Strategy Spotlight: Equity long short, One Manager's Approach

While 2008 was a difficult year for many hedge fund managers, there are those who have done well despite the difficult trading conditions. I would like to highlight one of them, not so much for their performance, which has been good, in 2007 the manager returned over 25% and in 2008 over 10%, but because of the approach, discipline and sophistication. Because I am not in the business of promoting managers, I will not name them.

The manager operates an equity long short strategy based on the careful selection of stocks based on fundamentals rather than trading frequently on technicals. The fund is run by two portfolio managers who have worked together for some 6 years and who have honed their process over the years. The aim of the fund, as in most hedge funds is to make money over the cycle but more importantly to deliver absolute return so that it matters not when an investor invests in the fund or redeems from it. This is important. Too many hedge funds make and lose money too violently that an investor has to be careful when they invest and when they exit.

What are the ingredients of their success?

First of all, it makes intuitive sense. And it is simple. That is important. Investment strategies should make intuitive sense. Even if a strategy may be counter-intuitive, the manager should be able to explain away the counter-intuition to the point that the intuitive logic becomes evident. If the strategy is simple, it certainly helps this understanding.

Second of all, it is highly process driven. This means that the strategy can be repeated again and again with success. And the probability of accidents and bad luck is minimized. It also instills discipline and discourages laziness, sloppiness, and the ever present will to make exceptions and trade against the odds.

Thirdly, the strategy is rooted in academic rigour and research. The clever intuitive conjectures have been formalized into theory and have been tested against real life data. In other words, the strategy has been verified and validated.

Fourthly, and this is less advertized by the manager themselves, the strategy involves a high level of sophistication in the actual implementation and execution. They say that the devil is in the detail. It is.

So how does the strategy work? It relies on good stock selection and robust risk management. How then does the manager select stocks? They try to take advantage of the errors that people make in forecasting. Specifically, managers of companies must have some expectation for how well or poorly they will do. They will have the same expectations when they decide to increase or decrease capital expenditure, take on a project, hire or fire. Every business decision has behind it some objective and some expectation of return. Managers are not always good at assessing the return potential of the projects they undertake. The fund managers capitalize on this tendency, of emotion and irrationality on the part of company management, in order to form opinions about the quality of businesses, upon which they then bet, long or short.

The fund manager focuses on company cash flow metrics to capture the success versus expectations of company management. This is a bit more sophisticated than buying companies with strong cash flows and selling those with weak cash flows. As part of the process, two cash flow ratios are used to filter and screen for prospective companies to buy and sell. The first is an indication of the cumulative cash flow efficiency of a company, namely cash flow as a proportion of operating assets, and the second is cash flow yield. The first metric tries to discover if company management is making judicious use of capital in generating cash flow. The second metric attempts to determine investors pricing of the cash flow generative capacity of a company. Generally, they are long efficient allocators of capital and short profligate management. This is a gross oversimplification of the process of course, but were it not, I would be able to replicate what they do. Natural adjustmen
ts need to be made for handling financials, or asset intensive industries, industries undergoing cyclical or secular capacity build. Beyond wholesale industry adjustments, forensic deconstruction of balance sheets and cash flow statements is necessary to put all the numbers on a comparable and useful basis. One other thing to note about this fund manager is that they do not rely on any broker or sell side research. Their views are entirely based on the financial statements of the companies they invest in, the information that these

companies provide from time to time, and their own opinions.

There is a strong behavioral element to their strategy which is not directly apparent. Investors and traders in the stock market are highly driven by the forecasts and guidance of company management. Company management forecasts are often highly autocorrelated. That is, they are slow to adjust to actual numbers. Company management who grossly underestimates their own profits don’t adjust to the correct number in one step. They usually do so gradually, erring on the side of being conservative. The same goes for over-confident company management. They are slow to adjust down. Investors themselves are slow to react to company management’s revisions of their own forecasts. This autocorrelation of investor reaction to autocorrelated management forecasts creates an interesting lag that can be capitalized upon.

Having a good strategy and process does not guarantee success. Nothing does. But it improves the odds. Having a good risk management process is also crucial, particularly in difficult times like these. The purpose of this article was to highlight a particular approach to equity long short investing so nothing is said here about risk management. The fund managers do run a diversified portfolio to prevent any accidents from hurting too much, and they have guidelines on stop losses and net and gross exposures as well as diversification guidelines.

Once again, I will not name the manager because I am not in the business of recommending hedge fund managers, at least not on this website. This website is for education purposes and for the airing of interesting views and opinions.