 days to form. The investor needs to distinguish wide, loose, and sideways patterns. The reason is bearish chart patterns resemble the bullish chart patterns. The difference is that bullish patterns resemble are far more sharp and well defined.

 “As in prior years, 2007 saw a significant number of late trading and market timing cases involving hedge funds. The U.S. Attorney for the Eastern District of Pennsylvania brought the first criminal case against a hedge fund for deceptive market timing in charging Beacon Rock Capital, LLC.” “The information charged that Thomas Gerbasio, a registered representative of two broker-dealers, helped Beacon Rock conceal its identity and the nature of its trades in order to engage in market timing trades and circumvent controls implemented by mutual funds seeking to restrict market timing or other excessive trading.” “The SEC filed a parallel civil injunctive action, alleging the following techniques to evade mutual fund restrictions on market timing: "misrepresenting the nature of their trades to the funds, opening dozens of accounts under different names to conceal the customers' identities from the funds, entering trades in amounts designed to avoid the funds' detection triggers, [and] trading in funds where management was less likely to detect market timing." “Gerbasio settled the SEC action by  [\*610]  consenting to an injunction against violating Exchange Act Section 10(b) and agreeing to pay $ 540,044 in disgorgement and prejudgment interest, later waived down to $ 100,000.” “The court did not impose a civil penalty, based on Gerbasio's sworn financial statements to the Commission that he lacked the financial resources to pay.” “In a follow-on administrative proceeding, the Commission barred Gerbasio from association with broker-dealers.” “In the criminal matter, Beacon Rock entered a We argue that short interest is an attractive measure of misvaluation for two

reasons.” “First, short interest can be viewed as “polling” investors about misvaluation; thus, our measure is less likely to be confounded with growth opportunities, because it does not rely on the ratio of a firm’s market price to firm fundamentals (as does the market-to-book measure).” “ For example, Maksimovic, Phillips ,and Yang (2010) find that misvaluation proxies based on the market-to-book ratio(e.g., Rhodes-Kropf et al. (2005)) are correlated with future productivity. Second, short positions are costly. Short sellers do not have access to the sale proceedsuntil the short position is closed, and lending contracts include loan fees that have been estimated at 1.64% (annually) for New York Stock Exchange (NYSE) stocks and 3.74% (annually) for National Association of Securities Dealers Automated Quotations (NASDAQ) stocks (Diether and Werner” (2011)). “The cost of short selling is what links short interest to mispricing. Specifically, informed short sellers must earn higher expected returns to compensate for the cost of short selling; they will short a stock only when the marginal benefit of shorting

equates to or exceeds the marginal cost.” Thus, high short interest is indicative

of mispricing, because it is mispricing that induces investors to initiate costly

arbitrage” (Drake, M., Itzhak, B.D., & Roulstone, D., (2015). P. 4).

 “The possibility that short selling would influence listing decisions is suggested by two Schools of thought. First, prior research (Figlewski and Webb, 1993; Danielsen and Sorescu, 2001) often views options and short sales as substitutes insofar as a bearish investor can choose to either short the stock by borrowing shares or synthetically short the stock by trading a combination of options.” “Because of this substitutability between options and short sales, exchanges may assume that stocks with greater short activity will have higher levels of option volume as informed investors will migrate from the shorting market to the options market once options become available” (Blau, B., & Brough, T. , 2014, p. 704).

 Return on net operating assets equals net operating profit after tax/ average net operating assets. Return on net operating assets equals net operating profit after tax/ net operating assets. Return on equity equals net income attributable to controlling interest / average equity attributable to controlling interest. Return on net operating assets equals net operating profit after tax/ average net operating assets. Net operating profit margin equals net operating profit after tax/revenues. Net operating asset turnover equals revenues/average net operating assets. Return on equity equals net income / average stockholder’s equity. A decline in the above ratios would be an appropriate short sell candidate.

 The current ratio is current assets/current liabilities. The acid test ratio equals cash + current receivables + short term investments/ current liabilities. The current cash debt coverage equals net cash provided by operating activities/ average current liabilities. The lower the above ratios the better a stock would be a short sell candidate.

 Accounts receivable turnover equals net sales/ average trade accounts receivable. Asset turnover equals net sales/ average total assets. Lower ratios means the company is a better short sell opportunity. Inventory turnover equals net sales/ average total assets. A higher ratio would mean the company is a better short sell candidate.

 The debt to assets ratio equals total liabilities/ total assets. A higher ratio is necessary to short sell. The times interest earned ratio equals Income before income taxes and interest expense/ interest expense. The cash debt coverage equals net cash provided by operating activities/ average total liabilities. The book value per share ratio equals common stockholder’s equity/ outstanding shares. A decline to the above ratios would improve short sell opportunities.

 Production variance are used to make internal decisions. None of them are available to the public. Normally, companies short sold have negative variances. The direct materials price variance equals actual quantity \* (actual price- standard price). The direct materials quantity variance equals standard price \* (actual quantity used – standard quantity). Direct labor rate variance equals actual quantity \* (actual price – standard price). The direct labor efficiency variance equals standard price \* (actual quantity – standard quantity). Variable spending variance equals actual cost- (actual quantity \* standard price). Variable overhead spending variance equals (actual quantity \* standard price)-(standard quantity \* standard price). The fixed overhead spending variance equals fixed overhead cost-budgeted fixed overhead cost.

 “The two primary reasons for swapping interest rates are to better match maturities of assets and liabilities and/or to obtain a cost savings via the quality spread differential.” “In an efficient market without barriers to capital flows, the cost savings argument though a quality spread differential is difficult to accept.” “Growth in interest rates swaps has been extremely large in recent years.” “Thus, the arbitrage argument does not have much merit.” “Consequently, one must rely on an argument of market completeness for the existence and growth of interest rate swaps.” “The interest rate swap market assists in tailoring financing to the type desired by the borrower.” “Both counterparties can benefit (as well as the swap dealer) though financing that is more suitable for their asset maturity structures” (Eun, Resnick, 2015, p. 360).

 “What do markets do?” Asset valuation- market prices offer the best way to determine the value of a firm or of the firm’s assets, or property.” “This is important not only to those buying and selling businesses, but also to regulators.” “Risk management- futures, options and other derivatives contracts can provide protection against many types of risk, such as the possibility that a foreign currency will lose value against the domestic currency before an export payment is received.” “They also enable the markets to attach a price to risk, allowing firms and individuals to trade risks so they can reduce their exposure to some while retaining exposure to other” (Levinson, 2014, pp. 2-3).

 “Most relevant to our study is Berkman et al. (2009), who find that stocks with high disagreement and/or shorting costs have lower average returns around earnings announcements, consistent with Miller (1977).” “It is important to note, however, that this finding concerning average returns does

not imply a negative asymmetry in returns. To confirm this, we show in a simple model (available upon request) that a lower average return to earnings news for high short-sales constraints/high disagreement stocks could be perfectly

consistent with either a positive or a negative asymmetry in returns.” “A negative asymmetry would be likely only if the shorting constraint is severe enough. Whether or not shorting constraints are binding enough in the real world to generate a negative asymmetry is therefore an empirical issue that must be tested; it cannot simply be inferred from the finding of Berkman et al. (2009).” “Moreover, the purpose of our study is quite different from theirs.” “Whereas they set out to test Miller’s theory, we examine how the theory sheds light on the torpedo effect, a phenomenon that has intrigued researchers since SS but whose existence and causes continue to be debated” (Mashruwala, C., & Mashruwala, S., 2014, p. 526).

 “These results clearly indicate that the decline in premium in Table 1 is not

due to the short sellers driving prices down.” “Rather, it appears to be a result of

market participants being concerned about the potential for short sellers to

drive prices lower.” “This concern appears to manifest itself in investors reducing

their trading in pilot stocks, which combined with the increased asymmetric

information risk results in an increase in spreads” (Deshmukh, Gamble, & Howe, 2014, p. 1349).

 The investor needs to be able to distinguish from both bull market and bear market chart patterns. This is because both are similar in shape. Bull market chart patterns are tight and well defined. They occur on average over a six month period. The patterns are cup with handle, saucer with handle, W, ascending base, and a box. The stock price can increase 1 month to over a year. Bearish patterns are head and shoulders top, wide, sideways, and loose W, cup with handle, saucer with handle, and ladle with handle. The chart patterns are formed between three months and over two years. The stock price can decline in one month to over three years. Both cases call for patience and expertise.

**References**

Blau, B., & Brough, T. (2014). *Short Sales and Option Listing Decisions.*

 P. 703-724. DOI: 10.111/fima.12039.

Blumenthal, L., Rashkover, B., & Klienman, W. (2008). SEC Enforcement and

 Examinations Concerning Hedge Funds. *New York Law Review*. p. 599-634.

 Volume 52. Issue 4.

Cooper, D., & Schindlar, P. (2014). *Business Research Methods*. pp. 96-97.

 New York, NY: McGraw Hill.

Deshmukh, S., Gamble, K., & Howe, K. (2014). Against the Tide:

 The Commencement of Short Selling and Margin Trading in Mainland China.

 pp. 1319-1355. DOI: 10.1111/acfi-12032.

Drake,M., Itzhak, B.D., & Roulstone, D. (2015). *Acquirer Valuation and*

 *Acquisition* *Decisions: Identifying Mispricing Using Short Interest*. P. 1-32.

 DOI: 10.1017/S0022109014000611.

Eun, C., & Resnick, B. (2015). *International Financial Management*. p. 360.

 New York, NY: McGraw Hill.

Levinson, M. (2014). *Guide to Financial Markets*. pp. 2-3. New York, NY:

 McGraw Hill.

O’Neil, W., & Morales G*. How to Make Money Selling Socks Short*. pp. 6, 12, 16,

 19, 24, 32-33, 42-43. Hobken, NJ: John Wiley & Sons Inc.

Mashruwala, C., & Mashruwala, S. (2014). *Is There a “Torpedo effect” in Earnings* *Announcement Returns? The Role of Short Sales Constraints and Investor* *Disaggreement.* (2014). Pp. 519-546. DOI: 10.1177/0148558x14537827.

Taulli, T. (2011). *All About Short Selling*. pp. 12-15, 19, 21, 26, 31-32, 50-51, 135-

 136, 141-142, 150-151. New York, NY: McGraw Hill.

**Appendices**

Bear Market: “The general definition is when a market falls by at least 20 percent” (Taulli, 2011, p. 219.

Bond: Debt that an entity issues, which usually matures in 10 to 30 years.” “In the meantime, the entity will pay periodic interest payments” (Taulii, 2011, p. 219).

Candlestick Charts: Developed several hundred years ago in Japan, this is a technique to chart the price and volume of stocks” (Taulli, 2011, p. 220).

Covering a Short: “This is when a short seller closes out a short position and delivers shares to the financial firm that the original shares were borrowed from” (Taulii, 2011, p. 221).

Common Stock: “This represents equity ownership in a company.” “The shareholder will have certain rights, such as voting and possibly of receiving dividends.” “But in the event of bankruptcy, he or she is last in line to receive any proceeds” (Taulli, 2011, p. 220).

Convertible Bond: “A debt of a company that matures in a period from several to 20 years.” “It will pay ongoing interest.” “However, there is a formula that allows an investor to exchange the bond for a certain number of shares in the company” (Taulli, 2014, p. 220).

Correction: “This is when the market has a temporary fall, which is anywhere from 5 percent to 10 percent” (Taulli, 2011, p. 220).

Derivative: “A contract between a buyer and a seller.” “Each is betting on the direction of a stock or other security.” “Common derivatives include options and futures” (Taulii, 2011, p. 221).

Dividend” “A payment to shareholders.” “This is often based on a percentage of the stock and it is payable every quarter” (Taulii, 2011, p. 221).

Earnings per Share: “The earnings of a company divided by the number of shares outstanding.” “This is highly followed metric on Wall Street.” “If a company fails to meet expectations on a quarterly EPS, the stock price is likely to fall” (Taulli, 2011, p. 221).

Federal Reserve Board:”The central bank in the United States.” “The Fed tries to allow for low inflation and steady growth though changing interest rates and the money supply” (Taulli, 2011, p. 222).

Float: “The number of shares that are actually traded on an exchange.” “This can be much lower than a company’s outstanding shares (which often have resale restrictions).” (Taulii, 2011, p. 222)

Future : “A contract that gives an investor the right to buy or sell an underlying asset, such as commodity or an index.” “An investor will put up a small amount of the initial value of the contract, say 5 percent to 10 percent.” “This is done using a margin account” (Taulli, 2011, p. 222).

Hedge: “This is when an investor uses short selling or a derivative transaction to protect the downside of an investment” (Taulli, 2011, p. 223).

Hedge Fund: “This is a pool of assets from a variety of investors.” “Usually, they are institutions or wealthy persons.” “A hedge fund often has much latitude in terms of investment strategies, including short selling” (Taulli, 2011, p. 223).

IN the Money: “This is when the stock price is above the strike price for a call option; the reverse is true for a put option” (Taulli, 2011, p. 223).

Short Interest: “The number of shares shorted that have yet to be covered” (Taulli, 2011, p. 237).

 Limit Order: “An order placed at a specific price when purchasing a stock.” “This is an attempt to get a better price” (Taulli, 2011, p. 224).

Market order: “An order placed at the current market price when shorting a stock.” “While the investor will not get the best price, he will be guaranteed fast execution” (Taulli, 2011, p. 224).

 Moving average: “This shows the average price of a stock on a chart.” “This is often a 50-day or 200-day moving average.” “Investors will track these too get a sense of when a stock is ready for a move on the upside or downside.” (Taulii, 2011, p. 225).

Moving Average Convergence Divergence: “A common indicator for technical analysis.” “It is based on a 12-day and 26-day moving average” (Taulii, 2011, p. 225).

Out of the Money: “This is when the exercise price is higher for a call option than the current stock price; the reverse is trur for a put option” (Taulli, 2011, p. 225).

Price earnings ratio: “A company’s stock price divided by the earnings per share (EPS). “This provides a gauge of the valuation of a company’s shares” (Taulli, 2011, p. 225).

Put option: “This allows an investor to sell 100 shares of a company at a fixed price for certain period of time (typically three months).” “The value of a put option increases as the underlying shares shares fall in value” (Taulli, 2011, p. 226).

Resistance: “The price level where a stock price will encounter selling pressure.” “It is a key element in technical analysis” (Taulli, 2011, p. 226).

Retained Earnings: “The total earnings a company has generated since it has started” (Taulli, 2011, p. 227).

Reverse split: “This is when a company reduces the number of shares outstanding.” “This will increase the stock price.” “A reverse split is usually a large ratio, such as 1 to 10” (Taulli, 2011, p. 227).

Securities Act of 1933: “The federal law that regulates the disclosures companies must make when they issue securities to the public” (Taulli, 2011, p. 227).

Securities Exchange Act 1934: “The federal law that regulates the trading of securities.” “It regulates ongoing disclosure from companies and forbids fraudulent statements” (Taulli, 2011, p. 227).

Stop Loss Order: “An order for your broker to sell a stock when it reaches a certain price level in relation to strike price” (Taulli, 2011, p. 228).

Strike Price: “The price at which the order of a call option can purchase 100 shares and the price at which the put option owner can sell 100 sell 100 shares” (Taulii, 2011, p. 228).

Short Selling: “This is when an investor borrows shares from a financial services firm and then sells them on the open market.” “The goal is to buy back these shares at a price lower so as to generate capital gain” (Taulli, 2011, p. 237).

Shorting Against the Box: “This is when the owner of shares shorts them to lock in the price.” “Any increase or decrease in the stock price will have no impact on the portfolio.” “However, this may mean paying taxes on the capital gains” (Taulli, 2011, p. 238).

Short Interest Ratio” “This is the short interest divided by the average daily volume.” “This shows how many days it would take for short sellers to cover their positions.” “If this is a week or more, it could mean that there is a threat of a short squeeze” (Taulli, 2011, p. 238).

Short Squeeze: “This is when a stock price increases causing shot sellers to cover their positions.” “This will create even more demand for the stock and could exaggerate the stock increase” (Taulli, 2011, p. 238).

Short Swing Rule: “The rule that prohibits an insider from taking a capital gain on the company’s stock when the holding period is less than six months” (Taulli, 2011, p. 238).

Yield Curve: “A graph of the yields of short term to long term bonds (up to 30 years).” “In a normal economic environment, the graph will have upward slope” (Taulli, 2011, 229).

**Annotated Bibliography**

Abraham, R., & Harrington, C. (2013). Predicting Informed Trading at Merger Announcements.

 *Journal of Economic Studies*. P. 658-670. Doi: 10.108/JEJ-02-2012-0021.

A merger announcement indicates the acquired company is a poor short sell candidate. Top executives that leave companies on their own free will show that their firms are good to short sell. This is because the firm’s leadership is called into question. The investor needs to avoid companies that pay dividends. This is because the dividend reduces the capital gain and increases the capital loss of the short sale. Market makers hold informed traders in check by increasing spreads of bid and ask prices. Liquidity traders are the institutional firms such as hedge funds. They trade more for ownership than capital gains. The Great recession of 2007-2009, was started by macroeconomic conditions, not derivative products. A stock’s beta influences a stock’s return, this is because it measures sensitivity to market volatility. The Easley and O’Hara Model effects behavior of informed traders that can drive stock prices up or down.

Chen, F., & Partar, M. (2007). Value of a Put Option to the Risk Adverse Newsvendor.

 *Options Finance*. p. 481-500. DOI: 10.1080/074408170600941607.

Markets are unpredictable and firms need technological development to compete on a global scale. Effective hedging techniques to adjust for unforeseen barriers such as changing weather patterns enhances the investor’s return. The forward contract or option contract are some of the suggested derivative products that effectively hedge risk. The paper proves the optimal order quantity of an underlying stock can be the same with or without an option contract.

Cooper, D., & Schindler, P. (2014). *Business Research Methods*. p. 85-86. New York, NY:

 McGraw Hill.

Secondary data relies on interpretation of such sources as textbooks and scholarly reviewed articles and journals. It is necessary to verify the validity of secondary data. In the stock markets chart patterns repeat themselves over time. Some patterns such as the cup with handle indicate to be long in stocks. The head and shoulders pattern that has the stock prices drop below the fifty day moving average indicates to short sell stocks. Researchers are limited by a budget. This can result in out dated or inaccurate conclusions. Better resources after the fact can enhance the accuracy of conclusions. It’s an imperfect world, researchers try to provide reasonable assurance much like an auditor provides reasonable assurance of an audit opinion. Due to limited resources researchers do their best to conclude correctly.

Easton, P. McAnaly, M., Sommers, G., & Zhang, X. (2015). *Financial Statement Analysis &*

 *Valuation*. pp. 11-37, 11-41-11-42. Cambridge MA: Cambridge Business Publishers.

Increasing net income, earnings per share, and stockholder’s equity would indicate to an investor to trade long in a stock. Growth of assets would lead to growth of stockholder’s equity. This would enable a company to obtain financing to expand operations. A short seller wants companies have noticeable difficulty. This would include high executives resigning, declining, sales, net income, assets, and stockholder’s equity. Sales is a driver of net operating margin. The short seller would look for companies with declining sales and net operating profit margin.

Fox, M., Glostein, L., Tetlock, P. (2009). Short Selling in the News Preliminary Report on

 Empirical Study. *New York Law School.* P. 645-686. Volume 54. Issue 3.

Many Hedge Fund managers have violated SEC regulations. The top priority of the SEC is to develop and enforce effective rules and regulations against insider trading. The SEC filed Criminal and civil suits hedge fund manager Michael Guttenburg and tippees Eric Fanklin and David Taudy for $14 million in capital gains for insider trading. Another ring of inside traders was Morgan Stanley’s compliance Lawyer Randi Collotti and her husband Christopher Collotta. Both tipped off investors of various company mergers. This trading ring received $600,000 in illegal capital gains. The SEC brought a civil suit against Langley Partners LP, North Olmstead Partners LP, and Quantico Partners LP and their mangers Jeffrey Thorp for evading registration requirements. This ring also executed illegal naked short Selling in Canada. The SEC filed a criminal suit against Becon Rock Capital, LLC for concealing deceptive market timing trades in 2007. In October 2004, the SEC filed an administrative proceeding against Investo Funds Group, AIM Advisors, and AIM Distributors for illegal market timing trades. The SEC won all the above criminal, civil, and administrative action suits.

Grunewald, S., Wagner, A., & Weber, R. (2010). Short Selling Regulation After The Financial

 Crisis-First Principles Revisited. *International Journal of Disclosure & Governance.*

 p. 108-135. DOI: 10.1057/jdg2010.2.

Evidence suggests short selling stocks hamper stock price discovery. The article suggests more regulation of short selling is necessary to result in fair stock prices. The SEC rules and regulations have cause stock market inefficiency in the United States.

Gropelli, E., & Nikbakht, E. (2012) *Finance*. p. 110. Hauppauge, NY: Baron’s Educational

 Series.

Arbitrage pricing theory uses a discount rate to calculate rate of return. Arbitrage is less restrictive than Capital Asset Pricing Model. Capital Asset Pricing Model is less complex. Arbitrage Pricing Theory model runs into sampling distortion. Capital Asset Pricing Model helps investors understand discount rate of a firm. Capital Asset Pricing Model only takes into account market index. Arbitrage Price theory considers many factors.

O’Neil, W., & Morales, G. (2005*). How to Make Money Selling Stocks Short*. pp. 32-33, 42-43.

 Hoboken, NJ: John Wiley & Sons Inc.

Although short sales can be done year around, it is preferred to do it in a bear market. That way the investor is not fighting the tide. Most stocks decline in a bear market. Investors would desire stocks that trade in high volume for liquidity. Former stock market leaders with huge price run ups are good candidates to short sell. Head and shoulders formation in major market chart patterns in high volume that break below the 50 and 200 day moving average lines signals a bear market. Short selling stocks yields higher capital gain by avoiding dividend paying stocks. Dividends paid are deducted for capital gains and add to capital losses. Close out short sales of stocks often to take 15-30% capital gains. Wedging is a clue the stock will break downward in price, this occurs on the right shoulder of the head and shoulder chart pattern. Railroad tracks pattern is high volume retracement that indicates a stock is under distribution. An island top is a bearish pattern that looks like a small square floating by itself. It indicates the end of a rally.

Sincere, M. (2014). Understanding options. pp.151-160. New York, NY: McGraw Hill.

Buying put options is less risky than short selling stocks without a stop loss order. In that case the loss is limited to the investment principle. The loss is unlimited short selling stocks without a stop loss order. Look for bad news in a company to buy a put option on its stock, such as the CEO resigning. When buying a put option on an underlying stock it can be out of the money, at the money, or in the money. The relation of market price to strike price determines how expensive the put option will be. The market price is what the underlying stock is trading at. The strike price is chosen by the investor. The investor wants the market price to trade lower than the strike price to make a capital gain. Short term capital gains are the option holding period is under 1 year and long term is longer than 1 year. A market price below the strike price is in the money. A market price that equals the strike price is at the money. A market price that is above the strike price is out of the money. It is wise to close out positions of a put option when the market price of the underlying stock is 15-30% below the strike price. This will be a capital gain of 15-30%. It’s important to utilize stop loss orders to minimize losses. Recommended stop loss order for a put option is 8%. This is when the market price rises 8% above the strike price. Then the put option position is automatically closed out and the capital loss is 8% of the strike price.

Taulli, T. (2011). All About Short Selling. pp. 133-142. New York, NY: McGraw Hill.

Common themes of a bear market are deflation, historical highs of price earnings ratios, and inverted yield curve of bonds. The Federal Reserve tightening the economy by raising the Federal Funds Rate can indicate a bear market. The formula was developed by Richard Arms. The formula: (number of advancing stocks/number of declining stocks)/(advancing volume/declining volume. A trading index of 1.20 or higher would signal a bear market. The Volatility Index is a good indicator of the short term direction of the market within 90 days.

Sarkar, A., & Li, K. (2002). Short Sales Constraints and the Benefits of Diversification. Current

 Issues in Economics and Finance. p. 2-3. Volume 8, Issue 3.

Derivative products can smooth out returns in volatile foreign markets. Short selling can reduce losses in long positions when the stock market indexes decline. Economists claim diversification lends itself well to consistent returns. In declining stock markets bonds can offset losses in long position stocks.