

Effectively converting risk to return through loosening the constraints on shorting

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As investors continue to search for additional sources of alpha, there has been growing interest in strategies that implement both long and short positions to increase the opportunity set for generating returns. Allowing fund managers to short stocks in a portfolio can be an effective way to increase portfolio efficiency, make maximum use of a manager's investment insights and reduce stock specific risk. However, managing short positions requires a different skill set from managing long-only portfolios, after all, allowing short positions gives a manager more room to get it wrong as well as right. Fund managers must therefore be able to demonstrate that capturing the opportunities afforded by going short is a natural and proven extension of their existing investment process.

If implemented as an integral part of an investment process, allowing short positions in a portfolio enables the manager to reduce stock specific risk. To understand this you need to consider the constraints imposed on a long-only manager trying deliver an excess return over a benchmark. To generate a return in excess of the benchmark that manager must make decisions about companies to invest in and ones to exclude from the portfolio. Traditionally the manager will undertake research and invest clients' assets in attractively valued companies, say 50 stocks. However, what about companies that this research highlights as being unattractive? The traditional manager can only benefit from this information by not holding the company, therefore creating an effective underweight relative to the benchmark's holdings. If you consider the FTSE All Share, over 500 stocks have less than a 0.1% weight; therefore, this manager can only take a -0.1% position or less in any of these companies he does not like. Now compare this to the +1.0% or +2.0% overweight positions he takes in the 50 or so companies he does like - you begin to get an idea of the skewed risk profile of the portfolio versus the benchmark.

Permitting a manager to go short means that alpha generation is more balanced between overweight positions and underweight positions relative to a benchmark, rather than generated predominantly by overweights. This has the significant effect of reducing portfolio risk. It will mean that to generate the same level of expected excess return the manager can take smaller positions relative to the index, with overweights balanced by underweight positions. Statistically, smaller, more diversified positions lead to lower risk. Additionally, the manager can fully utilise the research output, taking into account both good and bad company ideas.

However, to benefit from the decrease in overall portfolio risk that long/short portfolio construction provides you need to be sure of two things. Firstly, that this is a natural extension and integral part of the investment process, and secondly the manager has significant experience in the risk control of managing short positions.

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