

Shopping for shorts

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The broad concept behind capital markets is a simple one: match the needs of those wanting to borrow money with the expectations of investors willing to lend it. The tactics used to fulfil that concept are anything but simple; however, if thoroughly managed, they are effective.

Problem: An effective method of meeting investor expectations five years ago may not be sufficient today. So what gives? Do investors become less demanding? Do managers offer products with lower returns? Or do managers become smarter and expand their universe of tools? Hopefully the latter is true, but this is only viable if investors understand, trust and then demand these new and innovative products.

Due to shifting market trends, managers are progressively incorporating measures of alternative strategies into their traditional product lines—essentially expanding their universe of tools—in order to capture greater risk-adjusted returns. Shorting is one of these strategies.

If the only predicable risk inherent in stock markets was the risk of stocks going up, there would be no case for shorting. So long as the concept of “perfect information” remains just that (a concept), however, long/short-savvy managers should be able to ascertain when a stock is likely to fall. As always, there are arguments for and against.

For: Use it, don't lose it

The case for taking a negative view of a stock results from the same kind of research performed in order to take a positive view of a stock. It can be thought of as a logical use of resources; if an analyst researches a company and decides it is too expensive, why lose that research and discard a potential opportunity?

This mentality ties in with the theme of symmetry. Taking market-neutral views (i.e., buy 5000 Fantastic Bank plc, sell 5000 Not So Great Bank plc) is an extremely efficient way of utilising a manager's resources. The benefits are explained below.

Use all the data available: The fund manager is able to make fuller use of negative information as well as positive information. In deciding which stocks to include in a long-only portfolio, fund managers naturally spend a great deal of time deciding what they do not wish to own. If the outlook for a company is poor, the strongest position a long-only manager can take is to not own the company's shares. Short selling enables the manager to take a negative view of a stock to its logical conclusion.

Reduce overall portfolio risk: Even while aiming to generate higher levels of excess return, a fund manager is able to employ the approach of taking highly-diversified and symmetrical positive and negative positions across a wide range of stocks. In addition, the fund manager is able to mitigate unwanted risks by hedging long positions through shorting.

Against: Will I be at the cutting edge or the bleeding edge?

The arguments for including shorting in the range of investment techniques available to a fund manager are compelling, but many institutional investors have been reluctant to loosen the constraints on their equity managers to permit short selling.

Matching a great story with great performance: An increasing number of investment managers are experimenting with adding short selling to the range of strategies they employ in core equity approaches, but relatively few can point to a successful track record of implementing and managing short positions. This is not purely a question of having experience in dealing with the administrative and legal complexities of sourcing stock for short positions, or having well-established appropriate trading systems and risk controls. Common sense suggests that shorting techniques will be applied most successfully in core equity portfolios by fund managers who already have extensive experience of implementing short views. However, common sense also suggests that shorting will be applied most successfully where it forms a natural extension of an established investment process, rather than being applied in an ad hoc or opportunistic fashion.

More rope to hang themselves with? One frequent concern among investors is that while permitting shorting in a portfolio gives fund managers more scope to generate returns, it also increases the scope for fund managers to lose money. The value of a long position can fall by 100% and no more (if the stock becomes literally worthless). The holder of a short position, on the other hand, *makes* money if the stock falls in value. If the value of the stock rises rather than falls, potential losses are theoretically uncapped, as there is theoretically no limit to how far a stock can rise. This underlines the need for relevant risk controls and trading rules to counter the potential downside of holding short positions.

Does leverage belong in a core equity portfolio? All long/short strategies involve leverage. This is firstly in the form of borrowing stock to implement short positions. The second form of leverage results from balancing short and long positions. Cash realised from short sales is invested in long positions in undervalued equities to ensure that the portfolio retains full market exposure and to pursue additional return opportunities. In the case of a fund that is able to short sell 30% of its portfolio, and therefore also takes an additional 30% in long positions, the overall effect is to have invested 160% of the assets under management.

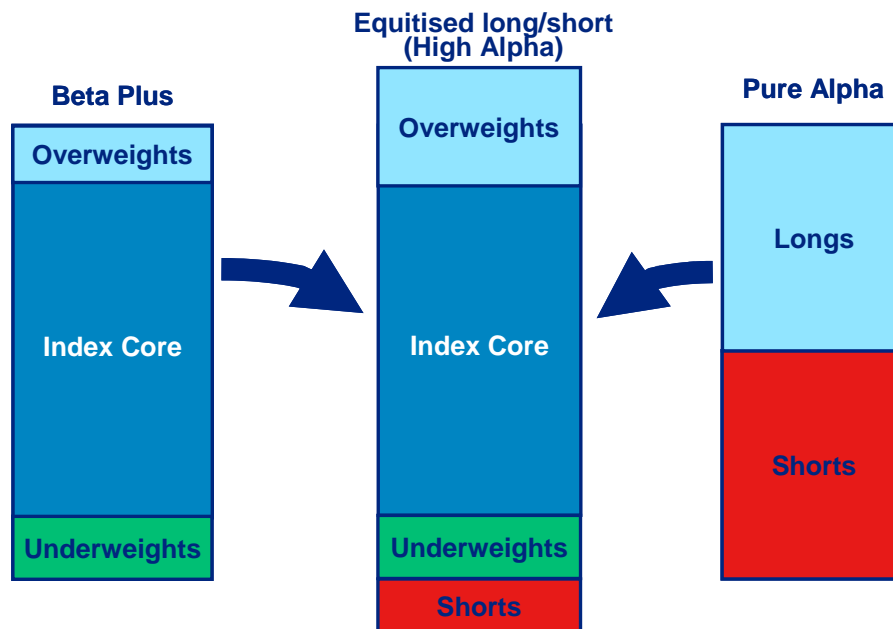
The risks of introducing this level of leverage into the portfolio will depend upon the nature of the investment approach being employed. A key factor to look at is the expected tracking error (risk) of the strategy.

A harmonised approach to a polarised industry

Institutional investors have historically favoured products that provide 100% market exposure by way of a core benchmark holding plus above- and below-benchmark holdings. Hedge fund investors have historically favoured pure alpha products that are meant to provide no market exposure, relying solely on the individual skills of the manager. Two factors are helping reshape the way products are being designed:

- Institutional investors are demanding more than just beta plus modest outperformance
- Hedge fund providers are keen to attach market exposure to their pure alpha strategies to attract institutional investors

The chart below illustrates the trend that is emerging as the contrasting profiles of institutional and hedge fund investors edge toward a middle ground that can offer higher risk-adjusted returns.



“Equitised long/short” or “limited shorting” refers to a strategy that uses short positions but still achieves 100% market exposure. In order to achieve this, the cash generated from the short sale is used to leverage long positions beyond 100%. The combined long positions completely offset short positions and give the investor 100% market exposure. This maintains the upside benefit of shorting, should a stock that the manager has a dim view of fall, but maintains overall portfolio harmonisation with the applicable benchmark.

This style of management can expose investors to benefits associated with larger managers:

A track record in managing beta: Managing a portfolio against an index of securities is essential for many institutional investors, and applying pure alpha strategies on top of a benchmark requires skill and proper risk controls. An existing institutional manager will have these skills in place; but they must also have the experience of running short positions.

The resources to properly address risk: If implemented with the proper care and attention, allowing short positions in a portfolio enables a manager to reduce stock-specific risk through diversification. Providing investors with long/short experience combined with independent proprietary risk teams and best-of-breed quantitative risk systems requires money and people.

Economies of scale: Traditional asset managers with tens of billions in assets under management spread over a broad range of asset classes generally have access to cost-effective broker and counterparty agreements.

Conclusion

The risk of shorting, in an investor/manager context, applies to a manager's investment process, experience and, importantly, to how intently an independent risk unit is watching the manager and their positions. If a manager has the resources and experience to trade long/short portfolios successfully, the investor needs to then make sure a) adequate risk processes are in place and b) those processes are properly enforced. The proposition then begins to look more like a sensible hedging process than an unnecessary risk-taking exercise.

Returning to the questions presented in the second paragraph of this piece, investment managers have to extend their universe of tools to meet investor expectations. Achieving this without investors having understood and accepted new investment methods, however, is impractical.

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