

NOVEMBER 2025

Porter's Guide To Shorting A Stock

Strategies, Mechanics, And Risks.... For Those Who Want To Play



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We rarely recommend shorting stocks because, over the long run, it's a sucker's game... But, as you'll see in this report, in the right environment, a well-placed short can be a lucrative play for your portfolio.

When shorting a stock, your hope is that the price of the stock goes down. And the best possible outcome from shorting is a 100% return if the stock goes to zero. The worst possible outcome, though, is losing more than the value of your original investment. There's no limit to how high a stock can go in the other direction from a short (that is, up) – and thus, no limit on the potential losses from going against it.

The risk/reward proposition is lopsided... For most people – forever-stock, buy-and-hold players – shorting is not the way to go. Set-and-forget is a great way to invest. And if that's you, we suggest not reading any further.

So, in general, why even play this game?

Because, even though this strategy doesn't pay off on average, in a bear market, the odds improve, and the profits from short exposure can be considerable. That's because of what's known as crisis alpha, or the ability to generate profits when everything else in a portfolio is falling in value. Those profits can then be redeployed into long positions at deeply discounted prices, setting the stage for massive long-term wealth creation.

In 2008 – in the midst of the worst bear market for U.S. stocks in decades – Porter made seven short recommendations that returned an average of 25%. His long recommendations fell in value, along with everything else during 2008. But the profits from shorts offset those losses. The end result was an average loss of 1.4% versus a 37% loss in the S&P 500. That's exactly what you want your shorts to do.

In a report he published on May 31, 2008, titled "Freddie Mac And Fannie Are Going To Zero," Porter recommended selling short the stocks of these two companies, which were the foundation of America's mortgage market. The short sales generated returns of 60% on Freddie Mac and 64% on Fannie Mae that year.

The real value of shorting stocks is not as an outright money-making endeavor, but as a tool for limiting losses, reducing portfolio volatility, and preserving capital during a bear market.

As we've written about extensively in the *Daily Journal* and to some degree in *The Big Secret On Wall Street*, the economy and financial markets are approaching a tipping point. With stocks trading near all-time high valuations, earnings momentum stalling, and cracks forming in the economy, this market is becoming increasingly less attractive for new investments.

For readers who aren't familiar with shorting shares, the process is very similar to buying shares, except the orders are reversed: you sell to open the trade, and then buy to close.

Let's jump into the process.

The Mechanics Of Short Selling

Short selling is essentially the inverse of traditional investing. Instead of buying low and selling high, you're selling high and buying low. When you short a stock, you are borrowing shares of a company from your broker and immediately selling them on the open market. The hope is that the stock price will decline. If it does, you then buy back the same number of shares at the lower price and return them to your broker, profiting from the difference between your initial selling price and the lower buying price.

Let's break down the instructions you'd give your broker. When you decide to short a stock, the first step is to ensure you have the appropriate trading permissions from your brokerage provider. This typically involves having the option to make short sales and often requires margin borrowing capabilities, as you are essentially borrowing shares.

Once these permissions are in place, most brokerage platforms will have a straightforward process not all that different from buying or selling a standard "long" position.

For example, suppose you believe shares of Tesla (TSLA) – trading for \$455 at the time of this writing – are poised to fall.

You would begin by inputting the company's ticker symbol into your broker's trading platform just as you would for a normal buy or sell order. However, instead of selecting "buy" or "sell," you'll look for an option to "sell short" or "sell to open," depending on your broker.

You'll then input the number of shares you'd like to short – in this case, we'll assume you've decided to short 10 shares, valued at approximately \$4,550 – and complete the trade. Your account will now show a credit of \$4,550 (minus any fees).

When the time comes to exit the trade – ideally at a profit – you'll repeat that process. Only this time, you'll choose "buy to cover" or "buy to close," depending on your broker.

For this example, we'll assume you were correct and Tesla shares are now trading for \$355, \$100 lower than they were when you opened your short position. When you place your trade to "buy to cover" 10 shares of TSLA, your account will be debited \$3,550 and those borrowed shares will be returned to your broker.

Once complete, your profit on the trade will be \$1,000 – the difference between the \$4,550 you received when opening the trade and the \$3,550 you paid to close it – minus any fees and interest expense your broker charges you.

The Risks Involved

While the potential for profit in a declining market is appealing, short selling comes with significant risks that investors must understand.

Unlimited Loss Potential This is perhaps the most critical risk. When you buy a stock, the most you can lose is your initial investment if the stock goes to zero. However, when you short a stock, there's no theoretical limit to how high the stock price can climb. If a stock you short at \$100 goes to \$200, you've lost \$100 per share. If it goes to \$1,000, your losses are \$900 per share. This asymmetry in risk-reward is a major deterrent for many investors. We suggest using a stop loss to limit the potential downside.

Margin Calls Since shorting involves borrowing, it's typically done on margin, which means borrowing the money to make the trade. If the stock price rises significantly, your broker may issue a "margin call," requiring you to deposit additional funds into your account to cover potential losses. If you can't meet the margin call, your broker can close your position, potentially at a substantial loss, even if you believe the stock will eventually fall.

Borrowing Costs And Fees Shorting isn't free. You pay a fee to the owner of the shares you borrow, known as the "borrow rate" or "hard to borrow fee." This rate can vary significantly depending on the demand for shorting the particular stock. If the company pays a dividend while you have a short position open, you are also responsible for paying that dividend to the original share owner. Additionally, transaction fees for both selling short and buying to cover can add up, eroding potential profits.

Short Squeezes A short squeeze occurs when a stock's price rapidly increases, forcing short sellers to buy back shares to limit their losses. This buying activity further pushes up the price, creating a domino effect that can lead to massive losses for short sellers. Short squeezes can be triggered by positive news, an unexpected earnings report, or even coordinated buying by retail investors. *One way to minimize this risk is to avoid shorting stocks with high short interest above 20% of the outstanding float.*

Timing The Market Successfully shorting a stock requires impeccable timing. You not only need to be right about the direction of the stock, but also the timing of its decline. A company might be fundamentally overvalued, but it could remain that way or even climb higher for an extended period, leading to mounting borrowing costs and the risk of a short squeeze before your thesis plays out.

How Often Is Short-Selling Successful?

Generally, short selling is considered a challenging and often unsuccessful strategy for the average investor over the long term. Stocks tend to rise over time – shorting is the financial equivalent of swimming against the tide. Winning is generally a long shot.

Historical data consistently shows that the broader stock market tends to trend upward over time. This makes long-term short positions inherently risky. While individual short sellers can achieve significant profits, these successes are often exceptions rather than the norm.

However, the success rate for short selling can improve in specific market conditions, particularly during a bear market or economic downturn. In these periods, the general sentiment shifts, and more stocks are likely to experience declines. As noted earlier, the concept of *crisis alpha* comes into play, where profits from short positions can offset losses in a broader portfolio during times of market stress.

For instance, the examples of Porter's recommendations during the 2008 financial crisis demonstrate that well-timed and well-researched short positions can be highly profitable in severe bear markets. However, even in such conditions, the risks remain high, and identifying truly vulnerable companies requires extensive due diligence.

Professional hedge funds and institutional investors often employ sophisticated short-selling strategies, but even they face considerable challenges. Their success often stems from deep research, proprietary data, and the ability to withstand significant drawdowns.

For the individual investor, short selling should generally be approached with extreme caution and only as a small part of a well-diversified portfolio, if at all. It's often best utilized not as an outright money-making endeavor, but as a hedging tool to limit losses, reduce portfolio volatility, and preserve capital during periods of market decline, as emphasized in this report. The ability to redeploy those profits into long positions at discounted prices after a market correction is where the true strategic value of short selling lies for long-term wealth creation.

Categories Of Stocks Worthy Of Shorting

So while it's best to avoid this practice, there are opportunities when the odds are in your favor.

Even though this strategy doesn't pay off on average, in a bear market, the odds improve, and the profits from short exposure can be considerable. Plus, there are a few categories of stocks that we have identified that greatly increase the odds of a short position working out in your favor.

We look at five of those categories below.

1. The Zombies

Zombie is a name given to companies that are so burdened by debt that their core operations can no longer sustain themselves. Their survival depends on scrambling to make debt and interest payments. They are constantly refinancing, issuing new equity, or toying with accounting maneuvers to disguise structural weakness.

The number of zombie companies in the Russell 3000 index surged to 639 in October 2025, a 15% one-month surge and the highest level since 2022. Many of these businesses refinanced or extended debt maturities at near-zero rates during the post-pandemic years, but are now being crushed by higher funding costs, tighter liquidity, and the added pressure of tariffs.

At some point, this condition becomes fatal. Rising rates, shrinking liquidity, or even a mild economic downturn can push these firms into bankruptcy as interest obligations outpace cash generation. Once the ability to refinance disappears, solvency collapses. Zombie companies thus represent the late stage of a credit cycle – entities that are financially dead but kept alive by market momentum and misplaced optimism.

They exhibit a consistent set of financial warning signs:

- **Interest coverage ratios fall below 1x**, meaning operating income cannot cover interest expenses
- **Free cash flow remains negative** even during revenue growth, indicating structural unprofitability
- Debt loads rise despite stagnant or declining earnings, often driving **debt-to-EBITDA ratios above 5x**
- **Margins stay compressed**, working capital erodes, and return on invested capital lags well below the cost of capital.

These firms fund operations through dilution or short-term borrowings rather than internally generated cash – leaving them acutely vulnerable as credit conditions tighten and capital markets lose patience.

2. Bubble Stocks

Bubble stocks are businesses that have been inflated to such ludicrous prices that it's virtually impossible to justify their valuations – even if everything works in their favor. We focus on stocks with deeply flawed business models, no history of earnings, and no foreseeable path to profitability. We also look for stocks with heavy insider selling, indicating that even management views their stock as overpriced.

Finally, the key to making a move against a bubble stock is waiting until after the momentum dies – that is, after a stock has already dropped by 30% to 40%. We never want to short these stocks while they're making new highs, because there's no telling how far the bubble will inflate. We're looking to catch the rest of the ride down after the bubble has popped, rather than fighting it on the way up. So we set a stop loss at the previous all-time high to limit our risk.

3. Obsolescent Stocks

Obsolete stocks are companies whose products, services, or operating models have been permanently displaced – either by technological innovation or by irreversible shifts in consumer behavior. Their best days are behind them, and no amount of cost-cutting, rebranding, or digital transformation can restore growth. These are the corporate equivalents of extinct species: once dominant, now surviving only through inertia, regulatory shelter, or misplaced investor nostalgia.

Investors often mistake these companies for value plays, seduced by low P/E ratios and steady dividends. In reality, they are melting ice cubes – businesses earning declining returns on shrinking markets. When their revenue base erodes faster than costs can adjust, leverage magnifies the pain. The right time to short them is typically after the strategic failure is evident, but before the market fully prices in the terminal decline. Unlike bubble stocks that can implode overnight, obsolescence tends to unfold gradually – death by a thousand quarterly disappointments.

Obsolete firms often display a consistent financial pattern of negative revenue growth over multi-year periods, compressing gross margins, and declining returns on invested capital ("ROIC"). Capital expenditures tend to shrink as management stops investing for growth, instead preferring to preserve cash or sustain dividends. Asset write-downs, restructuring charges, and goodwill impairments may become recurring line items. Cash flow may remain temporarily positive, but it comes from liquidation, not creation.

4. Credit Cycle Victims

These are companies vulnerable to the growing risks of a credit-market melt-down. Starting in Q3 of 2025, we've seen the early signs of contagion spreading in the credit markets. This includes a series of high-profile bankruptcies from companies financed in the private credit markets – the epicenter of the most aggressive, high-risk lending over the past decade. Notable examples include subprime auto lender TriColor, auto parts manufacturer First Brands, and telecom firms Broadband Telecom and Bridgevoice.

As with every credit crisis, these early blow ups have started on the fringes – businesses with questionable accounting and financing practices, including strong evidence of potential fraud. But when these problems begin surfacing after a long period of credit expansion, as we've experienced in recent years, they rarely stop with just one or a handful of fringe players. As Jamie Dimon, the CEO of America's largest and most important bank, JPMorgan Chase, explained on the company's Q3 earnings call:

“My antenna goes up when things like that [TriColor bankruptcy] happen. I probably shouldn't say this but when you see one cockroach, there are probably more... everyone should be forewarned on this one.”

As the fringe players begin going bust, it creates ripple effects throughout the financial system. Lenders begin pulling back on extending more loans, or demanding more stringent terms, causing credit to tighten. This tightening credit then pushes more vulnerable companies over the brink, leading to further credit tightening, and so on in a self-reinforcing spiral.

We believe this process has only just gotten started. And we're looking for companies at the epicenter of the coming credit cycle bust. Our criteria is simple: we want to focus on the fastest-growing, most reckless lenders. Businesses that have made a lot of loans to subprime consumers, with rock bottom FICO scores below 600. And lenders with significant exposure to loans already experiencing alarming rates of default and delinquency. This includes student loans, credit card debt, and subprime auto loans.

5. Financial Bandits

Potentially fraudulent companies – businesses whose reported results don't necessarily follow generally accepted accounting principles – sit at the extreme end of risk. Unlike overleveraged or weak firms, these financial bandits depend on deliberate misrepresentation to boost their numbers for shareholders and lenders. Management inflates earnings, fabricates growth, or hides liabilities to sustain overextended valuations and access to capital. They thrive in euphoric markets where investors prioritize narratives over numbers, surviving only as long as confidence holds.

Frauds often emerge in late-cycle environments marked by abundant liquidity and relaxed scrutiny. As credit tightens and oversight increases, inconsistencies surface – inflated financial metrics, questionable governance, and conflicts of interest. What once appeared as innovation

unravels into aggressive accounting, undisclosed related-party dealings, or fabricated sales (i.e., lender backed financing). When credibility breaks, the collapse is swift and these stocks typically fall as the legal and regulatory pressure mounts.

Financially, potential frauds share distinct red flags. Operating cash flow diverges sharply from reported earnings, suggesting accrual manipulation. Receivables and inventories outpace revenue growth, indicating poor sales quality. Margin expands without cash conversion, frequent auditor or executive turnover, and opaque related-party transactions are further warning signs. Sudden equity raises and insider selling often accompany the downfall.

Frauds are rare but catastrophic. They flourish when optimism eclipses fundamentals – and die instantly when trust evaporates. Spotting them early requires skepticism, forensic accounting, and the discipline to question what seems too good to be true.



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P.S. If you'd like to learn more about the Porter & Co. team, you can get acquainted with us [here](#). You can follow me (Porter) on **X** here: [@porterstansb](#)

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