

Short selling, Margin Trading and Market Makers

Short selling

Short selling is the sale of shares that the investor does not own. The purpose is to profit from a future decline in the price of stock. The investor selling short, called the short-seller expects to be able to buy back the stock from the market at a price less than the price at which the stock was sold short.

Short selling is not complex, but it's a concept that many investors have trouble understanding. In general, people think of investing as buying an asset, holding it while it appreciates in value, and then eventually selling to make a profit. Shorting is the opposite: an investor makes money only when a shorted security falls in value. More specifically, a short sale is the sale of a security that isn't owned by the seller, but that is promised to be delivered.

The short-sale works as follows. Investor would borrow the stock from another investor through the broker, sell it in the market, and keep the sale proceeds with broker in the brokerage account. Later, when the price of the stock has declined, the investor buys the shares from the market to replace shares from the market to replace shares borrowed from the broker and closes out the short position.

The short-seller has to deposit some amount of money, called the margin, with the broker as collateral on the short-sale in the event the short-seller makes losses and becomes unable to return shares to the lender. There are two types of margin requirements-initial margin and maintenance margin. The initial margin requirement is the percent of value of shares that must be deposited with the broker at the time of the initial trade. The maintenance margin is the percent of the market value of shares that must be held as margin at any time after the initial trade.

Short selling facility is not available in the Colombo Stock Market.

Margin Trading

There are two ways to purchase stocks:

- a) The buyer can pay the purchase price in full
- b) Using a margin account. In a margin account purchase, the buyer pays a portion of the purchase price and the broker or the margin provider lends the difference. The buyer in turn pays interest on the broker's loan in addition to the usual commission fees. For collateral, the broker holds onto the stocks. Dividends earned from the stocks are used to help offset the interest payments.

If we explain this further, Margin trading is the purchase of stocks by borrowing a portion of the investment using stocks as collateral. It is buying stocks without having the entire money to do it. In other words, margin trading is a leverage transaction whereby the investor pays for the stock using investor's own money and funds borrowed from the broker.

As with short sales, margin trading also requires investors to have an initial margin and a maintenance margin. The initial margin requirement is at least 50% in some countries, which

means investors can borrow up to 50% of the stock value. The lower the margin requirement, more the investor can borrow. The maintenance margin, minimum margin that must be maintained at any after the purchase to protect broker against stock price declines, is at least 25% in the U.S. investor receive a margin call or a notice from the broker to add additional funds to the margin account when the margin falls below the maintenance margin. Typically, brokers give 2-5 days to put up margin after a margin call, and if the call not met, stock will be sold to pay off the loan.

Trading on margin greatly increases a traders buying power. It provides him an opportunity to make enormous profits using lesser money. Margin trading is a very common trading strategy that has both merits and demerits;

Advantages of Margin Trading

- Suitable for experienced investors, having knowledge of stock market trend patterns.
- More profit with less investment.
Investors generally use margin to increase their purchasing power so that they can own more stock (and make a greater gain) than their own resources allow
- Increased buying power with less money.
- An investor can borrow up to half of his purchasing price as initial margin.
- Greatly suitable for day traders, who need to complete more number of trades with higher volume stocks.

Disadvantages of Margin Trading

- Not advocated for novice investors.
- Have to pay off interest on margin.
- Add more burdens on investors' shoulders in losing trades. If the stock price goes down, buying on margin can work against you.
- Cannot trade all stocks - like penny stocks, IPOs etc.
- Your account balance and buying power changes with changes in stock prices.
- The chance of margin call is always prevailing.
- You are always obligated to keep a minimum account – the maintenance margin.
- With falling stock prices the investors have much less control.

Market Makers

A market maker or a specialist is an exchange member assigned to handle particular stocks. The specialists play to roles. They act as brokers to market participants by matching buy and sell orders. They also functions as dealers by buying and selling from their own account to maintain fair, liquid, and orderly market. They stand ready to buy into their own account when there is no buyer and stand ready to sell out of their own account when there is no seller for the securities assigned to them by the exchange. This activity, called market making, is an important activity for creating efficient markets. They earn commission for their role as brokers profit from their dealer operations. The CSE does not have market makers, and, hence, trades can only be done when both a buyer and a seller are present. This lack of market making reduces the liquidity.