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LONG/SHORT EQUITY: Choosing Alpha over Beta

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The steady rise of the S&P 500 over the past few years has been kind to traditional investors. Since bottoming in February 2009, the S&P 500 TR Index has rallied nearly 200%, while generating an annualized rate of return in excess of 20%. With this wind at their back, long-only equity funds and ETFs have produced significant gains, helping investors to recoup the painful losses suffered during the credit crisis.

Unfortunately, extended equity market rallies like we've experienced are the exception rather than the rule. History has shown that eventually a "correction" occurs, an unexpected crisis emerges, the economy falters, or bulls give way to bears. While these events tend to be fleeting, the pain they cause is typically acute, with the after effects lasting much longer than the events themselves. For instance, following the 50.95% drawdown experienced during the credit crisis, it took the S&P 500 TR Index more than three years to

reach its previous peak (nearly 4.5 years measured peak to peak). This period was not as anomalistic as one would think as can be seen in Figure 1 below. A similar story holds true following the 44.73% drawdown during the tech bubble, after which it took the S&P 500 TR Index more than four years to reach its previous peak (more than 6 years measured peak to peak).

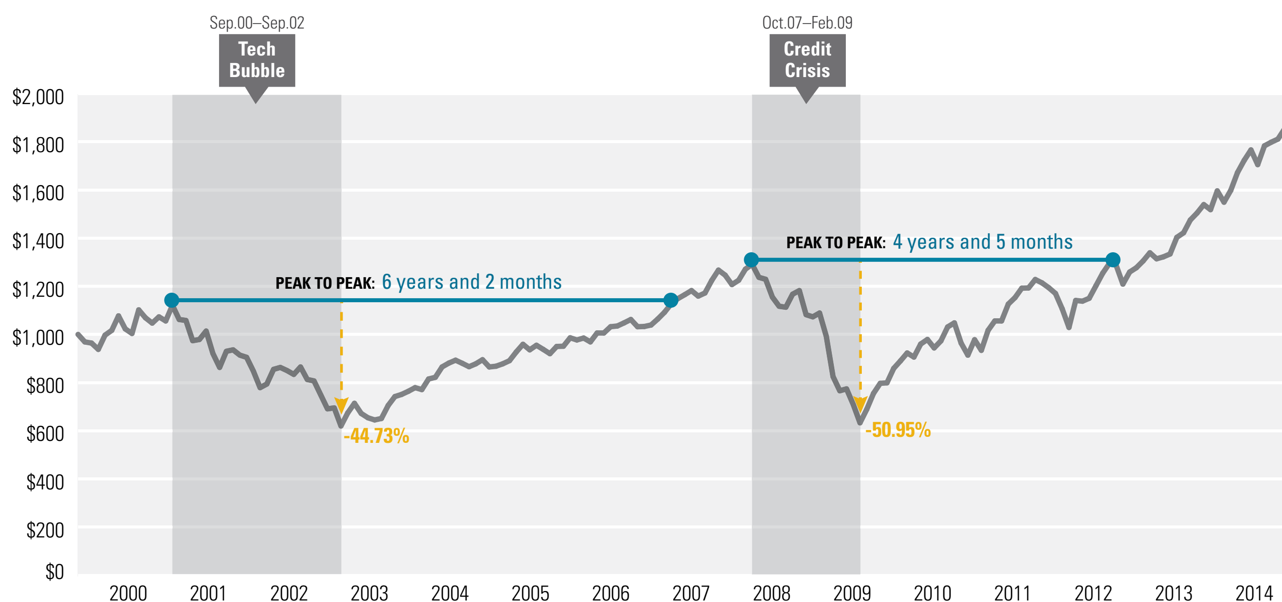
Today, many investors are wondering if there is a better way to manage their equity portfolios; a way to enjoy the benefits of owning stock in successful companies, without exposing their portfolios to the level of volatility and drawdowns which have become a hallmark of the market, particularly during the past few decades. We believe long/short equity strategies provide investors with the opportunity to mitigate the effects of volatility and market downturns.

This paper will explore why we believe:

- Long/short strategies can provide investors with the potential upside enjoyed by equities as an asset class, while seeking to achieve a degree of downside protection.
- Long/short equity managers have a greater opportunity to generate alpha.
- Managing a short portfolio is structurally different than managing a long portfolio, and requires attention to risks not always appreciated by managers new to running long/short strategies.

FIGURE 1.

MAJOR STOCK MARKET DRAWDOWNS | July 1999 – June 2014



Past performance is not indicative of future results. Stock market performance is represented by the benchmark S&P 500 Total Return Index for illustrative purposes and does not represent any particular fund. An index is not available for direct investment. Drawdown measures the peak to valley loss relative to the peak for a stated time period. Date range based on previous 15-year period. Source: Bloomberg.

Long is buying an asset/security that gives partial ownership to the buyer of the position. Long positions profit from an increase in price. Short means selling an asset/security that may have been borrowed from a third party with the intention of buying it back at a later date. Short positions profit from a decline in price. If a short position increases in price, the potential loss on an uncovered short is unlimited.

Passive Beta — Active Alpha

Long/short equity is an investment strategy that seeks to generate returns that are driven more by stock selection (alpha) than by market direction (beta). Beta is a statistical measure which indicates how sensitive a portfolio's returns are to changes in the market as a whole. In contrast, alpha is the portion of returns that are not explained by changes in the equity market, and instead are attributed to stock specific factors and manager skill. All else being equal, the higher the beta for a portfolio, the more dependent it is on a rising market to generate returns (and the more exposed it will be to market declines). Conversely, the more positive alpha a portfolio generates, the better it is likely to perform regardless of market direction.

Figure 2 shows how portfolios with different levels of alpha and beta would be expected to perform across various market environments. Portfolio 1's returns will be driven more by market direction (higher beta of 0.9) and less by stock selection (lower alpha of 2% per year), while Portfolio 2's returns will be driven less by market direction (lower beta of 0.5) and more by stock selection (higher alpha at 4% per year). This hypothetical example highlights how it is important to evaluate a portfolio's performance over the course of a full market cycle, as various market environments can favor certain types of portfolios. Portfolio 1 performed better during strong equity markets (Year 1 and Year 3), while Portfolio 2 performed better in a negative equity market (Year 2). Interestingly, despite having the worst performance during two of the three years, Portfolio 2 has the best performance over the full three year period due to superior alpha generation and less significant down years.

FIGURE 2.

IMPACT OF ALPHA AND BETA ON PORTFOLIO RETURNS

	Beta (vs. S&P 500)	Alpha (per year)	Year 1 Return	Year 2 Return	Year 3 Return	Cumulative Return
S&P 500	1.0	0%	+10%	-10%	+10%	+8.9%
Portfolio 1	0.9	2%	+11%	-7%	+11%	+14.6%
Portfolio 2	0.5	4%	+9%	-1%	+9%	+17.6%

For illustrative purposes only. Does not represent any particular portfolio. There is no guarantee that any investment will achieve its objectives, generate profits or avoid losses.

Beta is measure of volatility or risk; beta of 1 indicates a security or portfolio's price will move with the market; a beta of less than 1 indicates less volatility than the market; beta greater than 1 indicates more volatility than the market. Alpha is a measure of risk-adjusted performance; it represents the excess return of a portfolio relative to the return of a benchmark index.

No stock selection skill or portfolio management expertise is needed to generate beta, as it can be captured simply by purchasing a basket of securities in the same proportion as the market index. This is how most index funds and ETFs are managed, and why they are able to charge lower fees than their actively managed counterparts. This beta can be an inexpensive source of return, but investors who choose a passive long-only approach must be willing to withstand the inevitable drawdowns which periodically hit the market.

Unlike beta, generating alpha requires active management and can only be obtained by holding a portfolio that differs from the market index. It's this differentiation that creates the potential for outperformance (positive alpha) or underperformance (negative alpha) relative to the index. Regularly delivering positive alpha requires a high degree of skill and a robust investment process, and managers who can do so consistently often command higher fees than their beta driven counterparts. While these fees may seem high relative to more passively managed funds, these fees may be worth paying if the manager can consistently generate alpha in excess of their additional fees. This is why manager selection is critical when considering alpha driven strategies.

Double Alpha Opportunities

Long-only equity funds, even those that are actively managed, provide beta exposure to a particular market. These managers often construct their portfolios by starting with a “neutral” portfolio that resembles the market index and then increasing (“overweight”) or decreasing (“underweight”) position sizes and/or sector weightings based upon their relative opinions, research and market outlook. While managing position sizes relative to a benchmark might ensure that the fund provides the type of market exposure (beta) investors expect, it also hinders the ability to potentially generate more alpha because the manager may limit how much their holdings will deviate from the index (a requirement for alpha generation).

In contrast, long/short equity managers are typically benchmark agnostic, paying little attention to how much their holdings resemble the market index. Freed from these constraints, long/short equity managers are able to focus exclusively on those opportunities they believe will be most profitable, regardless of how much their portfolios ultimately differ from the market index. This unconstrained and flexible approach provides long/short equity managers with increased opportunities to generate alpha versus their more benchmark-focused counterparts.

More importantly, long/short equity managers possess a tool which effectively doubles the number of opportunities they have to generate alpha: The potential to profit from falling stock prices. This potential to profit from stocks declining in value is accomplished by shorting; a process which entails borrowing the stock from someone who currently owns it (long) and immediately selling it to someone else, with the intent of repurchasing it at a later date so it can be returned to the original owner. If the stock price declines during this period, the short position is profitable, if the price increases, the short position generates a loss. This opportunity to profit from stock price declines is unique to long/short funds. While long-only funds can avoid potential losses by not purchasing the stocks they expect to decline, there is no opportunity for them to actually generate profits from these declines. Long-only funds, whether passive or active, simply do not have the ability to capture “double alpha.”

It’s also important to note that while some funds may call themselves “long/short”, they may not actually short individual equities at all. Instead they may simply hedge their long positions by shorting index ETFs or futures. While these index hedges can be effective in reducing beta exposures, these index instruments do not provide the additional opportunity to generate alpha. Just as long-only managers must differentiate their long holding from that of the index in order to produce alpha, true long/short managers must actually short individual equities in order to gain the potential for “double alpha”. We believe that in order to reap the full rewards long/short equity strategies can potentially offer, investors should focus on managers who have the ability to generate alpha from both their long and short positions.

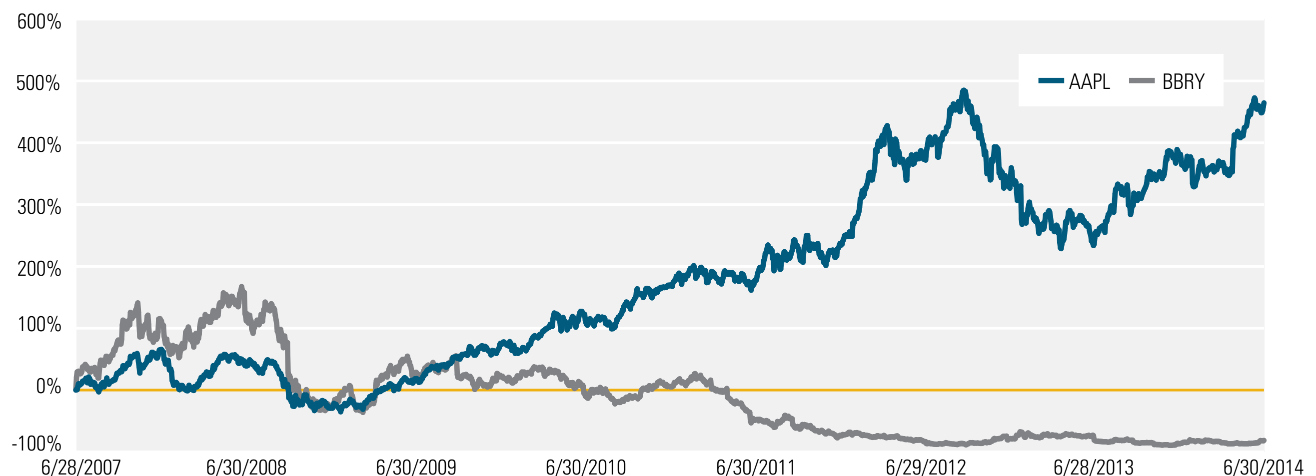
Alpha Through Stock Selection

Long/short equity managers seek to generate alpha by identifying stocks they believe are misunderstood by the market and where the current price differs substantially from what they consider to be the stock's true intrinsic value. This process typically entails deep bottom up fundamental analysis of a company's financial statements, business model, and competitive position, as well as a top down analysis of thematic macro factors which could impact the company's prospects. Once a mispriced stock is identified, most long/short equity managers will seek to understand why the mispricing exists, and then will attempt to identify specific catalysts which might cause the market to recognize the company's true intrinsic value, whether it is higher or lower.

As a hypothetical example applied to a real world scenario, consider the following: During most of the 2000s, BlackBerry (formerly Research in Motion) dominated the corporate smartphone market and the stock performed very well. Many people believed this dominance would last even after Apple introduced the iPhone, partially because executives had become all but addicted to the BlackBerry (leading to the term "CrackBerry") and the fact that their software integrated so simply with corporate infrastructure (while the iPhone's did not). Today, we know that the iPhone eventually became the dominant smartphone in both the consumer and corporate markets, while the BlackBerry has a significantly reduced market share. The performance of the two companies' stocks diverged significantly following the introduction of the iPhone on June 29, 2007 (Figure 3), but in the late 2000s, this outcome was far from obvious to many investors. For astute long/short managers

FIGURE 3.

APPLE VERSUS BLACKBERRY | June 29, 2007 – June 30, 2014



Past performance is not indicative of future results. Date range based on launch date of the iPhone on June 29, 2007. Source: Bloomberg.

who correctly analyzed the situation, a number of hypothetical trade opportunities were possible:

1. **Long Apple:** One point of view may have been that BlackBerry was likely to continue to dominate the corporate market, but the possibility that the iPhone could break into that segment was being underestimated by the market. In such a scenario, a long/short manager might have bought Apple stock on the view that it would perform in line with the market, but with a potential catalyst for significantly more upside if the iPhone were to unexpectedly capture corporate market share.

2. **Short BlackBerry:** Another point of view may have been that the iPhone was going to capture some corporate market share, hurting BlackBerry's revenues but not necessarily dominating the corporate or consumer segment due to the high cost of the device. In such a scenario, a long/short manager may not have been particularly bullish on Apple, but may have elected to short BlackBerry in expectation of slower revenue growth.

3. **Pair Trade — Long Apple and Short BlackBerry:** If a manager believed that the iPhone was going to take market share away from BlackBerry, but believed that both stocks were likely to increase in an up market (or decrease in a down market), they might have structured the trade as a "pair trade." In this example, the manager would have isolated their primary view (Apple will benefit at the expense of BlackBerry) while minimizing their exposure to broad market factors to which both companies may be exposed.

While any one of these hypothetical trades could have been profitable depending upon when a manager first invested, seemingly only #1 would have been available to long-only managers, while all three were available to long/short managers. #1 and #2 would have exposed investors to more market related risk, due to their unhedged nature, while #3 offered a more hedged approach.

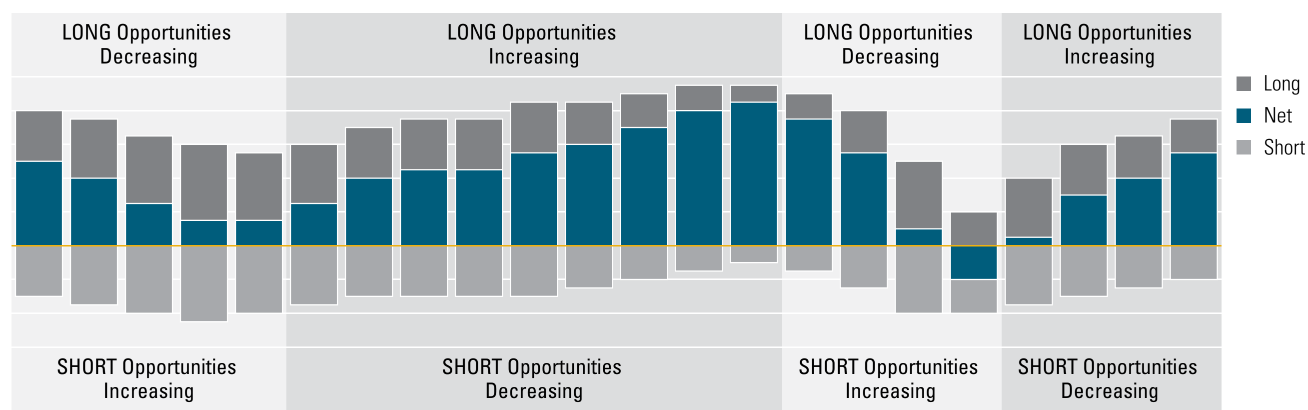
Active Exposure Management

Beyond selecting individual stocks, it's also important for long/short strategies to manage how much exposure they want to have to broad market moves. The long and short percentages a manager maintains can greatly impact their portfolio's beta and therefore the quality and composition of its returns. We believe the best long/short equity managers structure their portfolios such that their alpha from individual stock selection can match or exceed the returns they derive from beta exposure. To accomplish this, most long/short equity managers run hedged portfolios with moderate net long exposures. Nonetheless, it's important to know that these exposures are not static, and most managers will vary their net exposure depending upon the prevailing market conditions, as represented in Figure 4. Higher net long exposures (long exposure minus short exposure) generally correspond to periods of increased bullishness as managers find an increasing number of long (buying) opportunities and/or a decreasing number of short (selling) opportunities, while lower net exposures (or even net short exposures) may indicate a more cautious outlook as managers find a decreasing number of long opportunities and/or an increasing number of short opportunities.

While some long/short equity managers are very good at assessing the macro environment and adjusting their exposures accordingly, most managers vary their net exposure based more on bottom up analysis than top down macro calls. In fact, the very nature of the strategy tends to result in a contrarian "buy low, sell high" orientation, as over exuberant markets often result in poor quality companies becoming "expensive" (potential shorts) while market crises often result in high quality companies becoming "cheap" (potential longs). Perceptive managers may recognize a lack of compelling long ideas as sign of a possible market top, while a lack of compelling short ideas could indicate a market that is nearing its bottom. We believe that this ability to adjust market exposures based upon prevailing market conditions provides long/short equity managers an edge over traditional long-only portfolios, where managers are limited to relying on long-only stock picking abilities and are often subject to the full market beta (positive or negative).

FIGURE 4.

PORTFOLIO EXPOSURES CAN VARY BASED ON MARKET CONDITIONS AND OPPORTUNITIES



For illustrative purposes only. The success of an investment is dependent upon the ability of a manager to identify profitable investment opportunities and successfully trade, which is difficult, requires skill and involves a significant degree of uncertainty.

Setting Expectations

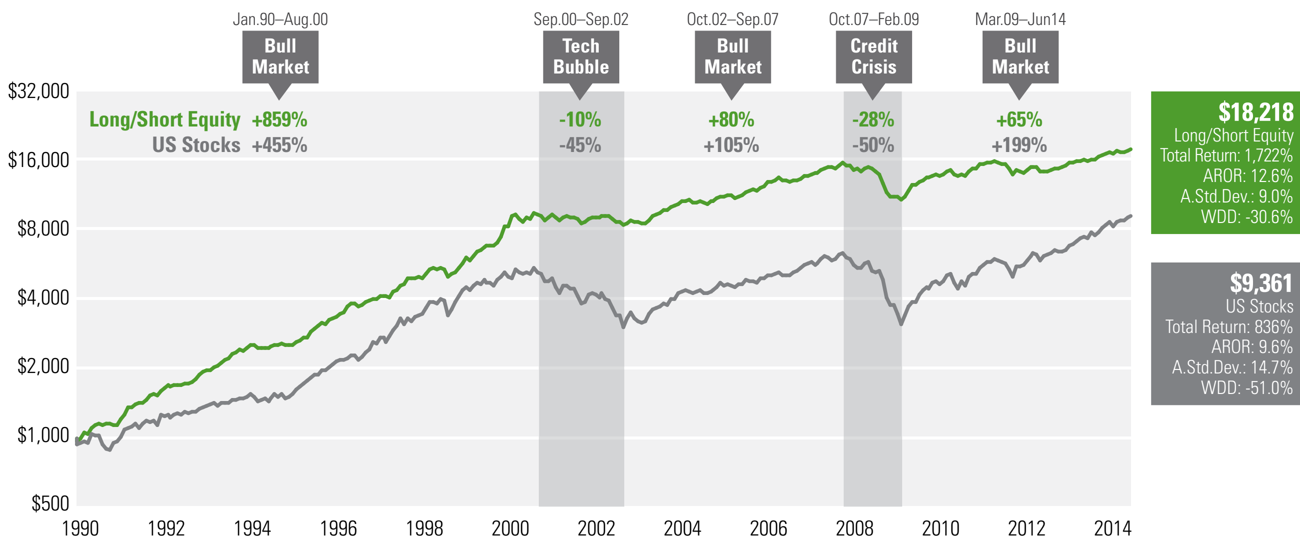
Maintaining an active short portfolio can provide a hedge against market declines, but investing in long/short equity is more than just a strategy seeking to mitigate downside risk. While past performance is no guarantee of future results, long/short equity has a long history of outperforming the S&P 500 TR Index over time (Figure 5). While the strategy tends to lag the market in beta driven rallies, the potential for positive alpha, lower standard deviation and lower drawdowns in market declines has allowed the strategy to not only outperform the S&P 500 TR Index over multiple market cycles, but do so with greater risk-adjusted returns. The benefit is a strategy with the potential to capture some of the upside in positive markets while being less affected during down markets.

FIGURE 5.

LONG/SHORT EQUITY OUTPERFORMED US STOCKS OVER MULTIPLE MARKET CYCLES | January 1990 – June 2014

Value of an Initial $1,000 Investment (Log Scale)

Long/short equity has more than doubled the total return of US stocks over the past 25 years, in addition to having less volatility and a smaller drawdown.



Past performance is not indicative of future results. There is no guarantee that any investment will achieve its objectives, generate profits or avoid losses. Percentages represent cumulative return for stated period. Returns are represented by benchmark indices for general market comparisons and are not meant to represent any particular investment product. An investor cannot invest directly in an index. Moreover, indices do not reflect commissions or fees that may be charged to an investment product based on the index, which may materially affect the performance data presented. Long/Short Equity represented by HFRI Equity Hedge (Total) Index; US Stocks represented by S&P 500 Total Return Index. Standard deviation (Std.Dev.) is a statistical measure of how consistent returns are over time; a lower standard deviation indicates historically less volatility. Source: Bloomberg, HFR.

The following describes how long/short equity strategies would typically be expected to perform during different market cycles. It is very important to note there is no guarantee that any investment or strategy will achieve its objectives, generate profits or avoid losses.

- **Bull Market:** On an absolute basis, long/short equity strategies should be expected to generate the highest returns in a rising market due to their typically net long biases (some beta exposure). However, these strategies would likely underperform long-only strategies due to their hedged portfolios.

- **Bear Market:** Long/short equity strategies should be expected to perform better than long-only strategies during market declines due to their hedged portfolios (less beta). While strong relative performance should be expected during these periods, the absolute level of returns are expected to be lower than in bull markets (and perhaps even negative depending upon how much beta exposure a manager has).

- **Full Market Cycle:** Due to their potential to preserve capital during market declines and their potential to generate alpha from both long and short positions, we expect well managed long/short equity strategies to produce equity-like returns with better risk-adjusted performance than traditional equity indices over a full market cycle.

This analysis is not intended to be all-inclusive. The investment expertise of a manager and their judgments about the attractiveness, value and potential appreciation or depreciation of a particular security may prove to be inaccurate and may not produce the desired results.

Know the Risks

It should be noted that shorting is not without its own specific set of risks. While a long position has a natural limit to its loss potential (a stock cannot trade below zero), short positions have no such theoretical bound (a stock can continue to rise infinitely). If a manager is wrong about a long position, the most they can lose on the investment is the amount they invested, but if a manager is wrong about a short position, and continues to maintain it, the loss could become a multiple of the amount the manager initially shorted. Worse, unlike long positions which shrink in size as a trade moves against you ($100 of stock becomes $90 if it goes down 10%), short positions actually increase in size when they move against you (a $100 stock becomes $110 if it goes up 10%). Understanding and effectively managing around these risks are unique skills that experienced long/short managers have honed over many years of pursuing their strategies.

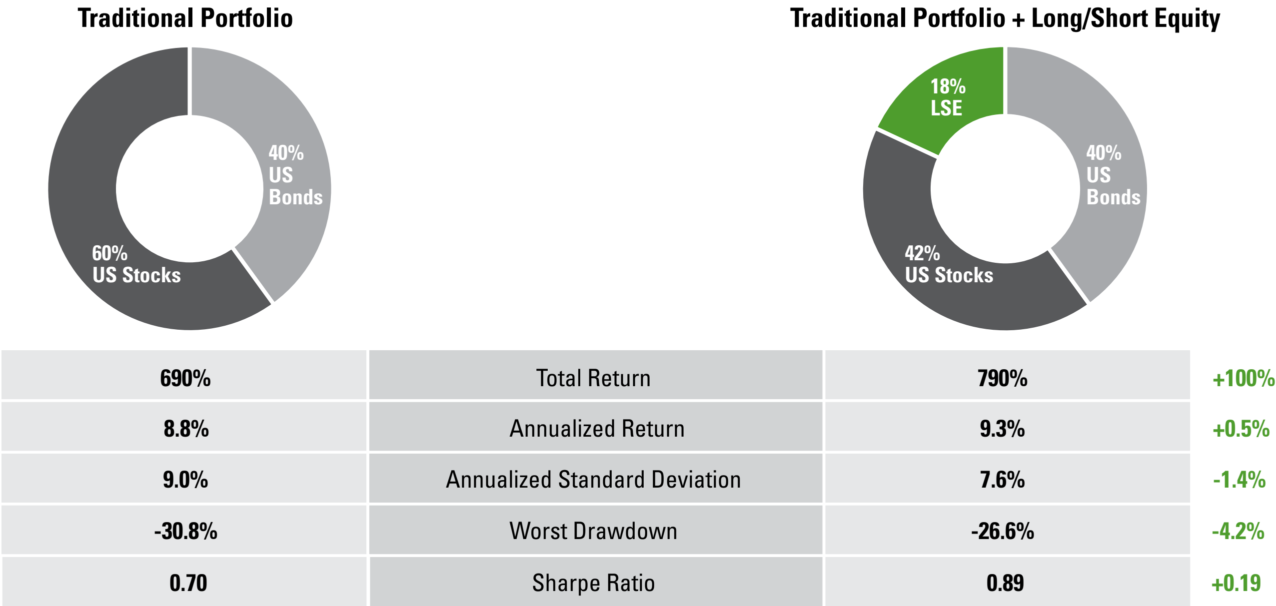
Those looking to invest in long/short equity should be cautious when considering managers who have only recently started shorting. Managers with little to no experience shorting stock may be unprepared for the unique risks it entails. While this risk can be mitigated by investing with managers who only short index based ETFs, it comes with the cost of giving up the double alpha opportunity true long/short managers enjoy. Instead, we recommend that investors allocate to managers who have extensive experience managing long/short portfolios, and a demonstrable track record of generating positive alpha from both individual long and short positions. While these managers often command higher fees than their less proven counterparts, we believe these fees are worth paying if the manager can consistently generate alpha in excess of their fees.

Conclusion

As investors explore better ways to manage their equity allocations, we believe they should consider long/short equity as a viable alternative to beta driven long-only strategies. Long/short strategies can provide many of the benefits derived from investing in successful companies, but with the potential to limit volatility and drawdowns during times of market stress. While past performance is no guarantee of future results, investors could have historically improved their returns and reduced their drawdowns by investing just a portion of their traditional equity allocation to long/short strategies (Figure 6).

FIGURE 6.

LONG/SHORT EQUITY IN A PORTFOLIO | January 1990 – June 2014



Traditional Portfolio		Traditional Portfolio + Long/Short Equity	
690%	Total Return	790%	+100%
8.8%	Annualized Return	9.3%	+0.5%
9.0%	Annualized Standard Deviation	7.6%	-1.4%
-30.8%	Worst Drawdown	-26.6%	-4.2%
0.70	Sharpe Ratio	0.89	+0.19

Past performance is not indicative of future results. There is no guarantee that any investment will achieve its objectives, generate profits or avoid losses. The above is not intended and should not be construed as asset allocation advice. Returns are represented by benchmark indices for general market comparisons and are not meant to represent any particular investment product. An investor cannot invest directly in an index. Moreover, indices do not reflect commissions or fees that may be charged to an investment product based on the index, which may materially affect the performance data presented. Long/Short Equity (LSE) represented by HFRI Equity Hedge (Total) Index; US Bonds represented by Barclays US Aggregate Bond Index; US Stocks represented by S&P 500 Total Return Index. Sharpe ratio measures return in excess of the risk-free rate, per unit of risk, as measured by standard deviation; assumed risk-free rate is 2.5%. Source: Bloomberg, HFR.

In closing, we believe that:

- By investing a portion of their equity allocation in long/short strategies, investors can benefit from the potential upside enjoyed by equities as an asset class, while also potentially achieving a degree of downside protection via hedged exposures and potential alpha generation.
- Long/short equity managers enjoy greater opportunity to generate alpha, due to their benchmark agnostic mandates and their potential to profit from stocks that decline in value. Long-only strategies and "long/short" managers who only short index ETFs or futures are limiting their potential for alpha.
- Shorting is a unique skill with its own set of risks which must be properly managed. Investors can potentially mitigate these risks by working with managers who have extensive experience managing long/short strategies.

For more information and perspectives on alternatives, please visit **www.altegrisacademy.com** or contact your alternatives consultant at Altegris Investments **(800) 828-5225**.

RISKS AND IMPORTANT CONSIDERATIONS

It is important to note that all investments are subject to risks that affect their performance in different market cycles. Equity securities are subject to the risk of decline due to adverse company or industry news or general economic decline. Bonds are subject to risk of default, credit risk, and interest rate risk; when interest rates rise, bond prices fall. Short selling and short position derivative activities are considered speculative and involve significant financial risk of loss.

Alternative investments involve a high degree of risk and can be illiquid due to restrictions on transfer and lack of a secondary trading market. They can be highly leveraged, speculative and volatile, and investor could lose all or a substantial amount of an investment. Alternative investments may lack transparency as to share price, valuation and portfolio holdings, and are subject to substantial charges for management and advisory fees. Complex tax structures often result in delayed tax reporting. Alternative investment managers typically exercise broad investment discretion and may apply similar strategies across multiple investment vehicles, resulting in less diversification. Trading may occur outside the United States which may pose greater risks than trading on US exchanges in US markets.

Mutual funds involve risk including possible loss of principal. An investment in an alternatives strategy mutual fund should only be made after careful study of the prospectus, including the description of the objectives, principal risks, charges, and expenses of the fund.

The analysis herein is based on numerous assumptions and past market conditions. Different benchmarks, market conditions and other assumptions could result in materially different outcomes.

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INDEX DEFINITIONS, DESCRIPTIONS AND RISKS

An investor cannot invest directly in an index. Moreover, indices do not reflect commissions or fees that may be charged to an investment product based on the index, which may materially affect the performance data presented. The referenced indices are shown for general market comparisons and are not meant to represent any particular fund.

Barclays US Aggregate Bond Index. The Barclays US Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the US investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. These specific indices include the Government/Credit Index, Government Index, Treasury Index, Agency Index, and Credit Index.

Key Risks: interest rate risk—bond prices will decline if rates rise; credit risk—bond issuer may not pay; income risk—income may decline

HFRI Equity Hedge (Total) Index. The HFRI Equity Hedge (Total) Index tracks funds that maintain positions both long and short in primarily equity derivative securities. Equity hedge managers would typically maintain at least 50% exposure, and may in some cases be entirely invested in, equities – both long and short. HFRI Equity Hedge (Total) is a fund weighted index and reflects monthly returns, net of all fees, of funds that have at least $50 million under management or been actively trading for at least twelve months.

Key Risks: stock market risk—prices may decline; industry risk—adverse sector performance may cause declines; leverage risk—volatility and risk of loss may magnify with use of leverage; currency risk—unfavorable exchange rates may occur

S&P 500 Total Return (TR) Index. The S&P 500 Total Return Index is the total return version of S&P 500 index. The S&P 500 index is unmanaged and is generally representative of certain portions of the US equity markets. For the S&P 500 Total Return Index, dividends are reinvested on a daily basis and the base date for the index is January 4, 1988. All regular cash dividends are assumed reinvested in the S&P 500 index on the ex-date. Special cash dividends trigger a price adjustment in the price return index.

Key Risks: stock market risk—stock prices may decline; country / regional risk—world events may adversely affect values

INDEX HISTORICAL PERFORMANCE | As of June 2014

Annualized Rate of Return	Common Period*	10-Year	5-Year	1-Year
Long/Short Equity	12.58%	5.35%	7.33%	12.42%
US Stocks	9.56%	7.78%	18.83%	24.62%

Annualized Standard Deviation	Common Period*	10-Year	5-Year	1-Year
Long/Short Equity	9.01%	8.68%	7.62%	4.56%
US Stocks	14.73%	14.64%	13.29%	9.07%

Worst Drawdown	Common Period*	10-Year	5-Year	1-Year
Long/Short Equity	-30.57%	-30.57%	-13.18%	-1.16%
US Stocks	-50.95%	-50.95%	-16.26%	-3.46%

**Common period start date is January 1, 1990. Past performance is not indicative of future results. There is no guarantee that any investment will achieve its objectives, generate profits or avoid losses. Returns are represented by benchmark indices for general market comparisons and are not meant to represent any particular fund. An investor cannot invest directly in an index. Moreover, indices do not reflect commissions or fees that may be charged to an investment product based on the index, which may materially affect the performance data presented. Long/Short Equity represented by HFRI Equity Hedge (Total) Index; US Stocks represented by S&P 500 Total Return Index. Source: Bloomberg, HFR.*

Drawdown is any losing period during an investment time frame; it measures the peak to valley loss relative to the peak for a stated time period. The figure is expressed as a percentage. Standard deviation is a statistical measure of volatility or how consistent returns are over time; a lower standard deviation indicates historically less volatility.

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