

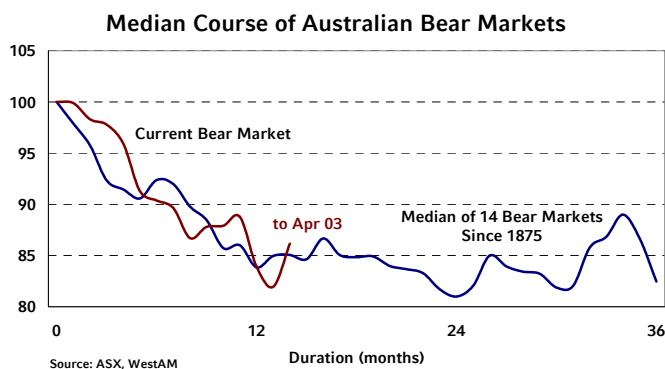
Australian Equity Long/Short (Part 2)

In our previous newsletter we introduced the concept of long/short investment and considered the underlying performance advantages. Long/short investing funds may be either equitised, carrying an exposure to the market, or market neutral, performing independently of the market. Market neutral long/short is also referred to as absolute return investing. In this newsletter we look at the different roles of equitised and market neutral investing.

Substituting market neutral long/short for equity market allocation

The recent interest in market neutral or absolute return investing is very much influenced by recent bear market sensitivity. For some institutions, including insurance companies, the bear market has highlighted a dangerous mismatch in asset and liability profiles and market neutral investing could be a valid substitute for equity market exposure in those cases. The expected return in excess of the risk free rate should be comparable to the equity risk premium, and the volatility of return for market neutral will generally be significantly less than for equity markets. At moderate risk levels it is closer to a defensive asset than a growth asset in volatility.

The growth/defensive mix of superannuation funds has drifted from 60/40 to 70/30 and beyond over recent decades, and the wisdom of that drift is open to question with the benefit of hindsight. Market neutral long/short lessens the performance drag of the defensive allocation and may support a more traditional mix. However, there is a timing dimension to any change in asset allocation.



Australian Bear Markets 1875-2003

Price Declines (Median duration 16 months)

Hi-Lo	Decline %	Hi-Lo	Decline %
9/1875- 1/76	-29	9/60-12/60	-19
11/'88- 3 /'94	-36	7/64-9/65	-18
6/14-12/16	-22	1/70-10-74	-55
4/20-2/21	-15	11/80-7/82	-37
2/29-8/31	-46	9/87-2/88	-45
3/37-3/42	-32	2/94-2/95	-17
5/51-12/52	-34	2/02-?	-18 (to Mar)

Source: ASX, WestAM

The chart and table above compare the fall in the local market since Feb. 2002 to the median course of Australian bear markets since 1875¹. So far this bear market has been in line with previous Australian bear markets. Most of the price decline historically has tended to occur in the first twelve months. Long-term investors who change policy asset allocation away from market exposure at this point need to acknowledge opportunity risk. Over the 23 years of history of the current S&P/ASX All Ordinaries Accumulation Index the Australian market has returned 12.5%pa, but excluding the best twelve individual months, that average return falls to 6.4%pa. Miss the best 24 months (<9% of the period), and the average return falls to 2.0%.

¹ A bear market is defined here as a price decline of 15% or more, from high to low regardless of duration. The historical indices used are the Commercial and Industrial Index 1875-1936, the Sydney All Ordinaries Index 1936-1979, and the ASX All Ordinaries Index since 1980. Measurement is based on monthly average index levels for historical consistency. Prior to 1936 the history excludes financial stocks, then published in a separate index, which underperformed industrial stocks in that era. Inflation increases the severity of the 51/52 and 80/82 bear markets in real terms while deflation softens the 29/31 bear market.

Substituting market neutral long/short for defensive assets

A sound case for market neutral long/short is as an alternative defensive asset to fixed interest. Market neutral long/short strategies have risk levels not much higher than bond indices, and active fixed interest management has not been able to improve much on what is a fairly narrow asset class risk premium, with the current yield curve slope only around 0.3%. There are two important considerations:

- fixed interest investments are a latent deflation hedge, as they will appreciate if bond yields fall further, but the same benefit is not available to market neutral long/short strategies.
- market neutral strategies are immune from the negative impact of any upward shift in global interest rates which might accompany an eventual global economic recovery².

An allocation of half of the Australian bond component of the typical diversified portfolio would marginally reduce overall portfolio volatility because of improved diversification and improve return by around 0.25%³.

Substituting equitised long/short for conventional equity allocation

The greater efficiency of long short investing, explained in our earlier Newsletter, translates to an improvement in reward to risk ratio of around 10%-15% for active management, and a natural extension of active risk. The table below shows how the return and risk estimates for equitised long/short compare to those for comparable conventional active management, based on some illustrative assumptions about market risk and return, and assuming competitive active management around the middle of the second quartile:

	Conventional Equity Management			Equitised Long/Short		
	Market %	Active %	Total %	Market %	Active %	Total %
Gross Return	10.0	2.7	12.7	10.0	6.0	16.0
Fees	0.0	0.5	0.5	0.0	1.7	1.7
Net Return	10.0	2.2	12.2	10.0	4.3	14.3
Volatility	15.0	3.0	15.3	15.0	6.0	16.2
Information Ratio (Gross)		0.9			1.0	

NB: Variations in fee structures, risk levels and quality of active management will affect comparison.

The impact on overall volatility is small, increasing from 15.3% to 16.2%, because active risk is independent of and swamped by market risk. However the return improvement after fees is significant, from 12.2% to 14.3%. Where the equitised long/short manager replaces a conventional manager in a three-way configuration for example, the volatility increase of the composite would be negligible, but the return improvement still meaningful⁴.

² While bond yields are very low compared to the last few decades, it is important to acknowledge that current levels are less remarkable compared to the last century overall, and the behavior of bond markets is such that low yields tend to be quite stable.

³ The return pickup is $(1/2) * 13.7% * (4.3% - 0.3%) = 0.27%$ based on 13.7% current average weighting in domestic fixed.

⁴ Where a three manager mix of independent tracking errors of 3/3/3% is substituted by 3/3/6%, volatility goes from 15.1% to 15.2%, composite tracking error goes from 1.7% to 2.4%, and return goes from 12.2% to 12.9%.

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