IFB214: Shorting - How to Handle When Your Company is Shorted, And What To Do

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(DAVE) All right, folks, welcome to Investing for Beginner's podcast. Tonight, we have episode 214, and we're gonna answer this great listener question. We got all the way from the Scottish Highlands.

So this is, Hey Andrew. I'm a regular listener to the podcast, and I've been since I started out investing just six months ago; it's been a great help. And I'm enjoying catching up on some older episodes, as well as the current ones. Thank you for what you do. My question is about skills and about shorting. I really like the company because they have no debt, fantastic year-over-year revenue growth at 92%, and very strong GP or gross profit at 95%. The marketing costs are high, but I'm okay with that. As they're early stage. So focused on revenue growth, which is working. What I don't understand is the online chatter about the stock being heavily shorted.

I'm not clear as to how people know this is true, and if it is true, why would investors pick on skills too short? Also, I'm very conscious of the day today's share price. It doesn't matter just now, especially as I've only held the stock for a month and planned to go long on it, but I'd be grateful if you could shed some light on this is the stock being really shorted. How do we know this? And why does it happen?

I realize this is a stock-specific question, but presumably, it's a pattern that repeats itself with many shares. So hopefully, it is one of interest to your oyster—many thanks, guys. And I'm crossing my fingers that you take this question on all the best from the Scottish Highlands, Stevie. So also PS, I hope your golf is improving and that you'll travel over here one day to take on the best courses in the world. And I will say this, Stevie, you have a beautiful country. I've been lucky enough to go there. I did try Haggis ate it, loved it. So I know that makes me very weird, but I did like it, and yeah, St. Andrews is actually the oldest golf course in the world. So that's kind of an interesting tidbit, but so besides the Scottish stuff, Andrew, what are your thoughts on Stevie's really good question.

(ANDREW) I've also golfed St. Andrew's as well, but it was on a, um, one of those simulators that top or graph act one of those. Gotcha. You wouldn't want me on there anyway; I'd be holding everybody up. So let's take the first part of the question.

Maybe some background, whether is it to short a stock. I think if you're a beginner and you're tuning in, and you really want a really good breakdown on this, we had an episode back in early 2021 called the lessons and blessings from the game stops short squeeze. We had a guest George Papa Paso, and he did a great job of breaking down shorting. Just the bottom line is people will root for a stock. That's when you buy it; you go along. And if you think that the stocks gonna go down, you short it, which means you will make money if the stock goes down.

So the first kind of question there is how you know, is the stock even being shorted. And there are several tools you can use to look at this. I like to use finvis.com, FINVIS .com, and they have this metric on their called short float. And it, so it tells you how, you know, what percentage of the shares are being shorted that are available. And so when I type in the company skills into fin BIZ, you get something like 22%, which is really, really high. I mean, Dave, you were talking about some companies off the air mm-hmm and you know, some really great companies will be sure that maybe 1%, half a percent, what was Tesla? Do you remember?

(DAVE) Uh, Tesla was at 3%, which to me seemed kind of high. We looked at Microsoft, they were like 0.6% visa was a little over 1%, which me, but another company that I've been looking at, FIS is their ticker symbol as Fidelity National Information, it's a payments company. And their short interest was like 0.7%. So yeah, 20% above, that's pretty serious shorting going on.

(ANDREW) So basically, a lot of people are betting that the stock's gonna go down. I guess the next part of his question is, why is it happening? And you know, why would people do it in general? And I think there's a huge, you saw it with a game stop for sure, where there's a huge backlash against any sort of short selling. And I think that's, you know, pun, excuse upon; I think it's shortsighted because there is a value that shorts, sellers bring to the market and they keep the game healthy, and they keep managements from being too fraudulent and, and all of these sorts of things it's needed for healthiness. You can't have all growth and no death. I mean, that, that would be an interesting world. You know, there are, I guess, many reasons why a company could be shorted, maybe off the top of your head. What, what can you think of?

(DAVE) I think there are probably several reasons why people would short a company. I think the first one that I can think of is that they just don't believe in the company, whether it's the product that's being produced or the service that's being sold, or they don't believe in the management that's running the company, uh, for whatever reason and, and

(ANDREW) Beyond meat, maybe an example. Yeah. That could be

(DAVE) The product. Yeah. Peloton would probably fall into that category at the moment too. There's just a lot of things about the company that people are all just like, eh, no, it goes public, and it becomes a public company. And then, you know, there's a good, and there's a bad to that. And when a company goes public, then, then it's out in public. And so people can see all warts, if you will, of the company and things that may have done well when it was private; a lot of that stuff was uncovered. And when, as soon as you go public, now it's all out there for everybody to see. So any dirty laundry that you may have, I know that that's probably what the company, the truck company, uh, Nicola more recently went through some, a lot of kind of dirty laundry scandal stuff when the company was trying to go public, uh, because there was just a lot of, I guess, shininess that was going on with management and the financials and some of those things.

So I think some of those things, uh, really lead to a kind of a natural choice, of shorting the company. I think another thing that could be is that sometimes I think it is easier to short the company because you just don't believe that it's gonna grow. It's probably more likely you're gonna go the other way. And so it's probably easier to make money. And I think when you look at the share price of this company, it's trading around $10, and this is something I kind of postulate when Andrew and I were talking through this before we came on the air, was that because it's only trading for $10, it's an easier company for a lot of retail investors to take opposite, be on that the company will do worse than it will do better because there's not a lot of money involved. It's not like it's trading thousands of dollars, and you gotta put a lot of money up to short, a company like this.

So there's maybe more potential to make money if the company does worse than they do if they do better. That's something that I was thinking about. So I guess those are a couple of things that kind of spring to mind. What are some of your thoughts now?

(ANDREW) Yeah, those are a, a good, an interesting idea about the retail investors. I mean, I have seen a lot of kinds of headlines talking about how a lot of average investors are really moving the market right now. It's kind of cool. And you know, you can move it, not just through buying and selling or buying and shorting, but also there's a ton of options activity. That's what really magnifies everything that goes on. And that includes when you see downward pressure. And so a couple of other things that can really cause people to shore. I mean, they, you have a whole subset of traders who call themselves technical traders, and there's a branch of that called trend following where, you know, you just buy the trend. So you buy something because it's going up, you short something because it's going down. And so if a stock gets caught in one of those trends, you know, it's a lot of times it is the fundamentals that drive it, but it can become self-perpetuating, and you can see any negativity start to snowball into worse and worse negativity.

If that picks up a trend, then you can see it getting worse and worse and worse. Another idea would be if a stock just got way too expensive, and if there was hype and then the hype went away, a lot of fads can be in that way. And if a company is in that situation, then that can explain the big short position. And of course, if people think that there's trouble with the company if they think that it could go bankrupt or they're gonna default in any way, then obviously you'll have a lot of shorts piling in there. Mm-hmm, I guess in the case of this company, did you see anything without you in particular?

(DAVE) I didn't, no. I just, uh, granted it's a superficial level of analysis. I didn't see anything that jumped off the page that just screamed. This is in bad shape and, you know, watch out below kind of idea. And that's again, without knowing much about the company or even what it is they do. And if you just look at the superficial nature of the financials, like Steve was saying, there are some things in there that are growing as far as expenses, which are causing the company to, as it makes more money, lose more money, which may sound counterintuitive. But as Stevie greatly pointed out, the company is in growth mode. And so when you look at the reason why they're probably losing money, more money as they make more money is because they're taking on more people, they're hiring more people to try to grow the business faster.

A lot of businesses do that. And it, you don't just see that with skills. You'll see that with CrowdStrike and CloudFlare and snowflake, any of the other companies that are out there that are in the tech world, that's very, very common to see that kind of pattern where they will grow their headcount because they're trying to take on more people because they have more demand for their products and their services than they can handle with what they currently have. But the revenue is being booked in the future. It's not booked today, but you gotta take on that cost to get to that point.

You and the same in just about any kind of business. Sometimes you have to take on those costs, whether it's an inventory or whether it's hiring more people to get to that other side where, you know, you're gonna have more revenues, but in the short term, you may have some losses or the financials may not look as good as they will. Six months, a year, two years from now. And that's part of the process of businesses as they become public and start to mature. And not saying that skills are anywhere near maturing at this point, but it's part of the evolution as companies go through their different life cycles. And those are all things that, as you learn more about finances and business and how they operate, will start to make a little more sense. But I don't see anything that screams to me that, Hey, you know, look out below. Did you see anything like that?

(ANDREW) It's interesting. You bring up the life cycle. And I think that makes it, you know, this what makes growth stocks so difficult at times is because I could look at the financials of like a Microsoft or a visa, and those are gonna be pretty strong. But if you're talking about being a brand new company that's innovating, and maybe you only have like a hundred million dollars in sales, a lot can go wrong, to really knock you out. I mean, you could have a competitor who's able to raise even more money than you at a short time and beat you out own game. Or if you're a really small fish and you're reliant on big fish, the big fish could, depending on, you know, how strong your competitive advantage is, sometimes the big fish can just swallow you whole, and that's kind of capitalism.

And so, I don't think it's Apple's apples to be able to say a company that's large and mature and has no debt. It is the same risk level as a small growing company with no debt. The small growing company is gonna have a ton of potential risk because of the fact that it's small. And the fact that it's trying to find its way into taking a piece of an industry that might already be there. Just to talk about this company, in particular, I did not study it hard. I'm just looking at the kind of surface level, but they are in mobile gaming. And so I have a stock that I own electronic arts, and they have a few mobile games that they do. And the gaming industry, in general, is very, very hit or miss; it's similar to like movies and TV shows in the sense that these studios will put out hundreds of pieces of content.

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And they'll get maybe one or two blockbusters. You see that with movies, you see it with TV shows, and you see it with Netflix, you see it with games. And so, like for this company, they're not in that game; they have a platform, from what I understand, that helps serve other games. And so they're maybe more shielded from that kind of dynamic, but you still have a very boom and bust industry that has just natural cycles because of the nature of that. Plus, you have all of the drama that's going on with Apple, with their iOS and epic games. You know, know how familiar people are if they're not in tune with kind of the finance world, but that's kind of a big pushback right now is apples like the big fish and this company, epic games, they make a really popular game with kids called Fortnite.

They're in a battle against Apple because they're saying that Apple is doing these predatory kinds of practices and, and not paying them, you are basically overcharging the developers. And so if you're a small fish, just like epic games is, or just like this company here is, you know, you would hope in a fair and just world that the courts can make everything fair and free trade becomes still fair, but sometimes it's not. And sometimes, you do have predatory situations. I'm not trying to imply that that's the case that all here; I'm just saying there are additional risks when you're a small company; when you're trying to disrupt that might not necessarily be there for a bigger, more mature, more established company. And so that's why these companies, if if you're gonna buy into, 'em be prepared for a wild ride. We, we kind of talked about that several weeks ago, but you prepare cuz that's what comes with the name of the game. And that's one of the reasons I don't play.

(DAVE) Yeah, that's a big reason why I don't play. And I think those are all fantastic insights. And those are all things you have to think about when you think about why some of these companies get shorted or what causes some of this to happen. You have to think about it too. All the different characters and players that are involved in creating a market that wants to buy and sell, uh, shares of skills. When we think about a stock market, it's not just an electronics sticker, or it's just not a place that everybody congregates.

It's a collection of people that are buying and selling shares of a business. And Stevie has the intention of buying this company and holding it for a long time in the hope that the share price that he originally paid will appreciate. And he'll make money from that investment. There are other people on the other side of that trade; they may be betting that this company is gonna go down, and they're hoping to make money by having the company go down.

There are investment firms out there, and that's kind of what Gamestop. And the Reddit crowd were really going after with some of those businesses that that's how they made money, was by betting on companies or investing in companies that they thought were gonna go down for a myriad of reasons. And you still see from time to time reports that come out from those companies, talking about why they think this company should be shorted.

And in some cases, it's self-serving because they will do those kinds of things in the hope that they're big enough that they can generate enough negativity about the company that stock price will drop. And then that's how they'll make money. And I'm not saying that all of 'em do this, but there are companies out there that they absolutely will do that. And I think that's what the Reddit people were really trying to go after.

Were those people, because you could argue that that's kind of a fraudulent idea as well. So you have to always remember, though, when we're buying and selling stocks, whether it's Skills or whether it's Microsoft or whether it's PayPal or Visa, there's always somebody on the other side that's either trying to take advantage of you selling at an inopportune time, or they're trying to buy it at a better price than you bought it at.

So there's always somebody else on the other side of the trade. And so I guess we had to kind of think about those things when we were buying and selling companies. And like Andrew was saying, the shorting part of it is sometimes getting a, a dirty name or kind of a dirty connotation. But arguably, there have been definitely times in the markets where there have been short-sellers, whether it's a firm or a person, that have really kind of helped bring down companies.

So one of the companies that kind of Springs to mind is was a bio firm company a few years ago. And I'm gonna blank on the name now, Valeant. Yep. That's it. Thank you, Bill Ackerman. And some of the other people that were super big on them, there were other people on the other side of that trade that were really pointing out some of the fraudulent stuff that was going on with what Valeant was doing.

And they kind of helped bring delight to some of the fraudulent things that were happening. And in that case, that was good for investors because that helped people see that, Hey, some of the things that were going on were not above board, and we really should be investing in something like this. And there was the whole debacle with Herbalife, and I'm not; it's still going on with that.

But there were lots of people that were shorting that. And then, of course, there was the whole 2007, 2009, great financial crash with Michael Burry and all those people that were shorting the housing market, they helped, you know, I guess instigate a systemwide review of what the banks were doing and all the shadiness that was going on with the banks. And unfortunately, a lot of people got hurt in that, and that was not a great outcome in that respect. But, the other side of that is, is that hopefully, the banking and the mortgage industry kind of learned something from that. And hopefully, those kinds of things won't be repeated. But a lot of that wouldn't have been known if the people that were shorting it hadn't gone public and talked about some of those things. So there are times where shorting a company, even if it's the company we love, and we can't understand why somebody is shorting it. Sometimes there are good reasons for those things is to happen.

(ANDREW) That's a great way to kind of describe some of the background behind shorting and some of the things that go into it. Yeah. It's not a black and white thing, and it's kind of an emotional topic, so it's good to get both sides on that. He does have a follow-up on the question. He says this is an email he sent later there. If the stock is being short, that how long is that likely to last is the fact that it has been targeted as a short, a reason to sell. If I believe the company has strong, long term prospects,

(DAVE) How long it could go on forever. , uh, you know, I think the short can last for as long as you are liquid enough to handle the short, yeah. Jim Chanos, who's one of the more famous short-sellers out there. I think he was short of Tesla for quite a while before he finally decided that he had had enough. I know Michael burry tried her for a little while, and he gave up; I think it really depends on the company, the amount of money that they're willing to invest and how to think, how big a bet they're willing to take on that. I couldn't tell you in number months or years, I, I would have no idea what about you?

(ANDREW) Yeah, It's completely; I mean, we have as good of a chance letting you know about that as we would, what the stock market's gonna do two weeks from now, mm-hmm, like, there's no way to know. And so he is asking good questions about, you know, mm-hmm, how do I kind of deal with this and should he continue to hold it, even though it's sure that Yeah,

(DAVE) Right. I mean, that's the better question, and that's a tougher question to answer. Yeah. I think it really comes down to your belief in what the company's doing and what you think their long-term prospects are. And if you really believe that skills is a great company and they have a lot of great long-term prospects, I could not speak to that because I know almost nothing about gaming, and especially in mobile book gaming, I even know less. And so I couldn't give you an educated answer on whether this is a strong position or not. I could, if you asked me about Visa, if you asked me about Visa, yes. I know enough about that industry that I could give you a good answer or not. And if you tried to short Visa, you're an idiot. So, but I guess my point being is, is that that really comes back to more of your knowledge of the industry knowledge of the company.

And what you think is a long-term prospect for the company. You're gonna find; as you learn more about investing, there are some companies that are lightning rods for controversy or whatever it may be. Tesla has probably the perfect example of that. Tesla has, you know, the fans, you know, the groupies, and then there are also people on the other side of that trade that think everything about it is nuts. There are both sides to that. And it's very much a lightning rod stock. And, but you're also gonna have companies like Walmart, that's pretty generic, vanilla generate a lot of emotion, strong or negative. And so you won't see something like that, be a big controversy about a short or not, but skills because it's a small company. And because it's in, in gaming or mobile gaming, and maybe there's some negative activity in the news right now that could make it, you know, by proxy a, a little bit more, I guess, lightning rod controversial company, that people may take a flyer onto short. I think it really comes down to your knowledge and what you believe the company is gonna do. So what are your thoughts on that

(ANDREW) 100%, if you think you have that circle of competence and you really understand the business, but make sure you do understand the business. And I think a great place to go when you're researching any company really is the risk factor section of the annual report. Because a lot of times, good companies that have good disclosures, will talk about who are the big companies who are the big fish that really affect our business. So, so Skywork solution is a good example of this. They are a supplier, one of Apple's suppliers. They're not like a small company. They're 20 billion. I think last I checked, which was a while ago, but they say in there, look, apple makes up like 65% of our revenues. So we go where apple goes. So that's something you wanna know if you're buying a company like that when it comes to a company like this, they're gonna have similar things.

I mean, I was just kind of scrolling through. They say they rely on AWS for their servers. So you wanna take that into consideration. I also know that there's a lot of controversy with, you know, this popped into my head in mobile. There's a lot of controversies because people are saying that there could be regulation because it's like gambling. And so that could be a risk factor as well. So every, I think a lot of industries might have those risk factors. A lot of companies do a good job of explicitly saying them. And so if your company doesn't do that, you know, read the annual reports of their competitors, cuz somebody in there will talk about the behind, you know, governments thinking that this is that mobile games are gambling or apples struggle against epic games. Those kinds of things can make their way into the annual reports. So I would say a hundred percent does depend on how strongly you feel. And that should be the way with any investment. You know, you wanna have that conviction to say whether the market agrees with me or not. I have the confidence to know that I'm in it for the long term. And that's really the only way you'll find success. Mm-hmm

(DAVE) Yeah, I agree with that. The other thing that I think that I would encourage people to do the reading through the financial reports to look for any sort of company-specific risk is absolutely the fantastic idea would be definitely to be the first place that you'd wanna go. I would also try to look for any sort of other writings or AOSE reports about the company on the positive side and on a negative side because you can get just as much from a negative viewpoint as you can from a positive viewpoint. And sometimes the negative viewpoint may point out things that you just may not normally catch, or you may not think of, or they may have some information about something that maybe the people that are on the pro side of the company may not be mentioning because it maybe doesn't fit their narrow. And so, they do not include that in the analysis because they may be an overweight bull on the company.

Sometimes it's better to look at people that are maybe a little, maybe not quite so enthusiastic about a company because sometimes they tend to overlook the things that don't fit their narrative. And if you're looking at the whole picture, then it sometimes will give you a better overview of what may actually be going on with the company. And we'll help you pick out some possible risks that you may not have considered just by thinking about some of those other things. And that's all part of the pie of trying to analyze any company, whether it's Skillz or whether it's apple or Walmart, it all kind of falls into the same kind of idea.

(ANDREW) And I think we mentioned this before, but it should be said again if the price is really telling you something in this case wall, Street's telling us that 20% is being shorted, make sure you at least understand why there's always gonna be a reason why you don't have to agree with it, but you need to understand why like if this stock is so, or, you know, another stock is so ridiculously cheap, why is it cheap? You should know why it is and then why you disagree with that? Mm-hmm, just to say, oh, this is such a great deal. And everybody's an idiot. I don't think that that's not gonna serve you very well. You gotta know why things are a certain way. And then you can make a smart decision after that. It's not to say that that price is right, but you really wanna know why.

(DAVE) Yeah. I agree that that's perfect. Cool. Okay. Anything else you would like to add, sir? Nope. Okay. All right. I'll go ahead and wrap in all right, folks. Well, with that, we are gonna wrap up our discussion for this evening. I wanted to thank Stevie for taking the time to write us that great question all the way from Scotland. That was fantastic. And that was a great conversation. So hopefully, you guys learned a thing or two from that, and hopefully, you were able to learn a little more about shorting and some of the ins and outs of that. So without any further due, I'm gonna go ahead and sign us off. You guys go out there and invest with a margin of safety emphasis on the safety. Have a great week. We'll talk to you next week.

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