Understanding Short Selling in the Forex Market
By Winsor AGA Hoang

There are many reasons why investors are unaware of or uncomfortable with short selling. One major reason is because it is counter intuitive. It makes more sense and is more intuitive for people to buy something, hold on to it, and then sell it at a higher price. You buy a stock at $2, hold onto it for 6 months, and then sell it for $3. Let’s take an example, you buy a house, you live in it, and then you sell it to buy another house. You can buy a house for investment, and you can rent it out to help pay for the mortgage. You don’t live there, but you still own the house. In all of these examples, you buy something, you own it, and then you sell it.

In short selling, you are selling something that you don’t own. It is counter intuitive because you can’t go around your neighborhood and sell a house that you don’t own. Hence, short selling does not make a lot of sense to people. Don’t worry, the next example will ease you slowly into the concept.

It is midnight, you are out of milk, and your kid is crying. You run over to your neighbor’s and ask to borrow a jug of milk. It happens that your neighbor just bought a jug of milk for $5, but he refuses to take your money. Instead, he tells you to buy him another jug of milk later, and you will be even. The next day, you go to the supermarket and the jug of milk is on sale for $3. You buy the jug of milk and return it to your neighbor and save yourself $2 in the process. Basically, you consumed the milk (an asset that isn’t own by you), and then you delivered an identical milk back to your neighbor at a later time. This is the concept of short selling. A short sale is the sale of a security that isn't owned by the seller, but that is promised to be delivered.

Say you don’t think that Nortel Networks’ share price should be at $120 per share because the company is not profitable. You can borrow 10 shares from your stockbroker, and sell them for a gain of $1,200. When the stock price drops to $70, you buy back the 10 Nortel shares at $700, and return them to your broker. You borrowed 10 shares from your broker, and then you returned 10 shares, pocketing $500 in the process. If the price of the stock rises, though, you have to buy it back at a higher price, and you lose money.

In Forex trading, you can make money in both up and down markets if you are able to anticipate the up and down trends in the market. If you believe that the currency pair is going up, you buy at the low price and then sell at the high price. Alternatively, if you believe that the currency pair is going down, you sell at the high price and then buy at the low price to recover. In real time Forex trading, the rates of the currencies can change at any time. For instance, the quotes accessible for a specific currency pair can move upwards or fall down within a blink of an eye. This forces the investors to be extremely flexible and to go with the trend. Whereas, in the stock market a bull run can last as long as several years; hence, it is difficult to switch your thinking from a bull to a bear market.

Even though you have tools of short selling and long buying to in the foreign currency market, Forex trading is extremely difficult to master and more than 95% of traders lose their money. Understand that any method or software that boasts a 300% return on investment will also contain a minus 300% drawdown. Ask the right questions before purchasing or renting any currency trading software.

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