Hedge Fund Strategy Spotlight: Equity Long Short:

This is the first of a series of Strategy Spotlights which will describe as simply as possible, certain popular hedge fund strategies. The content will be amended and added to from time to time and eventually the whole series will be uploaded to a perpetual part of this site as a reference guide.

Part 1: What is equity long short?

Most investors will be familiar with investing in equities. In the capital structure of a firm, equity is the most basic form of capital and represents share ownership. A company can be capitalized in a number of ways, including common equity, preferred equity, and various types of debt such as convertible bonds, junior debt, mezzanine debt, senior unsecured debt, senior secured debt and bank loans. Trade creditors and employees also represent a claim on the assets of a company. Equity long short investors concentrate on investing in the common equity of companies. They sometimes venture into preferred equity and sometimes invest or trade in equity derivatives such as futures, options and swaps.

Long only equity investing is the traditional form of investing we are familiar with. If we like a company, we buy its shares in the hope of selling them later at a higher price or collecting an attractive dividend stream. Most mutual funds investing in equities do it this way. A long only portfolio of equities will typically be highly correlated to the broad market as a whole. Thus a rising market helps the strategy while a falling market hurts the strategy.

The equity long short strategy involves buying long equities that are expected to increase in value and selling short equities that are expected to decrease in value. The rationale behind this approach is to achieve low or lower correlation to equity markets, or absolute returns, by which is meant low to lower dependence on the direction of the broad market as a whole. Equity long short strategies are therefore expected to make money regardless of whether the equity markets are rising or falling. In the long run, they seem to have achieved their objective although in particular periods such as 2008, they have displayed strong correlation to the underlying markets. There are reasons for this which we shall explore later.

Broad Approaches:

Equity long short is a very broad strategy and within it there are various approaches. No one is better than another but certain managers are just better at certain approaches than others.

The fundamental bottom up approach: Under this approach the manager selects stocks that they like or dislike based on examining the fundamental soundness and growth potential of companies, and then decides if market prices represent good or poor value. In some way, shape or form, most managers who take this approach are value driven investors hoping to identify relatively underpriced companies.

The top down thematic approach: Under this approach the manager first assesses the macroeconomic landscape, demographics, regional dynamics and industry prospects in their search for companies in which to invest long or short.

Hybrid approaches: It is rare to find managers who are entirely driven by fundamentals or entirely driven by themes. The more common approach is to try to apply the best of both approaches. A manager leaning towards a fundamental approach may first perform fundamental analysis in their security selection and then apply a thematic or macro approach as they construct the portfolio, neutralizing particular exposures. A manager leaning towards a thematic approach will often apply fundamental analysis at the final stage of their process in search of particular securities to express their thematic view.

Portfolio Construction:

The ability to distinguish between winners and losers is but one part of the strategy. Portfolio construction, trading ability and risk management are other important elements in any investment strategy. Portfolio construction involves constructing a collection of stocks, allocating the appropriate amount of risk capital to each position so that each position has a meaningful impact on the performance of the whole, while being sufficiently diversified that no single position going wrong can severely impact the portfolio’s performance.

Diversification and balance are considerations in limiting the extent that a particular sector (such as autos or energy or transportation or banks) or particular factor (such as interest rates, exchange rates, government regulation or policy).

An example is to balance a long position in Fiat with a short position in Renault. This hedges out the auto sector exposure, but it leaves the paired position open to country risk (long Italian versus short French stock), source of earnings risk (Renault is exposed to Nissan which is in turn exposed to the US economy), price point risk (Fiat has a luxury division selling Ferraris and Maseratis). Some of these risks are actively sought and may be the theme that is being expressed. For example one might be actively seeking exposure to the luxury sector, or to US versus European relative outperformance.

Some positions reinforce each other. A long Royal Dutch Shell position would likely be reinforced by a short Lufthansa position since energy (aircraft fuel) is a large cost component for Lufthansa.

Before we look at Market Neutral funds, its useful to look at some terminology.

The Gross Exposure of a fund is the sum of the Long Exposure and the Short Exposure. If a fund has 100 USD of investor capital and buys 70 USD worth of stocks long and sells short 50 USD worth of stocks, then the long exposure is 70% and the short exposure is 50%. The gross exposure is then 70+50 = 120%.

The Net Exposure of a fund is the difference between the Long Exposure and the Short Exposure.
If a fund has 100 USD of investor capital and buys 70 USD worth of stocks long and sells short 50 USD worth of stocks, then the long exposure is 70% and the short exposure is 50%. The net exposure is then 70-50 = +20%.

As a whole, equity long short funds tend to run with a long bias, that is their net exposure is typically and for the most part, non negative.

Notional exposure is of course but one measure of the level of leverage in an equity long short strategy. Different stocks have different volatility, that is one stock may exhibit more variability than another. The long portion of the portfolio, called the long book, will often have a different level of variability than the short book.

Taking into account the variability of stocks when sizing positions is an important part of portfolio construction.

A subtlety about shorting. When a position gains by 10% twice it gains by 21%. When a position declines by 10% twice, it declines by 19%. A long position that rises becomes bigger and a short position that falls becomes smaller. Thus, winning short positions become smaller and losing short positions get bigger. Conversely, winning long positions get bigger and losing long positions get smaller.

The use of futures, options, ETFs and swaps:

Often, a manager has a certain predisposition to being long or short. Most managers are better at selecting what to buy than what to short. It is possible to use index futures, sector futures, exchange traded funds and options as well as total return swaps to obtain specific hedging exposures for the portfolio. Once a manager uses derivatives, the strategy can get complicated if there are non-linear payoffs and financing issues introduced into the portfolio. Of course the operational aspects of venturing into derivatives are an important complication as well. Some investors do not like their managers to use derivatives in their trade expression. Common complaints are:

Shorting with a futures contract or ETF is seen as adding less value than finding a stock specific hedge or balancing position.

An index or ETF hedge introduces more exogenous risk since an index is itself composed of a collection of stocks.

Options may be used but the manager should understand the non-linear nature, the implied leverage, the time value and volatility attributes of options.

Market Neutral:

Some hedge funds choose to run a market neutral portfolio. In theory, this insulates the portfolio from broad market directional moves. Theoretically at least, the returns of the portfolio become dependent purely on the ability of the manager to distinguish between winners and losers and to invest accordingly. But market neutrality is a difficult concept, and even if conceptually resolved, is difficult to achieve in practice.

Different stocks exhibit different variability. The variability also varies with time. A stock that is volatile today may not be as volatile tomorrow.
Large stocks behave differently from small stocks, value stocks behave differently from growth stocks, autos from energy, banks from insurers and so on.
To construct a portfolio that is neutral with respect to market capitalization, value/growth, sector and industry exposure, is not easy.

Styles:

Every manager has their own style. Each style is suited to certain market environments. Generally there are two styles which unfortunately are rarely found together in the same organization and almost never found in the same person. The two approaches are almost mutually exclusive.

The Trader: A trader operates on the basis that the market will tell him if his right or wrong. If a trader likes a company and buys the stock, his view is confirmed if the stock rises and contradicted if the stock falls. Beyond a certain limit, the trader will cut his losses and either look elsewhere or try again later. A trader’s stop loss is therefore usually tighter and his turnover or trading activity, much higher. Their investment horizon is usually much shorter and depends on market volatility, and can range from intra day, to days to a few months.

The Investor: The investor takes positions with great conviction. It takes a greater price action to convince an investor that he is wrong. Stop losses are therefore wider and tolerance of losses is usually higher. For the investor, the stock price is less important a signal than the information about the underlying business, the quality of management, the strength of the business model. Their investment horizons are usually much longer lasting from 6 months to multiples of years.

Sector Specialists: Some sectors are highly technical and lend themselves to sector specialists. Healthcare which includes pharmaceuticals, medical equipment, services, biotech, is one good example. Some managers either hire or were previously industry practitioners who have crossed over to the finance industry. Technology, Media and Telecoms or Banking and Financials is another example of where sector specialists excel. Commodity related equity managers are also a growing area of specialization as is the very exciting are of Clean Technologies and Renewable Resources. Very often, sector specialists are also supply chain specialists, understanding an industry in great depth and picking winners and losers not just across a sector but vertically along their supply chains.

Country or Regional Specialists: Certain markets, particularly emerging markets have local peculiarities. In Asia, the ASEAN subset is one such area, India, China, Eastern Europe, Russia, Latin America are all areas where specialist managers are active and effective.

Part 2 will look at the Operational Issues, basically the plumbing of the equity hedge fund.