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Tribeca Investment Partners

The Future Role of Active Extension in Australia

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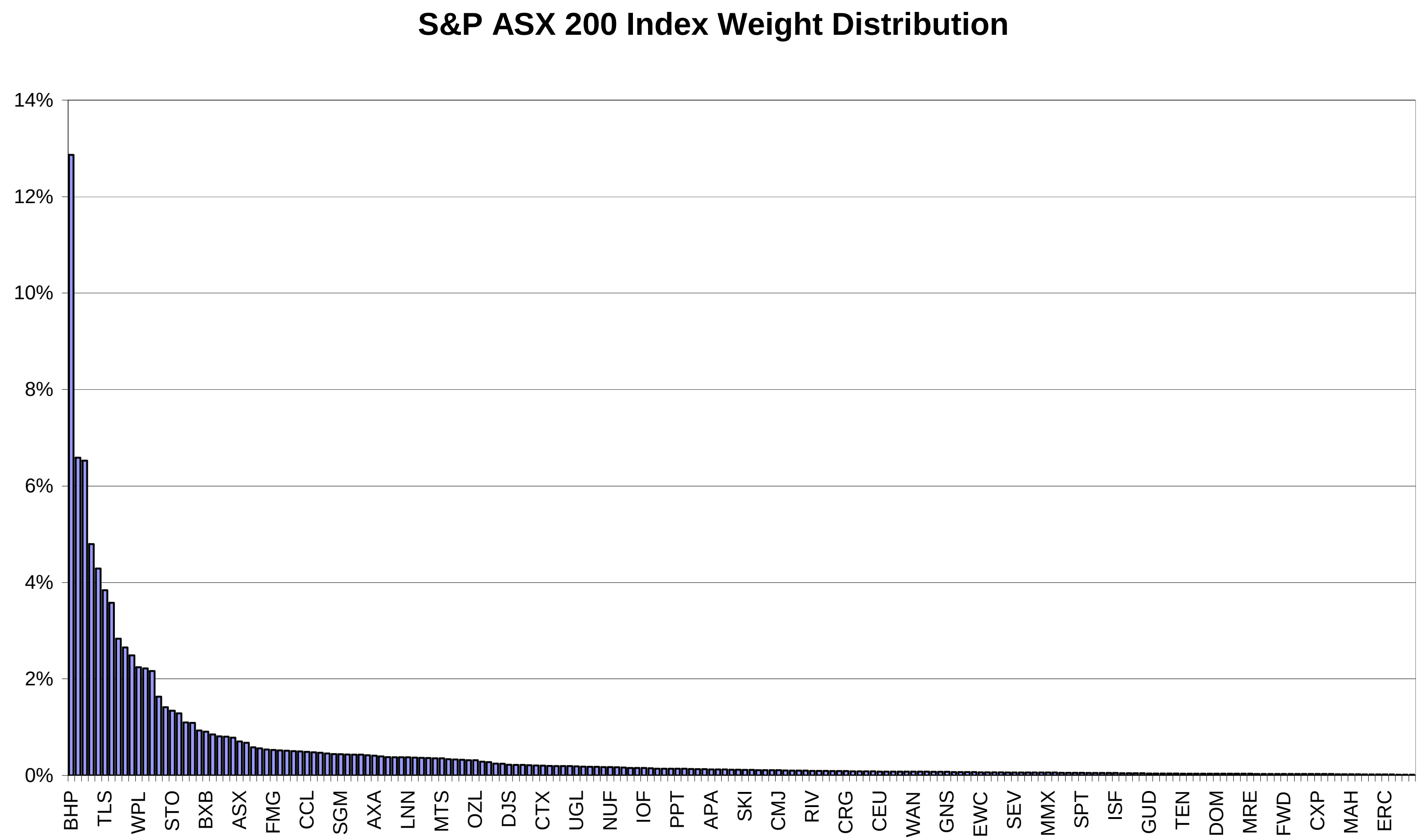
Agenda

- What is Active Extension?
- The Role of Short Selling
  - Treatment by regulators
  - Function in markets
- Advantages of Active Extension
- Evidence to Date
- Future for Active Extension

What is Active Extension?

- Active Extension involves short selling a range of stocks with weak investment characteristics and reinvesting the proceeds in preferred stocks
- Also known as Equitised Long Short or 130/30
- Different from a Hedge Fund
  - Hedge funds
    - Pure alpha, no beta
  - Active Extension
    - Full beta, more alpha
- Overcomes limitations of managing to a benchmark with a heavy market capitalisation skew

Active Extension



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Active Extension Rationale

- Significant market capitalisation skew in the Australian equity market
- Long only managers can only select underweights from a small group of large stocks
- This forces them to concentrate portfolios and take on style bias to achieve higher returns
- Active extension involves investors short selling some stocks and reinvesting the proceeds in preferred long positions
- Can capture more information (short alpha) with relatively less risk (greater distribution of active weights)

Short Selling is Controversial

- Short selling has had its controversies
- Throughout history it has been temporarily banned following market crashes
  - South Sea Bubble
  - Great Depression
  - Asia Crisis
  - Global Financial Crisis
- Regulators have viewed shorting as adding to market instability during times of panic

Impact of Short Bans

- Clifton and Snape (2008)
  - Studied the impact on liquidity for the FTSE 100 of the LSE ban
  - Found a general reduction in liquidity (increased spread, lower depth and turnover) for banned stocks
- Marsh and Niemer (2009)
  - Studied the impact on return distributions across 17 countries with short bans
  - Found no strong evidence of a change in the behaviour of stock returns
  - However, the period under study was too short and the exogenous influences too large to identify changes in informational efficiency

Regulatory View on Shorting

"The Commission notes that short selling plays an important role in the market for a variety of reasons, including contributing to efficient price discovery, mitigating market bubbles, increasing market liquidity, promoting capital formation, facilitating hedging and other risk management activities, and importantly, limiting upward market manipulations."

US Securities and Exchange Commission (2008)

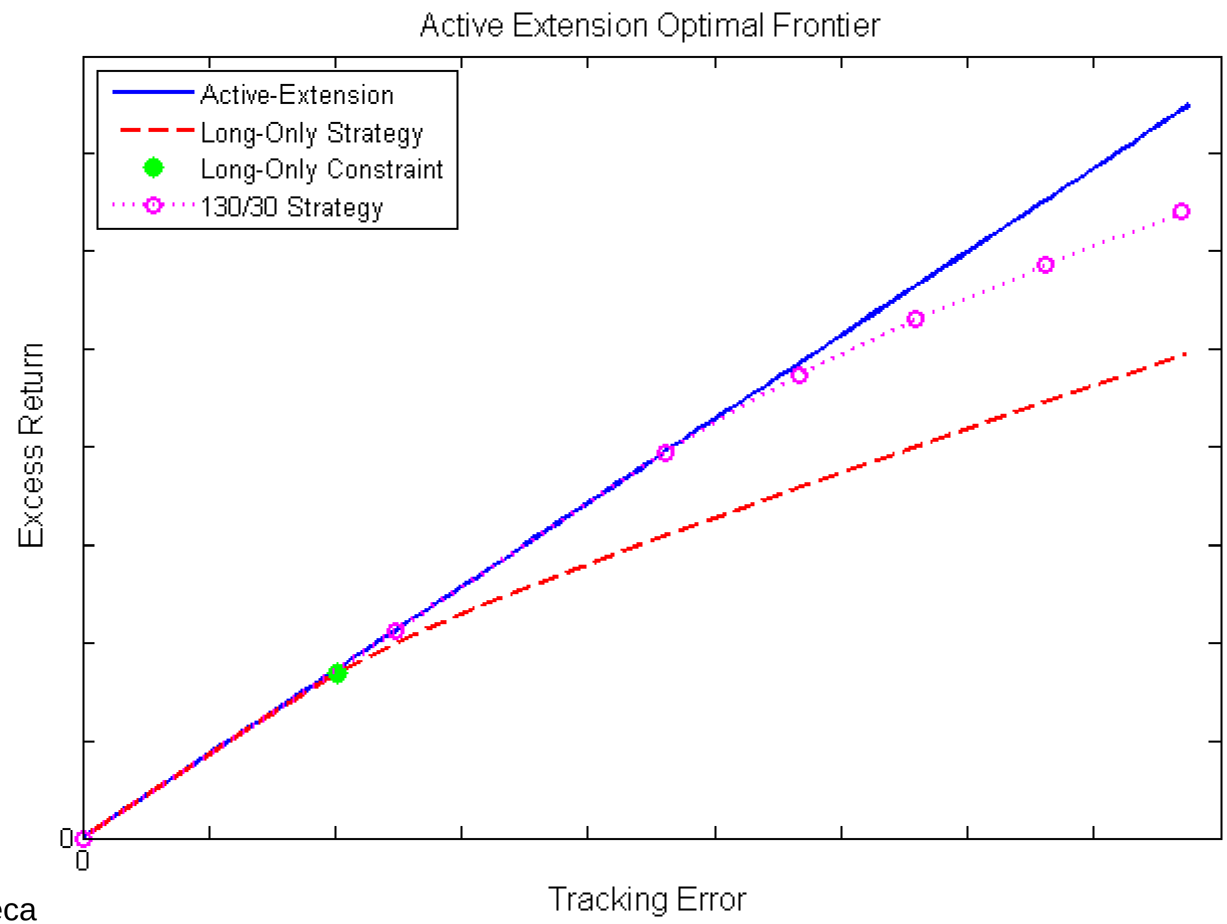
Active Extension Benefits

- Removal of the long only constraint allows managers to incorporate more information from the short side and improve the distribution of weights at higher tracking errors
- The challenge of active management is framed by Grinold and Kahn (2000) as:

$$\alpha_P / TE_P = TC \times IC \times \sqrt{N}$$

- Active managers can achieve better outcomes by increasing the predictive power of their stock research (IC) or their portfolio construction (TC)

Information Ratios Improve



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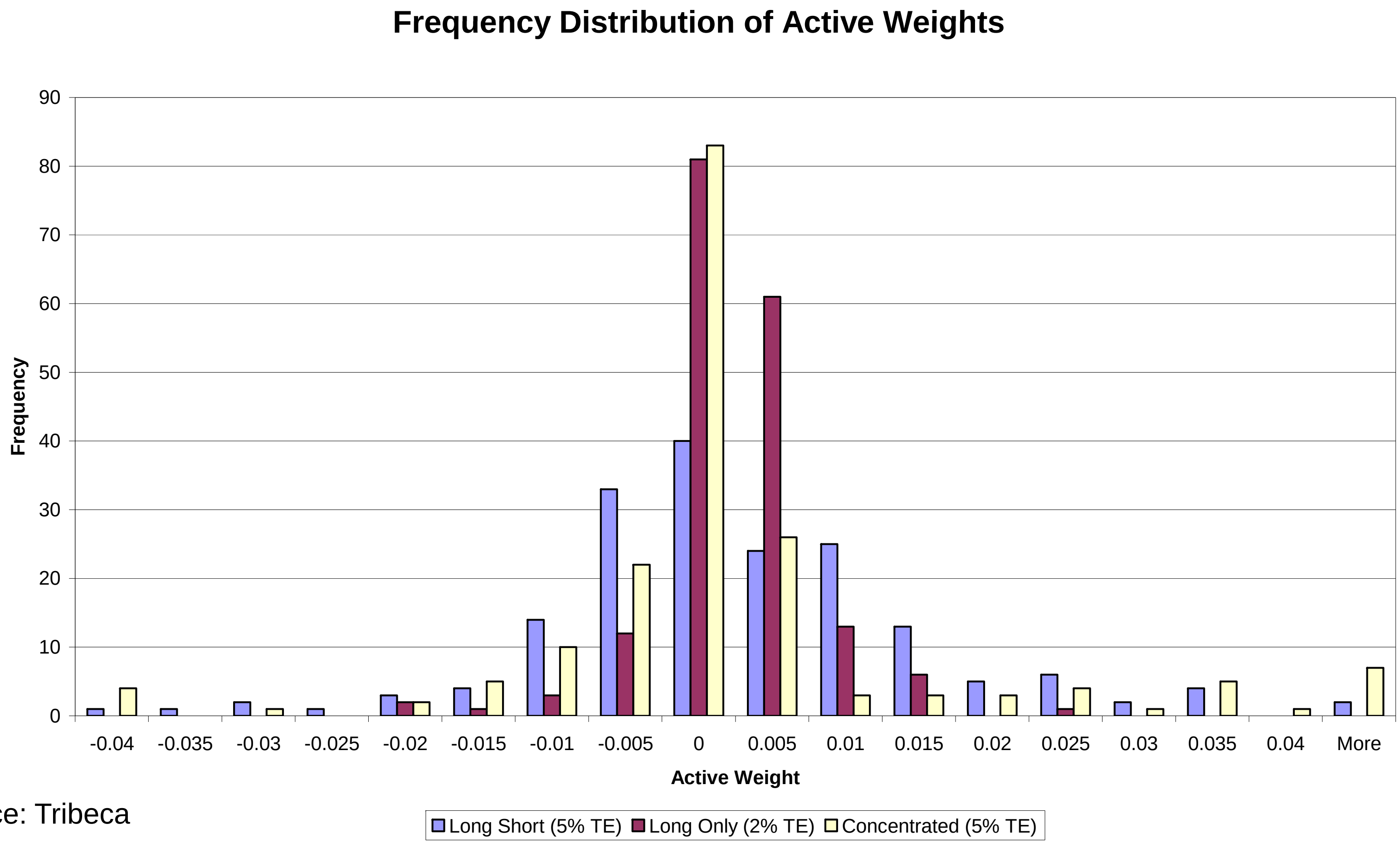
Active Weights are more “Normal”



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Evidence of Benefits

- The early experience from active extension was positive with material outperformance that accorded with theory

	S&P/ASX 200	Long Only Median	Active Extension Median
Oct-03 to Oct-07	25.0%	25.5% (56)	28.2% (6)
Nov-07 to May-09	-26.8%	-23.7% (87)	-27.6% (12)

Source: Mercer MPA Australian Equity Survey

- However, the situation has reversed post the Global Financial Crisis

	S&P/ASX 200	Pure Quant	Other
Nov-07 to May-09	-26.8%	-30.2%	-16.6%

Source: Mercer MPA Australian Equity Survey

- This is due largely to the over representation of quantitative investment strategies in the survey

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The Future for Active Extension

- The future of active extension has been clouded by short selling bans and recent underperformance
- Short selling has had its controversies, although there is general support from regulators due to expectations of improved market efficiency
- Active extension is an investment strategy that looks to exploit these inefficiencies
- Early evidence in Australian equities was positive
- Observed poor performance during the GFC is due more to a concentration of investment style in the sample than a weakness in the structure
- Investment strategies that are capable of delivering returns significantly above distribution costs on a consistent basis are likely to experience strong growth