Ready for a Long-Term Short Play? Consider Home Capital Group Inc.

Description

What is a short?

Holding short positions can be scary, and many investors avoid shorting stocks like the plague. With short positions, an investor must borrow the stock they wish to bet against, sell the stock, wait for the price of the stock to drop, buy the stock back from the market, and replace the initial stock borrowed.

This complex set of transactions is made much simpler by brokerage firms that supply the service for a fee. Short positions are typically short-term bets that a stock will underperform for a given time, and investors typically “cover” their short positions within days or weeks, depending on how far investors believe the stock can or will drop. These bets are usually made with “stops” which automatically result in a cover should the price of the stock rise above a certain level, as the downside risk for short positions is unlimited.

If the stock goes up in perpetuity, the short position must be covered at an ever-higher price, which can eventually bankrupt an investor if the short is held too long. This is what makes holding a short for a longer period of time a riskier, but potentially more lucrative, proposal should the stock eventually fall as per the investor’s initial inclinations.

Market perception of Home Capital Group

As of the end of December 2016, **Home Capital Group Inc.** (TSX:HCG) had over 30% of the stock’s float sold short due to a few high-profile U.S. investors who picked this stock out of the Canadian pile as one of the largest non-prime lenders in Canada. The argument made was that the Canadian housing market now resembles that of the U.S. housing market pre-crash, and Home Capital Group stands out among the crowd as the company with the largest exposure to loans that will potentially go bad first.

Currently, the number of HCG shares sold short sits at 2.41 million with a float of just over 59 million shares, meaning the short percentage is sitting around 4% — a far cry from 30%. The market perception of HCG thus appears to have shifted dramatically over the course of a few weeks.

Home Capital Group’s stock has remained relatively flat, and the crash that has been predicted has not come yet. Here’s where patience can pay off.

The reality

Home Capital Group provides a high percentage of its loans to borrowers who are unable to get bridge financing, second mortgages, or other forms of higher-risk financing from traditional Canadian banks. This company's clients will often be borrowers with sub-par credit or those looking for secondary or tertiary loans, using property with equity percentages that would be considered inadequate by traditional lenders.

In the movie, *The Big Short,* a number of unicorn investors, who took big short positions against the U.S. housing market, some as early as 2005, were showcased and made into heroes. The reality is, up until 2007, when loans started going bad, these investors were ridiculed by the market, and many nearly gave up hope.

The persistence shown by some of these investors in holding their short positions for years, in some cases, is remarkable. When the Canadian housing bubble does burst, the big payouts will go to those investors who are willing to hold short positions for a long time.

With a short percentage at 4%, right now may be a decent entry point for initiating a short position.

Disclaimer: lots of guts are needed to make a play like this — guts I don't personally have.

Stay Foolish, my friends.

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Date
2025/09/17
Date Created
2017/01/27
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