

## **130/30 LONG/SHORT AUSTRALIAN EQUITIES – SQUEEZING MORE OUT OF UP AND DOWN MARKETS**

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*During the period leading up to the Global Financial Crisis (GFC) and at a time when the Australian equity market was delivering returns of around 15% per annum, 130/30 long/short investment strategies attracted little notice. But in more difficult and volatile markets like those experienced in more recent times and likely to be expected in the period ahead, a 130/30 approach to investing in Australian equities may present an opportunity to enhance portfolio returns without unduly increasing risk.*

*With appropriate risk control, 130/30 strategies should be viewed as an alternative to long-only funds, where managers can use short selling as a possible way to generate additional alpha and improve portfolio efficiency by capturing more of the value of a manager's equity market insights.*

*This research paper shows how a 130/30 strategy can significantly expand alpha generation and improve portfolio efficiency by adding long and short positions while maintaining market exposure. It also considers different types of shorting strategies which can be utilised as part of the portfolio construction process.*

## Increased volatility – a sign of the times

Major shocks can cause market dislocation creating heightened volatility. The most recent example was the Global Financial Crisis (GFC) which began in mid 2007. Since the GFC, the Australian sharemarket has experienced five distinct phases, marked by considerable variation in performance and volatility.

Chart 1: Performance of S&P/ASX 200 Index since the GFC (Aug 2008 -Aug 2010)

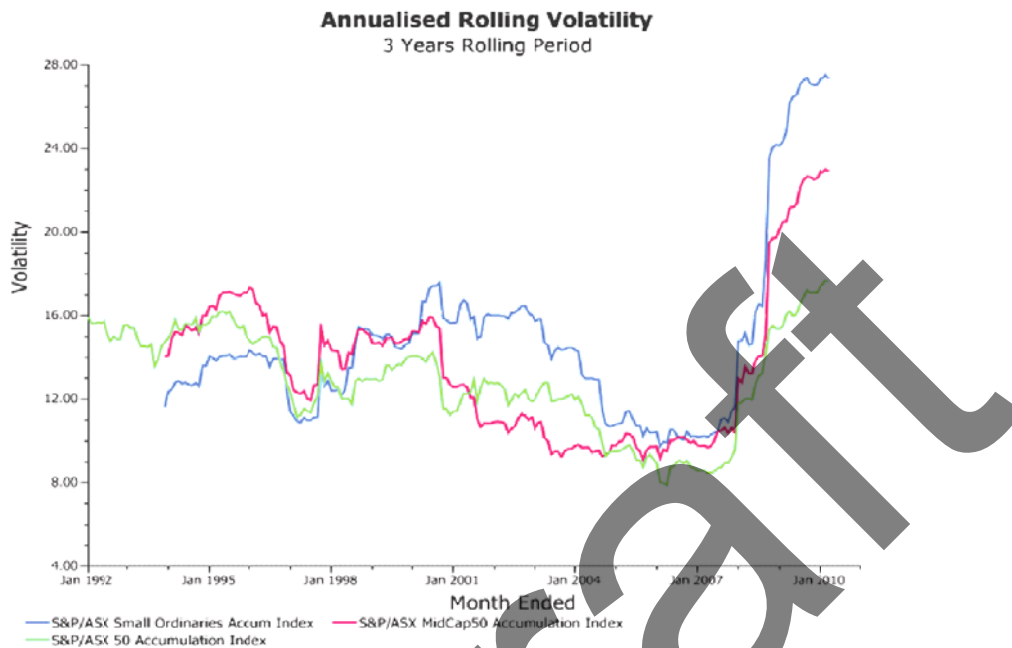


Source: ING Investment Management and Australian Stock Exchange.

1. **Extreme volatility & de-leveraging (2008).** The GFC's full impact was felt with volatility across all asset classes hitting extreme levels during 2008. Risk aversion hit record highs and investors rushed into safer haven assets such as cash and bonds. Volatility in debt markets saw a tightening in credit and forced many businesses to come to equity markets in order to raise capital for their near term funding requirements and to de-leverage their balance sheets.
2. **Final capitulation (January 2009 to mid March 2009)** – Volatility remained elevated and investors continued to de-risk their portfolios by reducing exposure to companies most exposed to the earnings cycle, and rotating into the defensive sectors. Consumer staples and healthcare were the main beneficiaries of the flight to safety.
3. **Initial recovery (relief rally – mid March 2009 to mid July 2009)** – Following a period of concerted government and central bank action globally to address the financial instability caused by the GFC, risk appetite began to return to the market. During this phase investors began investing in stocks that had underperformed the most (with the exception of REITs).
4. **Mid-cycle pricing recovery (mid July 2009 to March 2010)** – The strong rebound in the sharemarket was replaced by a period of more mixed performance. Even though investors continued to chase the cyclical banks, resources and industrial stocks, the market became increasingly concerned about the speed and extent of the recovery. Accordingly, relative valuation risks were beginning to emerge. However, systematic risk during this period continued to subside as economic fundamentals improved with substantial public sector support in place.
5. **Late cycle (since April 2010)** – It became clear to investors that the recovery was not going to occur in a straight line. The emergence of renewed macro concerns, sovereign debt issues in Europe, and a slowdown in China growth led to a resurgence in volatility. Investors became increasingly focussed on stock specific issues and emerging industry trends, particularly regulatory risk.

Chart 2 shows that elevated volatility has been a consistent characteristic of markets since the onset of the GFC. We expect this volatility to remain for some time due to the general economic risks of extremely low inflation, private and public sector de-leveraging and regulation risk. This represents a change from the relative benign environment of recent decades. Through the 1980s, 1990s, and 2000s, powerful, long-term secular growth drivers, including steady declines in interest rates, tax rates, and inflation, helped deliver a period of prolonged economic prosperity and stability.

**Chart 2: Volatility Measure of the Australian Sharemarket**



Source: van Eyk estimates, Bloomberg

What the changing drivers of the economy mean for investors is not the end of growth (although we expect growth to be slower over the long-term), but an environment of heightened economic and market volatility, and potentially shorter economic cycles, particularly if governments are forced to swing between fiscal and monetary policy to navigate the path between economic growth and prudence.

One of the reasons the economic cycles are shorter during periods when the government is a large portion of the economy and spending, and revenue highly variable, is that the long-term planning environment for businesses is less certain. The uncertainty of when taxes will be raised or cut, and what spending will be appropriated or terminated in the short-term, keeps companies from making long-term capital allocation commitments.

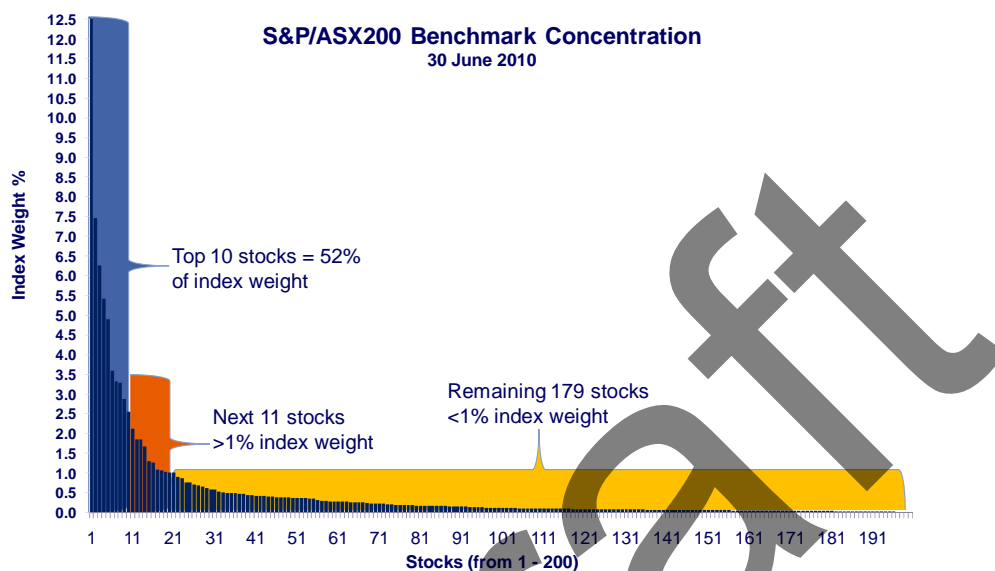
The bottom line is that the improving economic picture is a very uneven one. Economic recovery will be defined by short sharp cycles as aggressive political intervention, tax increases, regulation and strong public spending will tend to threaten economic recoveries after one or two years. It is because of this that markets are unlikely to return to the inflated valuation levels typical of the decade up to 2007.

A volatile market that produces multiple rallies and pullbacks provides opportunities to enhance performance through tactically taking profits when markets are at the top of the range and looking for attractive opportunities at the low end of the range.

## Shortcomings of the Index

Another problem for long-only Australian equity managers is the high level of concentration in the Australian sharemarket. Chart 3 shows that almost 90% of stocks have less than a 1% weighting in the S&P/ASX 200 Index. The lowest negative position that can be taken on a stock is a zero weighting. This means that a long-only manager is missing out on financial rewards for having a negative view on a stock that underperforms the market. Essentially it is a waste of investment insight, as the Manager is not able to transfer this information into real returns for the portfolio.

**Chart 3: Stock Dispersion in the Australian Sharemarket**



Source: ASX and ING Investment Management

## Introducing 130/30 long/short (ie. active extension) strategies

One way to benefit from negative views is to short stocks. Shorting in equity markets is selling stocks borrowed from a third party with the aim of buying these stocks back at a later date to return to the lender. The short seller aims to profit from this transaction by selling stock at a higher price than when it was later repurchased.

For the purposes of this paper, the discussion is limited to 130/30 strategies. These strategies combine a traditional long-only equity portfolio with an overlay of short positions in poorly rated stocks. This is achieved by offsetting up to 30% of the short positions by an overweight position of equal size in highly rated stocks (long positions) such that the net exposure to equities is 100%.

The ability to take larger overweights in attractive stocks (ie. long positions increase up to 130%) increases the alpha opportunity. These strategies are often referred to as active extension strategies – as the manager is extending the portfolio's overweight exposure to certain stocks while at the same time efficiently funding this outlay through 'selling' underperforming stocks. The opportunity that results from this strategy is that it generates two potential sources of alpha for the portfolio:

- i) the long positions outperforming the market; and
- ii) the short positions underperforming the market.

There have been numerous studies in Europe and the US that provide empirical evidence to support the theory that by adding shorting strategies to a portfolio, an equity manager can outperform his long-only counterparts in up markets – not just during down markets.

A study undertaken by Lee Munder Capital Group on US 130/30 long/short equity funds and US long-only equity funds over a 13 year period (from 1994 to 2006 ) shows the merits of investing in long/short funds over a long time period. Over the 13 year period the excess return from 130/30 long/shorts was substantially higher than long-only equity funds and was accompanied by a much higher information ratio<sup>1</sup>.

#### Chart 4: US 130/30 Long/Short versus Long-Only Equity Fund

Based on investment returns from 1994 to 2006

	Excess Return	Info. Ratio	Tracking Error	Batting Average	Turn-Over
<b>Domestic</b>					
Long-Only	7.61	1.25	5.43	61	52
130/30	11.27	1.51	6.48	65	106
Ratios	1.48 x	1.21 x	1.19 x	1.06 x	2.04 x

Source: Study by Gordon Johnson, Lee Munder Capital Group. Note: Data does not take into consideration transaction costs.

An important point to make is that 130/30 long/short strategies are not hedge funds. Traditional hedge funds are independent of benchmarks and will seek to achieve absolute returns, whereas 130/30 long/short strategies are similar to a long-only strategy, in that they have a beta 1 exposure. This means that their performance is pegged against an equity benchmark, such as the S&P/ASX200 Accumulation Index, which is considered to have a beta of 1.

For this reason, it makes sense to compare the performance of 130/30 long/short strategies with long-only funds because their risk and return characteristics are more closely aligned. Chart 5 provides a summary of the differences and similarity between active extensions funds, long-only funds and hedge funds.

Investors should be aware that short positions are accompanied by increased potential losses. If a long position is taken in a stock and the share price falls, theoretically the most you can lose is the invested capital. However, if a short position is taken in a stock and its share price rises, theoretically the loss is unlimited.

Therefore to ensure that risk is minimised active extension strategies require more complex oversight, risk controls and the skills in implementing and closing out short positions.

#### Chart 5: Where do active extension strategies fit?

Features	Long Only	Active Extension (eg. 130/30 long/short)	Hedge Funds
1. Investment Style	• Relative Return	• Relative Return	• Absolute Return
2. Benchmark	• Index	• Index	• Risk-free rate (Cash)
3. Beta	• Beta 1	• Beta 1	• Beta 0
4. Short Selling	• No - Long only	• Yes - Long / Short	• Yes - Long / Short
5. Leverage	• No	• Yes - Restricted	• Yes - Not restricted
6. Management Fee	• Base Fee	• Base Fee + Performance Fee	• Base Fee + Performance Fee

Source: Standard & Poor's and ING Investment Management

<sup>1</sup> The information ratio (IR) measures a portfolio manager's ability to generate excess returns relative to a benchmark, but also attempts to identify performance consistency. The higher the IR the more consistent a manager is.

## Shorting Strategies - When and How?

Active extension strategies aim to achieve full equity market exposure, so they are not immune from beta risk. However, they can provide additional alpha during different periods of the investment cycle. An effective shorting strategy within a tactical investment framework should be able to deliver alpha over all periods of the investment cycle by actively rotating the portfolio over a shorter time frame.

Shorting strategies require specialist skills. It is important for a Manager to know when to apply various shorting strategies in a portfolio purely because different strategies work in different types of market and stock conditions. Some strategies are more appropriate for generating higher alpha whereas others are more appropriate in preserving capital. Using a range of shorting options can also improve the risk profile of a portfolio.

In the following section, we discuss three shorting strategies which can be used in different investment environments.

### i) Outright Shorts

Outright shorts or 'alpha shorts' involve taking a short position in a company where there is an expectation that the company's stock price will fall in value. This involves an investor borrowing stock from a prime broker to sell it based on a belief that returns can be generated by buying back the stock at a lower price and profiting from the difference.

This strategy is used to generate alpha where research and analysis reveals that a company is structurally flawed or there is a belief that there are earnings risks over the near term which will put pressure on its share price. Alternatively industry or regulatory events could lead to an expected lack of support for the stock which would also make it a candidate for taking an outright short position.

As losses through the implementation of such a strategy are theoretically unlimited, it is just as important to consider the protection of investor's capital should the shorting strategy fail. In this case, stock can be short sold but with an attached long call option for capital protection. If a shorted stock ends up reversing and rallies aggressively, the option overlay offsets the short at a certain trigger point and stops out the position automatically – an important risk management strategy for implementing high beta shorts.

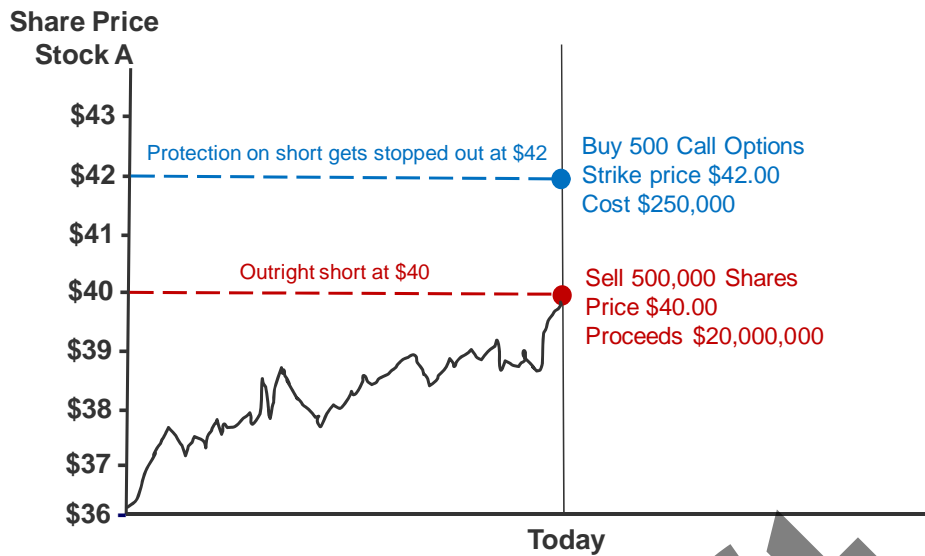
Let's take a look at an example of applying an outright short position within a portfolio where the investor is anticipating a decline in the price of the stock of Company A:

- The investor sells short 500,000 shares of Company A at \$40
- They buy 500 out-of-the-money call options<sup>2</sup> (with a strike price of \$42) for 50c each, representing a premium of \$250,000

These trades are depicted in the following chart.

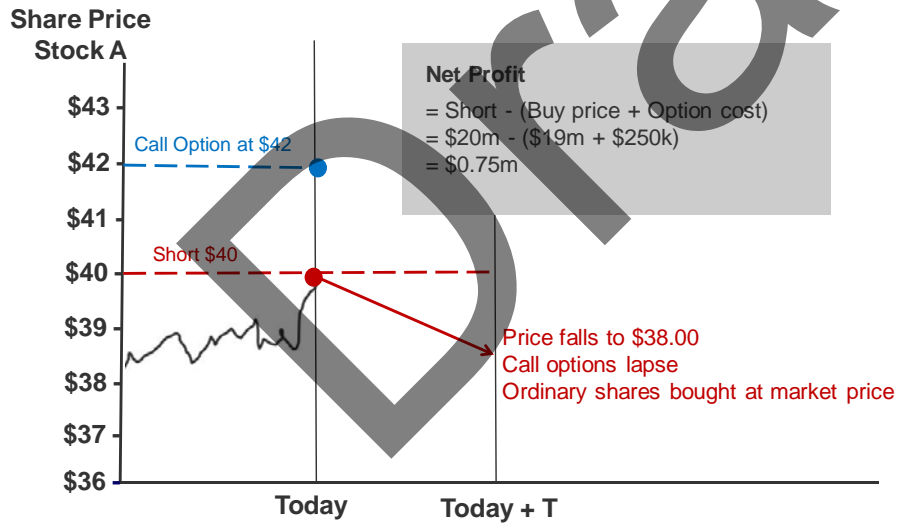
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<sup>2</sup> One option is equivalent to 1,000 shares.



Source: ING Investment Management.  
 Note: This is theoretical representation of a trade and does not include transaction costs.

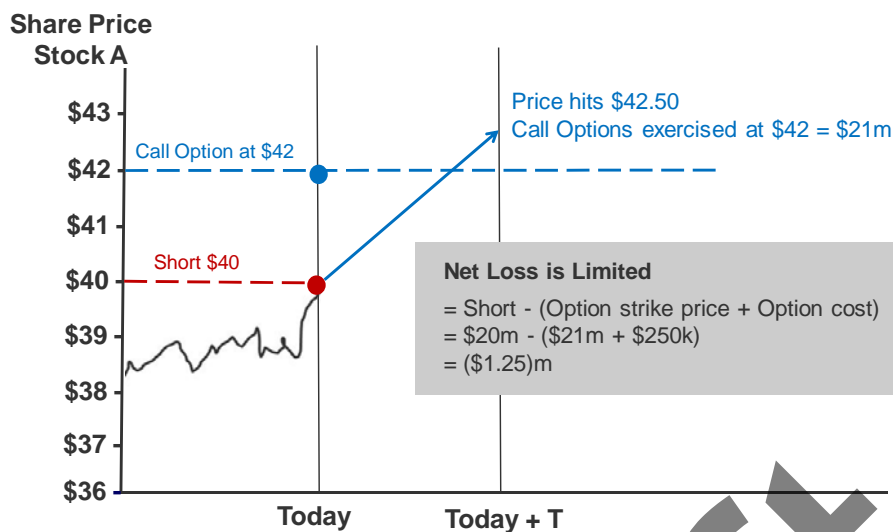
If the investor is right and the market price of Company A drops to say \$38, the investor can buy the equivalent number of shares at the lower price and claim the difference as a profit (pre any costs associated with the lending broker), thus covering the short sale and less the option cost (\$250,000). The call option itself will be left to lapse as it only served as a risk protection strategy in case the stock rallied.



Source: ING Investment Management.  
 Note: This is theoretical representation of a trade and does not include transaction costs

Alternatively, if the investor is wrong and the stock rallies through \$42.50, the position is closed out at that strike price of the Call Option (ie. \$42) and the Manager is not exposed to any further increase in Company A's share price, should it rally further.





Source: ING Investment Management.

Note: This is theoretical representation of a trade and does not include transaction costs

In this case, a \$20m position (500,000 shares at \$40 each) can be protected for a total cost of \$250,000 while at the same time delivering the upside potential of getting the short call right.

## ii) Pairs Trading

Pairs trading refers to taking opposite positions in two different securities within the same sector – that is, taking a long position in a company that is seen as undervalued and a short position in a company that is identified as being overvalued within the same industry or sector.

The objective is to make money on the relative price movements (or valuation gap) between the two stocks. It is this valuation dispersion that will drive investment returns.

The stocks that make good candidates for a pairs trade should have some measurable relationship (e.g. by PE or Book valuation or ev/ebitda). Ideally, the stocks should have a positive correlation and betas that are stable over time. It is when this correlation breaks down (i.e. valuation gap), that it gives rise to a pairs trading opportunity.

This strategy is a stock specific strategy rather than any general expectation of the direction of the sharemarket. Typically, the catalysts for implementing such a strategy are:

- Relative Earnings – an earnings surprise is expected for one of the companies; or
- Relative Valuations – the valuation differential is wider than historical valuation with an inadequate explanation for this.

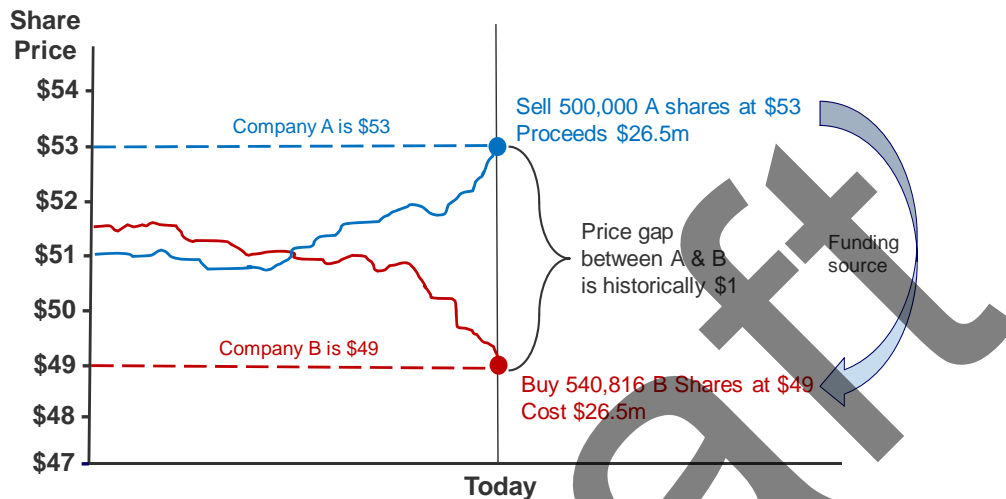
In implementing a pairs trade, the exposures to both stocks will be of equal value – thus netting one another out. Options may also be used in the implementation of this strategy and can simply be used as stock substitutes – i.e. long calls for long stock and long puts for short stock.

If the trade works out as planned the undervalued stock will increase in share price and the overvalued stock will fall in share price reverting to the normal valuation relationship between the two stocks.



Let's consider the following simple example. Company A is trading at a share price of \$53 while Company B in the same sector is trading at a share price of \$49 – a difference of \$4. The investor believes based on their analysis that the based on historical valuation differences, the differences in the share prices of the two companies should be closer to \$1. The current valuation gap is \$3 higher than the average historical difference and the investor could infer that either stock A is overpriced or stock B is underpriced.

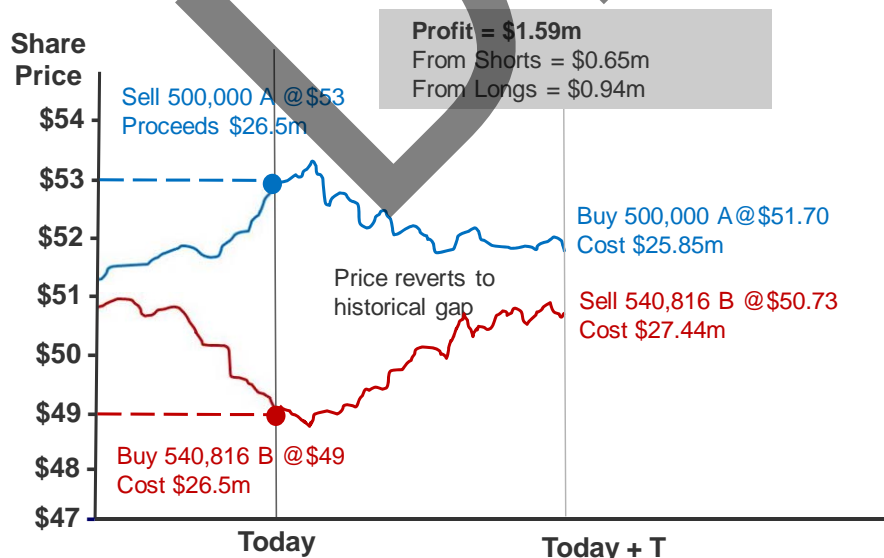
Expecting that the difference will revert back to the historical average of \$1, the investor would short sell stock A and buy stock B. The Portfolio Manager purchases \$26.5m shares in Stock B and offsets this with an equivalent short position in Stock A.



Source: ING Investment Management.

Note: This is theoretical representation of a trade and does not include transaction costs

If the trade goes as planned there is the possibility of making a profit on the pairs trade. Let's assume the stocks begin to revert to the average valuation gap. In a best case scenario stock A will fall in price and stock B rise in price – thus giving rise to profits from both long and short positions.



Source: ING Investment Management.

Note: This is theoretical representation of a trade and does not include transaction costs

If the trade goes against our positions in this pairs trade, for example structural news has come out such as profit warning or profit upgrade that negatively effects the pair, a stop loss would cancel these positions, thus limiting losses.

### **iii) A Funding Short**

In a funding short you sell SPI futures or other securities that are expected to under-perform the long part of the portfolio. If the Portfolio Manager is of the view that the market will rally aggressively he may be short some low beta defensive style stocks that will not keep pace with the market rally.

For example, stock A has had three profit warnings over the last 12 months and is down 20% year to date, while the sharemarket is only down 1%. Stock A is a low beta perceived defensive stock that will not keep pace with a rallying market and thus offers a positive return (in a shorting sense) as it lags the market.

## **Conclusion**

The GFC has altered the economic and investment landscape considerably. Despite a general mood of optimism about economic recovery and the improved performance of financial markets, the last few years has been characterised by increased volatility. Economic uncertainty and political intervention is likely to keep markets volatile as we enter a prolonged period of shorter and sharper economic cycles.

A volatile market that produces multiple rallies and pullbacks will provide opportunities to enhance performance through tactically taking profits when markets are at the top of the range and looking for attractive opportunities at the low end of the range.

In a low return environment investors are getting less return from the beta component of their total return. Hence a strategy which focuses on a higher alpha component from total returns would be desirable. One approach would be to adopt a 130/30 long/short active extension strategy. It will retain the integrity of Australian Equities exposure but also provide an element of shorting, thus boosting the alpha component of the total return.

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