WestAM

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Australian Equity Long/Short (Part 1)

Originally the domain of hedge funds, long/short investing is increasingly moving into the mainstream as institutional managers offer such products. This is a positive development for several reasons:

- These institutional products are typically better regulated and better structured;
- Direct investment with the manager avoids the cascading fees common in a fund of hedge funds;
- The underlying investment process and portfolio tend to be more transparent.

Long/short investing is attractive because it is an effective way of amplifying active return.

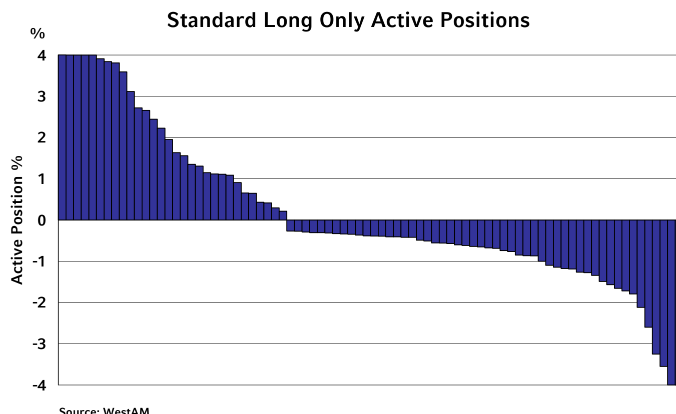
- Aggressive conventional equity management has in the past yielded mixed results.
- Amplifying the risk of conventional long only management worsens the reward to risk ratio, also known as the information ratio.
- Long/short investing maintains the information ratio at the healthy levels common with low active risk investment.

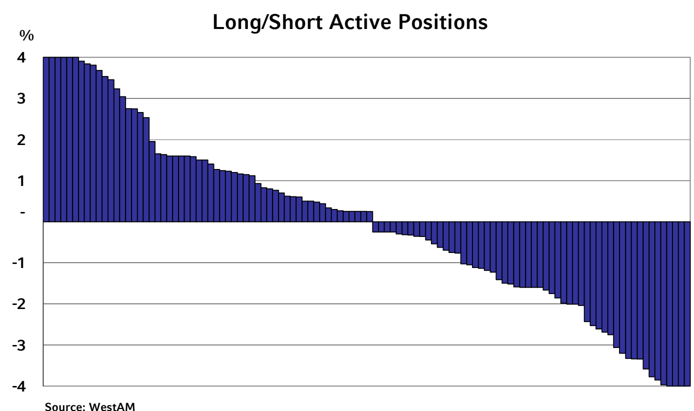
Why it works

When managing a conventional portfolio, an active manager will hold a portfolio with above benchmark positions in attractive stocks and below benchmark positions in unattractive stocks. The total of underweight positions must equal the total of overweight positions. In practice the maximum extent to which a manager can underweight a stock is simply not to hold it. Hence, underweight positions are capped at the stock's benchmark weight.

For example if Qantas is 1% of the S&P/ASX 200 index, a manager can normally only be 1% underweight Qantas by not holding it at all. If a manager avoids four stocks with an index weighting of 1%, this creates the opportunity to be overweight a single favoured stock by 4%.

The profile of active positions in a conventional portfolio consists of a large number of smaller underweight positions, which support a small number of larger overweight positions. This is inevitably lop-sided, and as a portfolio is run more aggressively, the profile of positions becomes more unbalanced. The restriction of holding either a zero or positive weight in a stock also constrains the overall level of activity in the portfolio, which can be measured as the sum of the absolute values of active positions. The chart on the left represents the conventional profile.





Where a manager is able to hold a negative weighting in a stock, the profile of active positions can be much better balanced and the overall level of activity can be expanded, as represented in the right-hand chart. For the same limit on individual active position (+/- 4% in this illustration), the level of activity can be increased by 70%-100%. (A manager holds a negative weighting in a stock by borrowing that stock from a stock lender and then selling the stock.)

Long/short investing carries higher costs than long only investing arising from higher turnover and stock borrowing costs.

- Net of these costs, WestAM estimate that the information ratio for long/short investing is around 15% higher than for conventional active management. Normally the information ratio declines when portfolio risk is increased.
- The return of long/short investing is therefore buoyed by both taking more risk and by achieving a better payoff for that risk.

There are potential hidden costs with long/short investing.

- Performance fees are typical but they may not have a threshold to cover expenses. Investors may find themselves paying a performance fee before all the costs of the investment have been covered.
- The brokerage rate paid by the manager can sometimes be quite high. The higher turnover of long/short magnifies high brokerage costs

Is it a good idea to amplify active risk in Australian equities?

A cursory inspection of performance surveys would suggest that amplifying active risk in Australian equities is a good idea because active Australian equity managers tend to do well.

- For the five years to December 2002, the InTech survey shows a median outperformance of 2.0%pa, and a median information ratio of 0.5[1].
- The logical choice for long/short management is a manager with a high information ratio and a process that can select unattractive stocks as easily as it picks attractive ones. This may not be straightforward.
- The information ratio of investment managers is very dependent on the value/growth cycle. With long/short investing, selecting a manager with a significant style bias can lead to unfortunate outcomes if the manager's style is out of favour.
- Information ratios over an extended period can abstract from the value/growth cycle. Based on van Eyk Research style classifications, style neutral managers as a group have had higher information ratios than value, growth or GARP styles over the past five years.
- Investors should look for a great deal of comfort with a manager's underlying reward to risk from conventional long management, before accepting an amplification of that active risk through long/short.

Equitised or market neutral?

Long/short investing can have the market exposure neutralised or it may carry the same market exposure as a conventional long portfolio. These two alternatives are addressed in our next newsletter.

[1] However the data are not without problems. For the five years previous, the median outperformance was 0.7%pa, and the median information ratio was only 0.2. Frontier Investment Consulting has estimated the substantial impact of survey distortions such as inclusion and survivorship bias, which significantly qualify these observations (Frontier Line Oct/Nov 2001 'Australian Equities Managers – Just How Good Are They').

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