

Long/Short Equity Investing Part I – Styles, Strategies, and Implementation Considerations

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This is Part I of a two part series. In Part I we focus on defining the various types of investment styles and strategies of long/short equity managers, as well as explore their portfolio construction characteristics and techniques. In Part II we will review implementation considerations when constructing a diversified portfolio of multiple long/short equity managers.

{ Overview }

Long/short equity is the oldest hedge fund investment strategy in existence, dating back to 1949 when Alfred Winslow Jones created the first fund. His goal was twofold: 1) to control market risk by introducing short sales to a portfolio of long equity positions, and 2) to achieve attractive performance through strong security selection on both the long and short side—with the intended result being a portfolio that had lower than market risk that performed well in both upward and downward trending markets.

Today, we see that Jones' pioneering long/short strategy continues to dominate the hedge fund landscape both in terms of number of managers as well as assets under management. This space has broadened over time to encompass a variety of styles and strategies designed to mitigate market risk as well as capture pricing anomalies, exploit market inefficiencies and/or create value through event-oriented investments.

This paper will review the broad spectrum of approaches to long/short equity and highlight their main differentiators based upon:

- **Style** – generally, technical trading versus fundamental stock selection
- **Portfolio Construction** – position sizing, risk controls and sell disciplines
- **Strategy** – market exposure and risk/return objective

Part II of this series will focus on pairing considerations when constructing a diversified portfolio of long/short equity managers.

{ Style Classification – Traders vs. Investors }

Prior to making an investment decision, it is valuable for investors to know the investing style of a manager in order to better understand their portfolio construction process and to help identify their strategy classification (both of which are described in detail below). There are a variety of styles in the long/short equity space but we classify them under two broad headings: Traders and Investors. The primary differences between the two are the length of time they intend to hold a position (both long and short positions) and, in general, how they make investment decisions.

- **Traders** – Traders focus on short term price movements when evaluating long and short opportunities. A typical holding period may be as short as an hour or a day and is generally held no longer than six months. When it comes to making investment decisions, Traders will generally rely on technical market factors. Technical factors relate to market, industry and/or company specific trends, such as momentum, resistance and support levels, past price movements, trading volume or changes in price driven by non-company related general macro events.
- **Investors** – Investors generally hold long positions for a year or more, with the expectation that a company's stock will be fairly priced over the long-term. Valuation is the key determinant for Investors when assessing both long and short positions. Investors may also rely on the success of catalysts to change the market's sentiment about a company's value. In its simplest form, this is known as buy and hold. However, there may exist a number of trades around each position in order to increase or decrease position sizes. When making investment decisions, Investors will generally utilize fundamental research, whether they focus on bottom-up (analyzing security valuations), top-down (looking for industry/sector themes first) or both.

Identifying opportunities based on technicals or fundamentals are not mutually exclusive. That is, Traders may look at company fundamentals and Investors may take technicals into account when making their investment or trading decisions.

IDENTIFYING INVESTMENT OPPORTUNITIES

Both Traders and Investors subscribe to similar factors when initiating or trading around a position. These factors include:

- **Discounts** – For almost all fundamental, bottom-up long/short equity managers, the opportunity set can be narrowed down to stocks selling at a discount to certain metrics, including: 1) historical valuations, sector or industry peers, and/or 2) intrinsic value whether calculated on current assets or expected future growth. The reverse is generally true for single name short positions i.e., they are selling at a premium to the aforementioned metrics. Traders may identify discounts based on prices relative to certain trend lines or peer group comparisons. It is important to note that in most cases, while the opportunity set may be identified by one of the above criteria, it is generally not the sole factor considered when initiating positions.
- **Catalyst Driven** – For value investors, catalysts are important factors both in terms of reducing risk and of value realization. There are two primary types of catalysts—hard and soft—and each of those can be further broken down into internal or external.
 - *Hard catalysts*, as the name suggests, are those with a high probability of occurring while soft catalysts are much more speculative.
 - *Internal catalysts* refer to an event that occurs at the company level such as a change of management, spin-offs, new product line or a new business strategy. External catalysts are broader and fall into industry or sector related changes, such as an increase in merger activity or a change in business cycles.

In some cases there may be a series of catalysts that form a path to unlocking a company's value. Whether there is one or many, catalysts drive stock prices because they can affect market perception the company and/or the industry.

- **Market Inefficiencies** – Opportunities are often created due to short-term inefficiencies in the market. Inefficiencies may occur due to a broad misperception about a company or industry, or due to non-company specific technical factors which could cause a stock to trade at a discount or at a premium for some time. Over the long-term, markets tend to be more efficient, giving those with patience and the ability to see through market inefficiencies the chance to capitalize.

In summary, Traders focus largely on market inefficiencies and may, to a degree, focus on catalysts and/or discounts. Investors focus primarily on discounts and catalysts, and may use market inefficiencies to initiate or re-size positions. Once potentially attractive opportunities are identified, most managers, regardless of style, will engage in a fundamental evaluation of the business with the goal of verifying whether the stock is or over- or under-valued, understanding why the value gap exists and confirming that there is a reasonable expectation that the valuation gap can and will be closed.

{ Portfolio Construction Characteristics }

Once a long/short equity manager's style has been identified, the next step is to evaluate how they construct their portfolio. Understanding a manager's construction and management philosophy will help investors evaluate portfolio changes and establish performance expectations.

INITIATING POSITIONS

Position sizing is a very important contributor to a manager's risk and return characteristics. Managers typically initiate positions in a combination of ways that are dependent upon:

- When and how value will be realized
- Perceived risk assumed and the potential reward
- Relative attractiveness to other positions in the portfolio
- Diversification factors or correlation with other securities in the portfolio

In general, positions are added to a portfolio in three broad ways (these apply both to Traders and Investors alike):

- **Small, toe-hold positions** – Managers may initiate with small position sizes that can range from basis points to over 1%, depending on the number of portfolio holdings and the desired position diversification. The size of initial positions depend upon factors such as timing (as it relates to the current price of the stock as well as macro and technical factors that may influence that price) and portfolio construction attributes (keeping in mind sector, industry and country exposures, themes, targeted long/short ratio and other risk metrics.) Typically, managers will initiate small positions with the intention of building the position as conviction grows and/or catalysts unfold.
- **Midsized positions (larger than toe-hold, but not full position size)** – Positions may be added to a portfolio at less than the full target size weighting due to less upside relative to other positions in the portfolio, but may also be initiated with the same intent as toe-hold positions.
- **Maximum (stated) position size** – When a manager initiates positions at the maximum weighting, it is usually a high conviction position potentially with a near-term catalyst.

Depending on the portfolio manager's philosophy, a maximum size position at onset may be fairly common or quite rare. Some do this regularly since a position's risk/reward is usually greatest at onset.

POSITION MANAGEMENT

Position management is another important aspect of a manager's philosophy, trading style and risk management process. Traders frequently make changes to position sizes based on technical factors as well as market and company specific news. As discussed above, Investors practice more of a buy and hold approach where changes are made to position sizes based on a value re-assessment or through periodic rebalancing.

Risk/Reward Assessment – Regardless of style, a constant risk/reward assessment is applied to existing portfolio positions as well as to new ideas in the pipeline. As positions move closer to their price target, they are inherently viewed as more risky as the potential for give-back of open profits is increased. Managers will generally cycle out of these positions in favor of new positions where the risk/reward profile is more attractive, the conviction level is higher or where the investment thesis is clearly taking hold. In some cases, managers allow position sizes to grow organically and fully exit the position once a price target is hit. Others actively trim the position as it increases in price, so they have very little exposure remaining as it reaches their target.

Active Rebalancing – Active rebalancing is an approach typically used to manage core positions that a manager expects to hold in the portfolio for several years. With core positions, the process, in the most simple form, is trimming from the winners and adding to the losers. This process may occur on a formal basis or as market moves dictate. In other instances, managers will trim from positions that reach predetermined size constraints and redeploy the capital elsewhere.

The Role of Catalysts – Managing catalyst driven positions can vary substantially based on the expected timing of the catalyst as well as whether the catalyst is hard or soft.

- *Near-term* catalysts will generally receive a full position size when initiated while *longer-term* catalysts may be sized up as the expectation for the event nears.
- For positions that have a series of catalysts that in aggregate will unlock value, the position is generally sized up at certain stages or as each catalyst occurs.
- Hard catalysts usually lead to larger initial positions since there is greater certainty that the event will occur while soft catalysts will be sized based on the expected probability the event will occur and may be sized up or down as that view changes.

When catalysts fail to materialize, an assessment must be made as to whether there are additional events that may cause the market to reassess the value of the company. If so, the position size may remain the same or be cut to a size more in-line with a lower probability outcome.

SELL DISCIPLINE

One of the biggest shortcomings of an active manager in any asset class is the lack of a disciplined exit strategy. Understanding a manager's process for determining when they will close out a long or short position, or at least reduce it, is critical to selecting a manager for one's portfolio.

Traders typically do not have a hold period in mind when entering positions and instead rely on stock or market specific technical factors to determine their exit. Investors rely on fundamental research, typically proprietary, to identify potential opportunities and set expectations for a future exit. The process for exiting positions for investors varies from methodical to less formal. The primary exit methodologies include:

- **Price Targets** – Many managers set price targets on each of the names they add to their portfolio. Targets can be adjusted based on new information uncovered during the investment’s life, but once targets have been hit, the position is usually closed out. Some managers may keep a portion of the position on the books to get a little extra from market momentum though most have other attractive opportunities and put the capital to work there.
- **Better Opportunities** – As mentioned earlier, a risk/reward assessment keeps portfolio names churning based on relative attractiveness which results in an exit prior to a name reaching a price target.
- **Establishing a Thesis and Checking It** – When positions don’t move in-line with expectations, the investment thesis is re-evaluated. If the thesis no longer holds true, the position will be exited. Exits also occur when catalysts fail to materialize.
- **Macro Factors** – Macro factors can also lead to a sale of positions. Major macro issues will drive a reassessment of portfolio positions and may cause some to be exited due to exposure, real or perceived, to factors such as the uncertainty surrounding government interventions, U.S. consumer troubles, European sovereign debt concerns, or Chinese consumption.

SHORT PORTFOLIOS

There are multiple ways to create and use a short portfolio. Understanding the objective and size of a manager’s short book, as well as the type of securities used, are critical determinants for evaluating a manager since they have a significant impact on his risk/return profile.

Objectives

The two main objectives of a short portfolio are to provide a hedge against long positions and/or to act as a standalone profit center. These objectives are not mutually exclusive and many short books will seek a combination of hedges and alpha generators (stocks expected to drop in price based primarily on company specific factors), though most have a bias towards one or another.

The objective of hedging long positions is to reduce portfolio volatility and minimize the impact of market downturns. This may be achieved through the use of index hedges (e.g. short the S&P 500 Index, Russell 2000 Index, S&P Financials Sector Index or MSCI EAFE Index) or customized baskets of securities defined by the manager, or a combination of the two. A hedge may also be a complementary position relative to a long position. The latter is defined as “pair trading” which involves two securities, often competitors in the same industry, which tend to be correlated in their price movements. When the correlation weakens, i.e. when one stock moves up while the other moves down, the pairs trade would be to short the outperforming stock and to go long the underperforming one, in an effort to build a position that will benefit when the "spread" between the two eventually converges.

When the short book is established to act as a standalone profit center, the objective is that the performance of the short book will be additive over time. While this objective may not always result in reduced volatility it may, like a hedged short book, protect in market downturns. Single name short positions (e.g., short IBM) are normally used to achieve this objective. If executed correctly, a single name short position should lag a broad index in up markets (costing the manager less than using a hedge) and lose more than an index in a down market.

Sizing

The size of the short book will vary widely between managers and is dependent on a number of factors such as shorting risks in their investable universe (liquidity and availability of borrow), volatility or beta targets, return objectives, and the manager's competency on the short side (both idea generation and performance). Some managers will target net exposure ranges that are tight (e.g., -20% to 20% or 70% to 100%) while others have very flexible mandates and may have a wide net exposure range (e.g., -10% to 80%). The size in relation to the long book will play a significant role in the expected return and volatility profile of the fund. In general, the larger the short book in relation to the long book, the lower the return profile and volatility. Conversely, a small short book in relation to a long book typically results in a return profile closer to that of a long-only index with the potential for lower volatility.

{ Strategy Categorization }

Once a manager has been identified as either Trader or Investor and the portfolio construction process is identified, the next step is to determine what type of strategy the manager employs. Investment strategies relate to specific portfolio objectives that may include managing to a specific volatility range, beta target, or net exposure range. Certain other factors that may contribute to an investment strategy include market capitalization focus, position concentration/diversification, as well as value/growth bias. For example, a manager may be described as running a diversified, low net, low beta book with a large cap value bias whereas another manager may be described as a concentrated, directional, high beta manager with a small cap growth bias. Each of these strategy examples will provide investors with a significantly different investment experience over time. The diversified low net exposure manager would typically be expected to provide lower upside capture with lower volatility while the concentrated manager with high net exposure would typically be expected to provide larger drawdowns and higher volatility with the potential for outsized returns.

Each strategy provides a unique contribution to a portfolio's overall risk and return characteristics. Specifically, each strategy's market exposure may have a significant impact on its ability to participate when markets rise or protect when markets decline. As such, when constructing a diversified portfolio of long/short equity managers, achieving an investor's return and risk objectives will be heavily dependent on the combination of different equity hedge strategies.

Convergent Wealth Advisors has developed four major proprietary strategy categorizations.

- **Category 1: Market Dependent – High Beta.** Managers fitting into Category 1 are those which run long-biased portfolios without *dedicated* short books (i.e. they may not have short positions at all times) and may be willing to use margin leverage to increase market exposure above 100% of capital. Category 1 managers usually short, selectively, for alpha as opposed to hedging their long book. Unlike most long/short strategies, Category 1 managers usually generate higher than

market volatility, exhibit high beta and may experience significant drawdowns (or periods of loss). Performance can typically be better than the market in positive periods, but can be as bad or worse in down markets.

- **Category 2: Core – Flexible/Directional (70-100% Market Exposure).** Category 2 managers are also long-biased managers, but they consistently maintain short books for both alpha generation and hedging purposes. The mandates are generally flexible so they are designed to reduce exposure in poor environments and protect capital, but increase in upward moving markets to catch a good portion of the market move. Net exposure will typically fall in the 70% range and higher with volatility, beta and drawdowns less than Category 1.
- **Category 3: Core – Hedged (30-70% Market Exposure).** Category 3 managers have conservative mandates with net exposures ranging from 30% to 70%. A short book is maintained at all times and many managers view their short book as a profit center as well as a hedge or volatility reducer. In positive markets, Category 3 managers are expected to lag the market, but they provide significant protection in negative markets due to lower correlation, beta, and drawdown potential.
- **Category 4: Market Dependent – Low Beta (0-30% Market Exposure).** Category 4 managers are generally market neutral, either on a dollar (dollars on the long side equal dollars on the short side) or beta adjusted (beta on long side matches beta on short side) basis. Because of this, they lack correlation to most market indices as well as to peers. Performance is expected to be positive in most environments with volatility significantly lower than market indices. In strong markets they will lag significantly, but are expected to provide better performance when the reverse is true.

In general, Traders typically fall under Category 3 or 4 while Investors could fall under any of the four categories.

{ Risk Controls }

The way in which a Trader invests is highly dependent on opportunities in the market, many of which are created by increased or high levels of volatility, as well as uncertainty, as it relates to the economy, markets and/or specific companies. When Traders experience periods of low volatility, returns may suffer as price moves will be less dramatic. While there is no way to avoid or dictate the level of volatility in equity markets, the impact of a low volatility environment on traders may be somewhat mitigated through position sizing and manager pairings. These managers are extremely opportunistic, thrive on volatility and uncertainty, and tend to have a relatively low correlation with equity markets as well as their counterparts, the Investors.

For Investors, style drift and technically driven markets are common sources of risk. Style drift, as it relates to an investor's style, most often occurs when the manager deviates from his fundamentally focused research process to trading primarily on market technicals or macro factors. We saw many Investors attempting to become more like Traders following the 2008 financial crisis as many believed this approach would allow them to avoid future corrections. This change in style may have worked for a small minority, but ultimately, when one is constructing a portfolio of managers, a style drift away from core competency and the investment style they were initially hired to provide warrants further review.

For those Investors who stick with their style, a technically driven market environment can have the most significant impact on pure fundamental, bottom-up stock pickers, specifically when they have an investment horizon more consistent with a buy and hold investor. In this environment a fundamental manager's long book will typically lag the market. Managing a short book in these environments can be very difficult as these overvalued stocks tend to be favored by Traders due to their strong upward momentum that can defy fundamentals for extended periods of time.

Whether Traders or Investors, drift in position concentration and exposure, both gross (longs plus shorts) and net (longs minus shorts), is a risk that needs to be monitored on an ongoing basis. Position concentration can become a problem in a number of ways, the most significant being the potential for decreased liquidity (i.e. inability to close a position due to lack of trading volume), high volatility of performance, and the potential for significant loss and short squeeze if the position is a short (rush to cover the same short position by many market participants thereby bidding up the price of the stock). A significant change in exposure is another risk that may lead to a different performance experience than originally expected as well as a change in actual volatility, both of which impairs one's ability to pair complementary, lowly correlated managers effectively.

{ Concluding Remarks }

The long/short equity space started with Alfred Winslow Jones' basic premise that, as a fundamental investor, he wanted to profit from his insight regardless of the valuation and to reduce his net exposure to the markets. With 50 years under its belt, the long/short equity arena is stocked with managers that come in different shapes and sizes varying by strategy, style, and portfolio construction philosophies. Understanding the different types of managers is critical to an investor's portfolio construction within each category to ensure complementary pairing of managers. In Part II of the Long/Short Equity Investing Series we will discuss additional qualitative factors as well as the quantitative aspect of the construction process. We will also discuss the four categories in more detail to arrive at a proper balance between each in order to achieve the desired investment goals.

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