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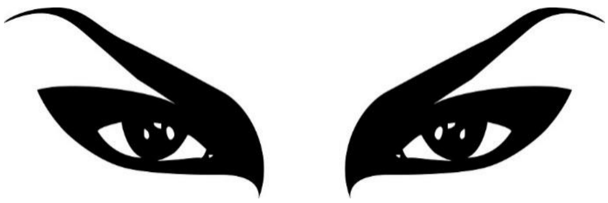
INVESTMENT PARTNERS

The Seduction of Long / Short Funds



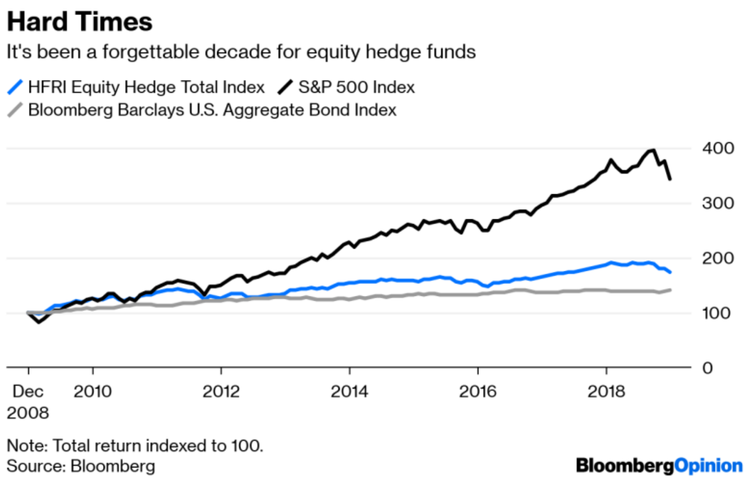
The marketing brochures continue to tell us that the main advantage of adopting a long/short equity strategy is the versatility that it provides to a portfolio to make money in both rising and falling markets.

This versatility allows a long/short fund to separate bets on perceived pricing irregularities that might provide benefits over the long-term. The beauty of these vehicles is that there is no standard investment allocation with funds usually changing direction based on diverging trends in sectors or geographical markets.

Irrespective of whether a long/short Manager adopts a net short position, a net long position or a market "neutral" exposure the concept remains to provide a type of portfolio insurance to protect the portfolio when markets become irrational.

While there are examples of mangers getting this right, the facts point to it being lot harder than one would think. At Heathcote we are increasingly approached by *you-beaut* investment ideas that appear useful in theory albeit invariably fail when put to the test. Often these concepts are supported by 'what-if' proxy data, that has enjoyed the delights of the longest bull market run in history. In other words, they have never really been tested… that is until October 2018. For all of the postulating by the industry-investment-scientists around the cake-and-eat-it benefits provided by long / short funds, the reality is that the large majority simply have failed to deliver – both over the longer term, and (more significantly) since October last year when they were tested.

So why such an enormous gap between the performance of the share market (as represented by the index) and highly-paid stock traders?



From our observations there are three fundamental things that long/short funds should be able to do, but clearly battle to do:

1. Manage risk

This is the decision to go big versus stay at home. This was put to the test in September 2018, when we asked a number of long/short fund experts when they were aiming to get set in a widely-acknowledged over-priced market. All unanimously declared that, although the market was richly priced, the business risk of missing the rally outweighed the portfolio costs of setting up shorts. In an industry that insists on monthly reporting and tighter risk limits, portfolio safety has become counterproductive – when Managers are focussed on building something of "institutional quality" at the expense of portfolio nimbleness.

With hindsight it is clear that the biggest risk to portfolios in September 2018 was having too little market exposure. The challenge for those long/short Managers who failed to get set prior to the market drawdown, was that the expense of selling shorts soon became prohibitive in the latter part of 2018 (which arguably is still the case today). The net effect was that the long/short Manager ended up being a long-only Manager.

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2. Short stocks on a systematic basis

The actual process of setting up a short position is – in practice – not an easy one. There is no inherent return, and over the long term the position is betting against the market with unlimited downside. For the long-short process to work, long/short Managers must constantly have short positions in place, and to do that well is hard to the point of impossibility for most – both from an operational and a cultural perspective. To make life a bit easier, there is a temptation to use low-beta stocks for shorts as the lack of volatility makes such positions cheaper. Unfortunately low beta stocks have also proved to be good performers over the past decade.

3. Friction is a killer

The reality is that trading commissions and little losses soon add up. For the early adopters (ie: those who got their shorts set before October 2018) their reputations were made, so friction was not a problem.

Scale up to thousands of long/short funds and more than a trillion dollars in capital at work, however, and the friction is noticeable, ensuring that prime brokers are well rewarded during these times.

After literally years of monitoring a large variety of long/short Managers we have arrived at the conclusion that shorting stocks produces a binary outcome (eg: win big / lose big), is tough to implement, requires unique skills that are typically not possessed by long-only Managers and very rarely works. Theory just does not match reality.

As Figure 1 supplied by FE Analytics demonstrates, the premium paid for 2 popular long/short global equities Managers (K, A) failed to outperform both the S&P500 Index or two popular long-only Managers (T, C) during recent times of market volatility.

Locally in Figure 2 (and over a longer time frame to demonstrate how shorting can repeatedly go wrong), a domestic long/short Manager (S) has failed to keep pace with the ASX100, with the two long-only Managers (C, H) delivering a much better outcome for investors. Note that Manager C adopted a long-cash approach to investing, with circa 40% of their fund held back in cash during this time.

Globally frustrated investors have continued to pull money from long/short strategies, to the tune of -$5.93 billion in January 2019. This was the largest redemption among primary hedge fund strategies and is on top of the -$10.74 billion investors pulled from long/short equity funds during 2018.

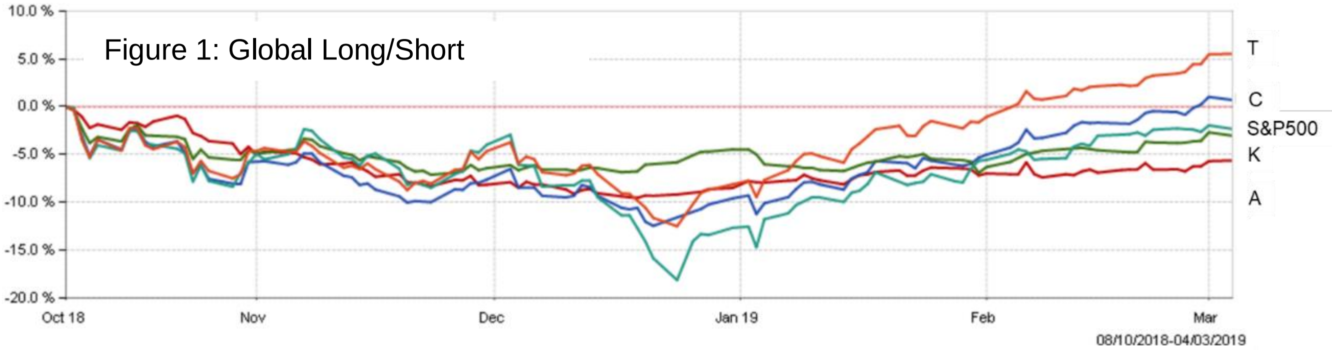

Figure 1: Global Long/Short

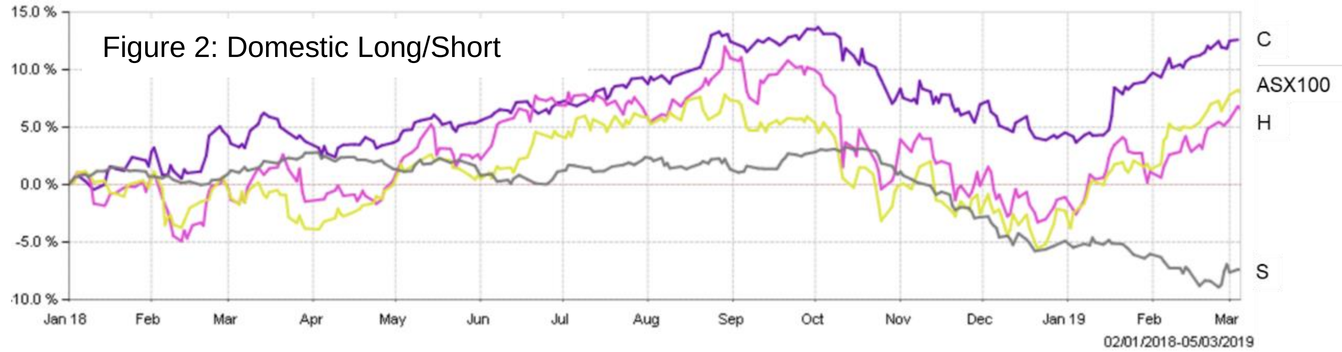

Figure 2: Domestic Long/Short

Most other primary strategies, including Managed Futures, Macro, Relative Value Credit and Event Driven funds, also saw investor outflows, although these outflows were small by comparison.

The solutions available include:

1. Asset Allocation:

Advisers can become more active in both Strategic and Tactical Asset Allocation of client portfolios, utilising long-only funds managers to capture specific exposures. This self-drive model involves disseminating a wide range of macro information to ensure that the portfolios are best positioned to achieve the required outcomes. Alternatively, advisers can appoint an internal / external investment specialist to periodically contribute to their overall investment committee reviews.

A third (and less enthusiastic aspect) is for advisers to effectively outsource a portion / all their active client portfolios to an active multi-manager strategy which best reflects their portfolio aspirations. A partial allocation to a multi-manager capability can be used as a core position, with various tilts around the periphery to represent the bespoke nature of the client's portfolio.

2. Outsource the lot

I've spoken about this option on numerous occasions and will address this briefly (as many of you have heard my soapbox previously). In short; as portfolio returns normalise and look more like single figures, then the various costs will increasingly be challenged by investors. In a country – such as New Zealand – with limited tax or superannuation complexity, the set-and-forget or outsourcing approach to portfolio construction will be a tough one to charge for. Under these circumstances, investors will be increasingly reluctant to pay simply for the privilege of being your client.

3. Absolute Returns

Of course, investment nirvana is to receive an absolute return on investments all the time. Investors are consistently seeking higher returns with limited / no risk. This is where absolute return capabilities have become especially alluring, with promises of all the gains and no losses (much like the packaging of long / short funds). The reality is that most absolute return funds either fail to achieve expectations or minimise risk to the point of providing negligible investor returns.

The most successful absolute return strategy that we've noticed is when Managers can't find anywhere to invest, then they simply leave the money in the bank – aka a long / cash capability.

4. Measure, monitor, manipulate

Throughout our travels we often ask advisers how they construct their portfolios or determine the underlying investments. Often its on the back of attending a slick presentation, reviewing some proxy data, or (…and I've heard this…) looking to support a capability who have supported their dealer group / conference etc.

Our preference is to sit on the side lines for a minimum of 18 months, and to test how the investment capability works in differing environments. We also seek attribution analysis to illustrate how the Manager has managed to add value through converting risk into returns. Ultimately, we utilise a tool such as FE Analytics to measure, monitor and manipulate performance data to ensure that we have a sound understanding of the performance attributes before we look the Manager in the eyes. Either way, we rely on our own data rather than any of the flash pitchbooks or evidence provided by Managers.

As we head into the frothy investment markets of mixed sentiments and conflicted opinions it is critical – now more than ever – that advisers become increasingly sceptical and pragmatic about their choices, and avoid the seduction of a good story well told.

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