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The Real Deal: Long/Short Equity

May 2010

In This Paper

This paper addresses Long/Short Equity in its purest form, which we define as a long equity portfolio that is offset, or hedged, by a short equity portfolio. This hedge typically is achieved via individual equity positions, which can be augmented with index shorts and/or options. The value of the short portfolio is two-fold. First, it provides a hedge. Second, it may also provide an incremental alpha opportunity as managers seek to profit from shorting stocks that underperform the market. True Long/Short Equity funds typically are net long, but have the ability to adjust the net exposure as markets shift, thereby potentially producing alpha, which is defined as the excess return beyond the benchmark. The manager may also choose to keep a portion of the portfolio in cash, should the prevailing markets warrant caution.

«Key Point»

"A look at the history of Long/Short Equity hedge funds shows that they have consistently outperformed long-only equity exposure and have done so with less risk."

A TRULY HEDGED FUND

Investors poured more than $7 billion into Long/Short Equity hedge funds in the latter half of 2009—more assets than any other hedge fund strategy.[†] Managers took advantage of the rising equity markets to increase their net exposures and produced gains on the long side in 2009. The strategy rewarded investors with a 24.6% gain for the year, beating the overall returns of 20.0% for the hedge fund industry as a whole in 2009.[‡]

What attracts investors to Long/Short Equity hedge funds is their tendency to exhibit a strong absolute return performance profile across a broad array of market conditions.

A look at the history of Long/Short Equity hedge funds shows that they have consistently outperformed long-only equity exposure and have done so with less risk. The ability to shift exposure in changing market conditions allows the strategy to participate on the upside in rising equity markets while protecting capital in adverse market conditions.

WHAT IS A LONG/SHORT HEDGE FUND?

Given the amount and range of media coverage dedicated to hedge funds today, let's step back and define what a hedge fund is, and then get to the matter of specifically defining a true Long/Short Equity hedge fund, along with its historical and ongoing role in a portfolio.

There likely are as many definitions of hedge funds as there are people you can ask for a definition of a hedge fund. For our purposes, hedge funds are private investment partnerships in which the manager of the fund is able to trade in a variety of global markets, with the ability to be long and/or short, using both cash and leveraged positions. Typically, the manager has a significant personal stake

[†]SOURCE: Credit Suisse/Tremont

[‡]SOURCE: Hedge Fund Research, Inc.)

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in the fund, which aligns the incentives of the manager with those of investors in the fund.

KEY DRIVERS OF GROWTH

One industry insider speculates that in the 1970s there were no more than 30 hedge funds with the largest having approximately $50 million under management. The 1980s saw the scions of the industry introducing their funds, including George Soros, Michael Steinhardt and Julian Robertson. Access to hedge funds was largely limited and the bulk of the assets under management came from high-net-worth investors, with only a smattering of more progressive endowments and foundations investing. Hedge funds were strictly a "cocktail industry" and not yet institutionalized. Investment decisions depended largely upon personal recommendations and introductions.

The 1990s was the decade in which hedge fund investing began to flourish, particularly the Long/Short Equity model. Many equity traders left their institutional desks to start hedge funds for the increased flexibility in trading style. In his book *Absolute Returns: The Risk and Opportunities of Hedge Fund Investing*, Alexander Ineichen notes that by 2001, more than 50% of the existing hedge funds were a variant of the Alfred Winslow Jones' Long/Short model (see sidebar below). Long/Short Equity had many advantages as a strategy, not the least of which was that it was relatively straightforward and easy to understand from an investor's point of view. The instruments were publicly traded and the terminology—large-, mid- and small-cap, value and growth—addressed concepts with which investors were already familiar. Other advantages came in the form of liquidity and capacity. In addition, Long/Short Equity managers had advantages not available to their long-only brethren—namely the ability to go short or go to cash if the market conditions were unfavorable.

« Key Point »

"In just one decade, hedge funds had grown from an "exclusive club" industry to an asset class, with Long/Short Equity funds representing more than half of assets under management."

According to Hedge Fund Research, Inc., in 1990, the hedge fund industry had assets under management of $38.9 billion, climbing to $456.4 billion by the close of 1999. Pension funds and endowments were increasingly entering the fold, including large respected institutions such as the California Public Employees' Retirement System ("CalPERS"), Harvard and Yale. In just one decade, hedge funds had grown from an "exclusive club" industry to an asset class, with Long/Short Equity funds representing more than half of assets under management.

The Jones' Move to the Investment Neighborhood

Alfred Winslow Jones is widely credited with creating the first "hedged fund" in 1949. That same Long/Short Equity fund exists today, which is a testament to the strategy's endurance. Prior to founding his eponymously named financial firm, Jones was a reporter and editor for *Fortune* magazine. Jones penned an article for *Fortune* entitled "Fashions in Forecasting" that sparked the ideas for the first "hedged" fund.

Fascinated by the technical analysis which market forecasters were using, Jones strongly doubted their abilities to consistently predict market direction. This led him to think about how to take advantage of gains in the market, while cushioning the blow of downward swings. His thought process resulted in the development of the model for the original Long/Short Equity fund. Jones consistently stressed that his was a "hedged fund" and not just a "hedge fund," pointing out that the most important characteristic of it was that the fund must be hedged.

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THE ANATOMY OF LONG SHORT

Long/Short Equity hedge funds have comprised the lion's share of hedge fund assets since 1949. What drives these funds' longevity is the combination of effective stock selection and managing market exposure. The strength of a Long/Short Equity hedge fund comes from two factors. One, its manager's success in picking stocks on both the long and the short sides. Two, adjusting net market exposure up or down as appropriate to market conditions. Let's look at this in more detail.

1. Stock Selection

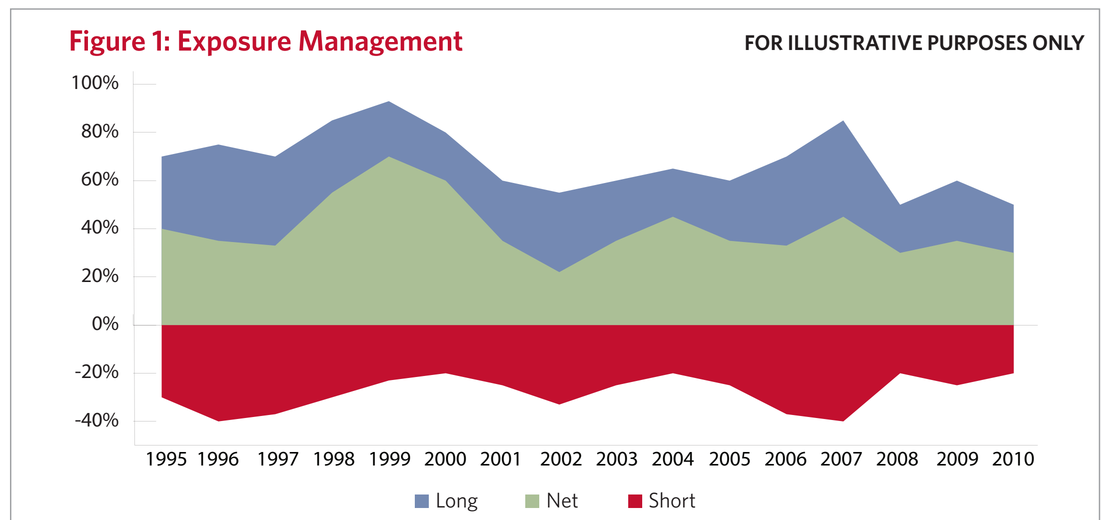
First and foremost, the manager's ability to pick stocks is a critical component of these funds and a core element in their ability to generate alpha. This is an important aspect in which Long/Short managers differentiate themselves from traditional long-only funds, for they must pick stocks on both the long and short sides and simultaneously understand and manage the delicate balance between them. Selecting stocks is a fundamental, research-driven process for both long and short portfolios. The process can vary from manager to manager, but typically will involve some combination of financial statement analysis, conversations with company management teams, suppliers, and/or customers, as well as a more subjective or innate ability by the manager to evaluate market dynamics. Common metrics used to compare stocks include valuation ratios, such as price-to-earnings, efficiency ratios such as return-on-equity, and leverage ratios such as debt-to-equity. Managers may invest in specific sectors (e.g., energy, consumer, financial services, technology); geographic regions (e.g., Asia, emerging markets, G7); and/or styles (value or growth). While similar factors are frequently analyzed on the long and short side, there is a definite art involved in short stock selection that cannot be attributed to metrics alone.

2. Managing Market Exposure

The second component of Long/Short Equity funds is the ability to manage market exposure. A Long/Short Equity fund will adjust its long/short exposure to changing market conditions over time. Higher net long exposures (long exposure minus short exposure) will generally correspond with periods of increased bullishness, while lower net exposures would typically indicate a more bearish outlook and/or cautious positioning (**See Figure 1**).

« Key Point »

"What drives Long/Short Equity funds' longevity is the combination of effective stock selection and managing market exposure."



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Long/Short portfolios can be highly flexible, with the exposure adjusted to react appropriately to market conditions.

This ability to adjust exposure on both the long and the short portfolios provides an edge over traditional long-only portfolios, where the manager must rely exclusively on stock-picking abilities. A Long/Short Equity hedge fund manager may carry a long bias, meaning the value of the long portfolio exceeds that of the short portfolio. This means that the manager is directionally exposed to the risk of the equity markets, which may be appropriate in one set of market conditions. Should those conditions shift, or should a manager astutely anticipate a shift, that same manager may shift the long exposure downward and the short exposure upwards in an effort to reduce exposure to the equity markets. Additional alpha may be generated by the manager's ability to pick stocks on both the long and the short sides.

In **Figure 2**, the portfolio on the left illustrates a representative Long/Short Equity portfolio, adjusted to hedge against swings in the market, while the portfolio on the right, which is 100% net long (high beta), leaves the portfolio vulnerable to swings in the equity markets.

STACKING UP THE HEDGES

Now that we've looked at the process and how the funds work, how do they stack up over time? In times of crisis, Long/Short Equity as measured by the HFRI Equity Hedge Index, has consistently outperformed the Standard & Poor's (S&P) 500 Total Return (TR) Index. Let's look at four time periods that roiled the equity markets for very different reasons and assess how the advantages of long and short stock-picking, combined with actively managing market exposure, stacked up against the S&P 500 TR index. The four periods shown below represent different stresses on the market and demonstrate the performance of Long/Short Equity hedge funds in each of those different conditions.

« Key Points »

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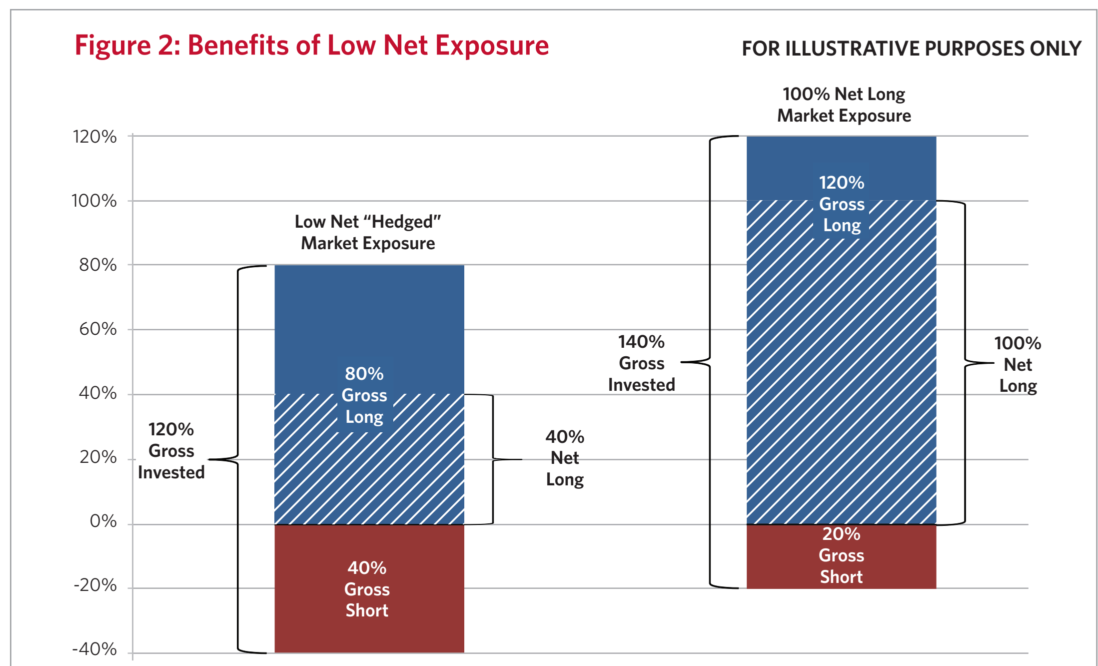
"In times of crisis, Long/Short Equity has consistently outperformed the Standard & Poor's (S&P) 500 Index."



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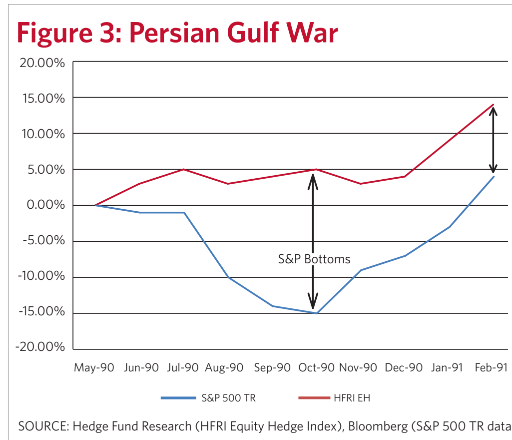
I. First Persian Gulf War (1990 - 1991)

In the lead up to the Gulf War, the United States economy was suffering from rising crude oil prices due to ongoing supply concerns. From June to October of 1990, the S&P 500 TR fell 14.69% while the HFRI Equity Hedge Index saw a gain of 5.10% (see **Figure 3**).

It took until February 1991 before the S&P 500 TR fully recovered from its previous losses, whereas from June 1990 to February 1991 the Long/Short Equity HFRI index gained 14.48%.

II. Russian Default (1998)

Figure 3: Persian Gulf War



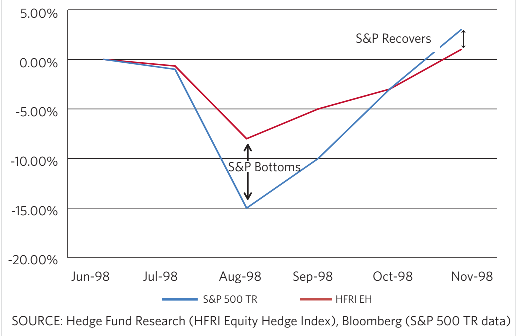
SOURCE: Hedge Fund Research (HFRI Equity Hedge Index), Bloomberg (S&P 500 TR data)

Following a series of financial and political crises, the Russian government defaulted on their sovereign bonds in August of 1998, sending global markets into turmoil. From July to August 1998 Long/Short Equity hedge managers posted a loss of 8.27% while the S&P 500 TR lost nearly twice that amount, down 15.37% (see **Figure 4**).

« Key Point »

"As evidenced by the four crisis periods, Long/Short Equity hedge fund managers, by virtue of their ability to pick stocks—both long and short—and manage market exposure have historically shown an ability to outperform in adverse and unpredictable markets."

Figure 4: Russian Default

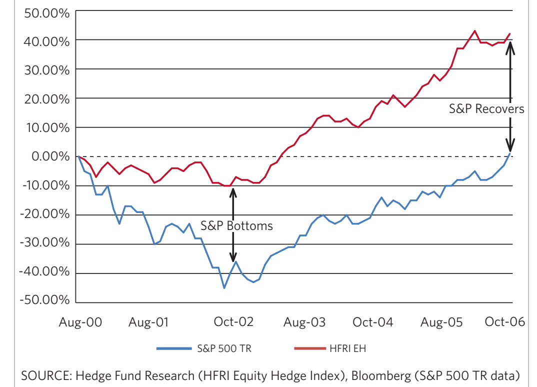


SOURCE: Hedge Fund Research (HFRI Equity Hedge Index), Bloomberg (S&P 500 TR data)

III. Tech Bubble (2000)

From September 2000 to September 2002, equity markets shuddered under the collective weight of the dot.com collapse, the terrorist attacks of September 11, 2001, and the accounting scandals at Enron and WorldCom. During this period, the S&P 500 TR lost 44.73%, while Long/Short Equity managers in the HFRI index posted a loss of 10.30%. The S&P 500 TR hit a bottom in September 2002 and did not recover until October 2006. During the period, from September 2000 through October 2006, Long/Short Equity funds posted a gain of 42.01%, significantly outperforming the S&P 500 TR (see **Figure 5**).

Figure 5: Tech Bubble



SOURCE: Hedge Fund Research (HFRI Equity Hedge Index), Bloomberg (S&P 500 TR data)

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IV. Credit Crisis (2007-2009)

During the recent financial crisis, the S&P 500 TR found a bottom in February 2009 but has yet to fully recover from its peak as of April 2010. From November 2007 to February 2009 the S&P 500 TR lost 50.95%, the HFRI Equity Hedge Index lost 30.57% . At of the end of April 2010, the S&P 500 TR remains down 18.85% from its October 2007 peak, while the HFRI Equity Hedge Index is down just 6.96% over the same period (see **Figure 6**).

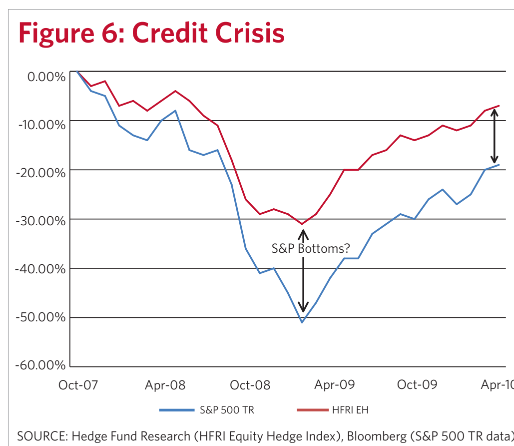

Figure 6: Credit Crisis

SOURCE: Hedge Fund Research (HFRI Equity Hedge Index), Bloomberg (S&P 500 TR data)

As evidenced by the four periods above, Long/Short Equity hedge fund managers, by virtue of their ability to pick stocks—both long and short—and manage market exposure have historically shown an ability to outperform in adverse and unpredictable markets. Although past performance is not always an indication of future performance, Long/Short Equity managers hace demonstrated a potential for providing significant downside protection when properly added to an investment portfolio.

UPSIDE PERFORMANCE

In addition to downside protection during times of crisis, Long/Short Equity funds have historically provided investors with attractive long term returns. Given their generally long bias, Long/Short Equity funds are designed to participate in market gains during bull market periods. During the past twenty years, from January 1990 through April 2010, the HFRI Equity Hedge Index gained 1,383% while US stocks were up just 419%. In other words, $1,000 invested in Long/Short Equity would have grown to $14,827 compared with $5,187 in the S&P 500 TR Index (**see Figure 7**).

« Key Points »

"In addition to downside protection during times of crisis, Long/Short Equity funds have historically provided investors with attractive long term returns."

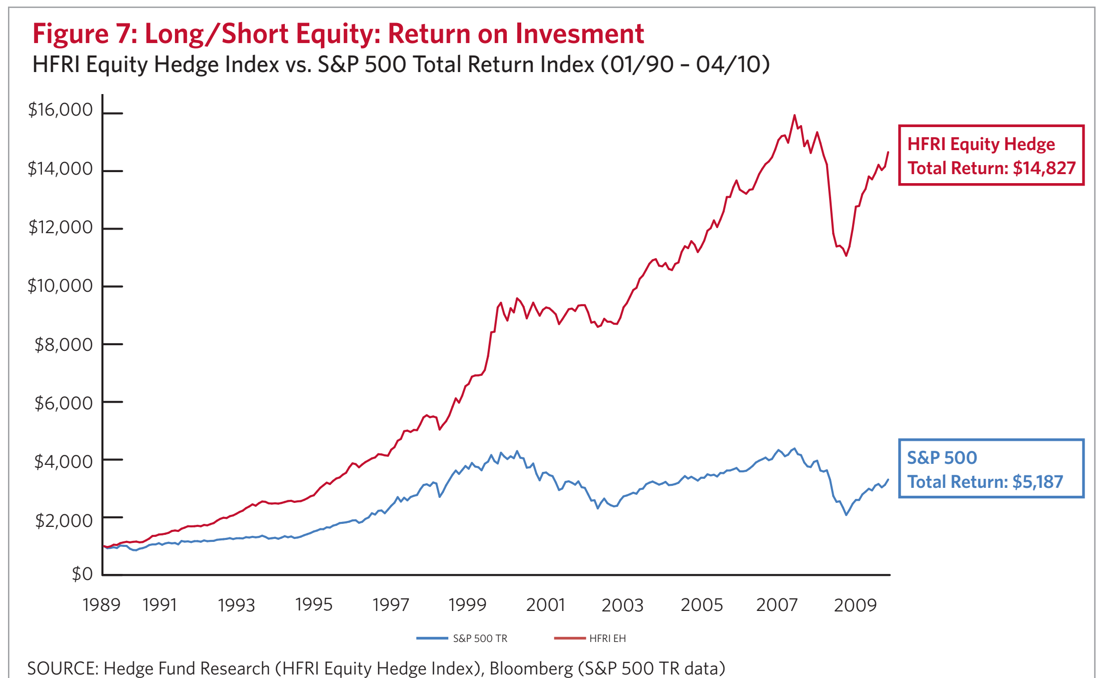

Figure 7: Long/Short Equity: Return on Invesment

HFRI Equity Hedge Index vs. S&P 500 Total Return Index (01/90 – 04/10)

SOURCE: Hedge Fund Research (HFRI Equity Hedge Index), Bloomberg (S&P 500 TR data)

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SEEKING THE RIGHT ALPHA MANAGER

Once the decision has been made to include Long/Short Equity in the portfolio, finding and choosing the appropriate Long/Short Equity hedge fund manager(s) is the next step. Selecting a hedge fund manager is a very different process from buying a mutual fund and requires a different set of skills, in the same way that selecting long and short stock portfolios need different skills. There are a three issues to keep in mind when conducting due diligence on a Long/Short Equity hedge fund manager.

First, not all Long/Short Equity hedge fund managers are alike. A manager should be a sound fundamental stock-picker for both the long and short portfolios. This is significant because it is the fundamental stock-picking ability that will generate much of the fund's alpha. Also, just because a manager does well on the long side does not automatically ensure equal skill on the short side. It is important to understand how the manager makes stock choices and what kind of research underlies these decisions.

Second, the skilled manager must also be able to manage the delicate balance between the portfolio's long and short exposures within the fund's stated investment framework. Specifically, an investor must understand how a manager adjusts the portfolio to ever-changing market conditions. Can the manager opportunistically shift exposures within the stated objectives or does the manager stray from his investment mandate when conditions become adverse?

Third, due diligence is an ongoing process. It is not simply about whether the manager is "hedged" and if the fund fits in a portfolio and delivers the desired performance. It is also about monitoring processes on all sides of the management firm, including operations and trading both initially and on an ongoing basis. It is making certain that the hedge fund manager is doing what it said it would do at all times and that there is no fraud or style drift.

IS NOW AS GOOD A TIME AS ANY?

Long/Short Equity hedge funds have demonstrated the ability to provide strong absolute returns across a broad array of market conditions. A relatively straightforward and mostly transparent hedge fund strategy, Long/Short Equity is reasonably liquid, which allows managers to remain nimble, providing they have sufficient assets under management and are not heavily invested in the small or micro-cap equities market.

While Long/Short Equity managers can navigate different market environments by adjusting their net and gross exposures, it is also their ability to pick stocks long and short that is the core of their potential alpha generation. This alpha is easiest to generate when correlations between individual stocks is relatively low. If stocks are highly correlated, longs and shorts will tend to move together, dampening the benefits of superior stock selection. However, if correlations are low, a manager should be able to benefit from the difference in performance between good and bad stocks.

« Key Point »

"While Long/Short Equity managers can navigate different market environments by adjusting their net and gross exposures, it is also their ability to pick stocks long and short that is the core of their potential alpha generation."

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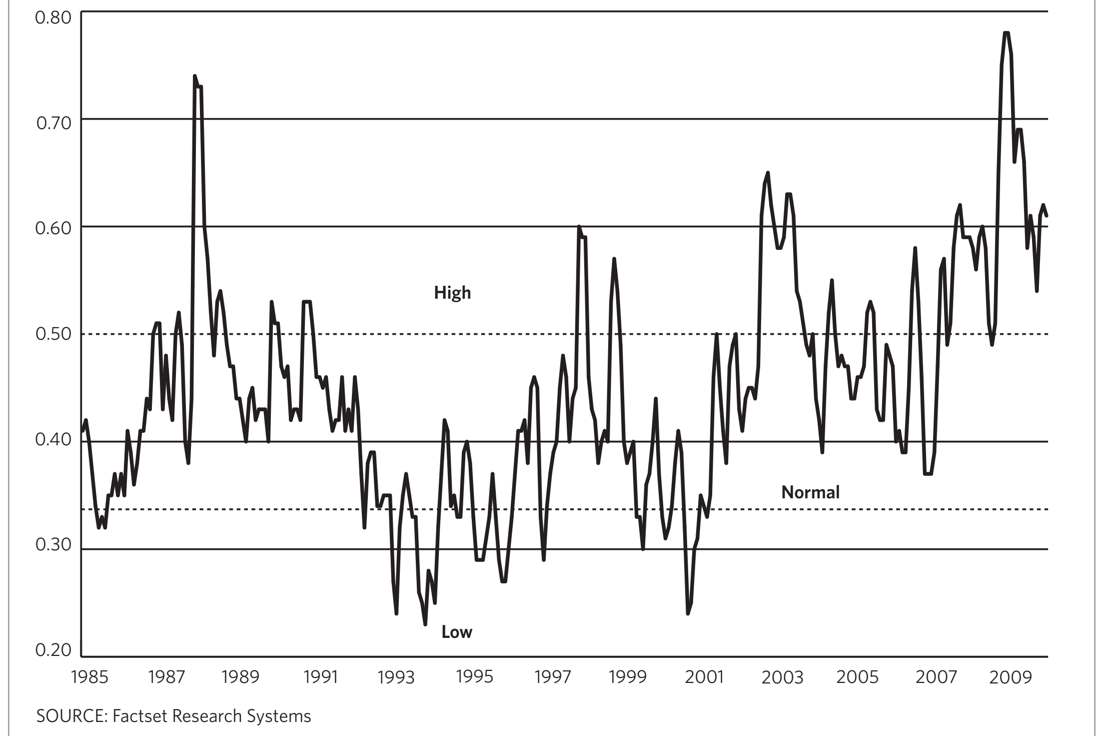
Figure 8: Average 60-Day Rolling Correlation of Single Stocks vs. Group Based on Top 500 US Public Companies (Market Value)

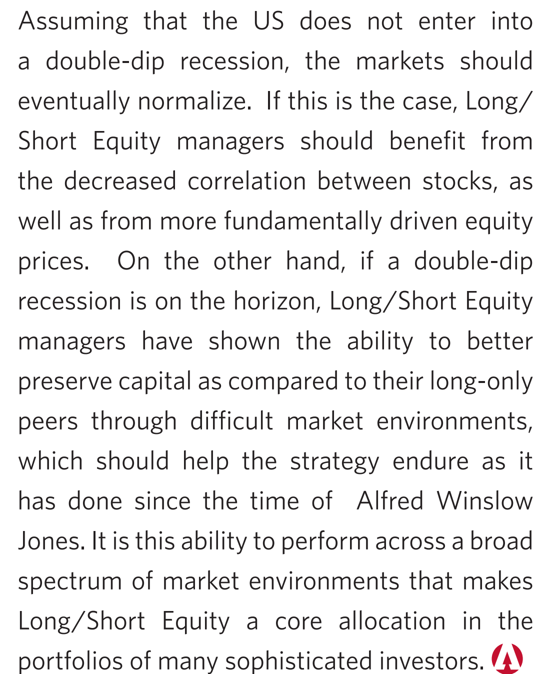


« Key Point »

"If the recent high correlation in stocks normalize, Long/Short equity managers should benefit."

Recently, individual stocks have been highly correlated to one another, especially during 2006-2009, as indicated in the above graph (**see Figure 8**).

Periods of high correlation do not last forever and tend to be mean reverting. They are also often the result of macroeconomic issues, which can result in market stress. Such periods of duress can result in broad based equity declines with little differentiation between good and bad companies. Subsequent central bank stimulus often results in upward momentum movements across individual equities, perpetuating the high correlation. Once markets normalize, and macro influences abate, idiosyncratic influences generally return, and individual equity fundamentals can once again affect stock price movement.



Assuming that the US does not enter into a double-dip recession, the markets should eventually normalize. If this is the case, Long/Short Equity managers should benefit from the decreased correlation between stocks, as well as from more fundamentally driven equity prices. On the other hand, if a double-dip recession is on the horizon, Long/Short Equity managers have shown the ability to better preserve capital as compared to their long-only peers through difficult market environments, which should help the strategy endure as it has done since the time of Alfred Winslow Jones. It is this ability to perform across a broad spectrum of market environments that makes Long/Short Equity a core allocation in the portfolios of many sophisticated investors.

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GLOSSARY

Alpha - Alpha measures the non-systematic return, that which cannot be attributed to the market. It shows the difference between a fund's actual return and its expected return, given its level of systematic (or market) risk (as measured by beta). A positive alpha indicates that the fund has performed better than its beta would predict. Alpha is widely viewed as a measure of the value added or lost by a fund manager.

Beta - A measure of the relationship of a fund's movement relative to a benchmark, such as a market index. Beta is the correlation (a measure of the statistical relationship between fund and benchmark) multiplied by the magnitude of relative volatility of the fund to the benchmark. A fund with a beta of 1.2 relative to a benchmark, for example, is expected to move 12% when the benchmark moves 10%. When the fund is comprised of the same instruments as the benchmark, beta can be thought of as a measure of relative volatility. A low beta does not necessarily indicate that the fund has low volatility, rather, it may indicate that the fund's returns are not related to the movement of the market benchmark.

Correlation - A statistical measure of the degree to which the movements of two variables are related. For example, a hedge fund's returns may have positive or negative correlation with the market.

Leverage - When investors borrow funds to increase the amount that they have invested in a particular position, they use leverage. Investors use leverage when they believe that the return from the position will exceed the cost of the borrowed funds. Sometimes, managers use leverage to enable them to take on new positions without having to liquidate other positions prematurely. Leverage can effectively increase the potential for higher capital gain returns on investment capital, but can also increase the risk of greater capital loss.

Liquidity - The ability to exit positions on demand. Many hedge funds may not want to or may not be able to exit positions on demand. Redemptions are normally limited to once a week, once a month, or even longer periods.

S&P 500 Total Return Index - This 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 U.S. 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.

HFRI Equity Hedge Index - Equity Hedge investing consists of a core holding of long equities hedged at all times with short sales of stocks and/or stock index options. Some managers maintain a substantial portion of assets within a hedged structure and commonly employ leverage. Where short sales are used, hedged assets may be comprised of an equal dollar value of long and short stock positions. Other variations use short sales unrelated to long holdings and/or puts on the S&P 500 index and put spreads. Conservative funds mitigate market risk by maintaining market exposure from zero to 100 percent. Aggressive funds may magnify market risk by exceeding 100 percent exposure and, in some instances, maintain a short exposure. In addition to equities, some funds may have limited assets invested in other types of securities.

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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.

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- Returns from some alternative investments can be volatile
- There may be a substantial risk of loss: you may lose all or portion of your investment
- The high degree of leverage often attainable in alternative investments can work against you as well as for you. The use of leverage can lead to large losses as well as gains
- With respect to single manager products, the manager has total trading authority. The use of a single manager could mean a lack of diversification and higher risk
- Many alternative investments are subject to substantial expenses that must be offset by trading profits and other income. A portion of these fees includes payments to Altegris
- Trading may take place on foreign exchanges that may not offer the same regulatory protection as US exchanges. Such trading may also entail exchange rate risk
- Past results are not necessarily indicative of future results

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Altegris Investments

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