

The long and short of share investing



FUND PERFORMANCE

	Inception date	Annualised compound return since inception (%)	All Ords compound return annualised since fund inception (%)	Annualised standard deviation since inception (%)	All Ords annualised standard deviation since fund inception (%)	Last 12 months performance for fund (%)	Last 12 months performance for All Ords index (%)	Fund minimum investment (\$)
LONG-SHORT FUNDS								
Cadence Capital Fund	Oct 05	17.27	0.25	17.67	15.64	61.7	7.75	5,000
Bennelong Kardinia Absolute Return Fund*	May 06	16.05	-2.13	8.83	16.06	21.18	7.75	400,000
Velocity Fund	Jul 06	39.71	-1.53	33.21	16.2	32.35	7.75	250,000
90 West Global Basic Materials Fund	Jul 08	25.24	-4.40	21.77	17.77	57.86	7.75	100,000
Evergreen Australian Equities Return Fund	May 10	38.19	-3.10	10.83	11.52	42.86	7.75	100,000
MARKET-NEUTRAL FUNDS								
BlackRock Australian Equity Market Neutral Fund	Aug 01	12.72	3.63	5.95	13.55	22.89	7.75	PDS to be launched
Bennelong Long-Short Equity Fund	Feb 02	21.01	3.39	11.91	13.47	26.46	7.75	500,000
Macquarie Asian Alpha Fund	May 05	12.03	0.25	6.52	15.64	19.73	7.75	1 million
Regal Tasman Market Neutral Fund	May 07	28.26	-6.47	14.92	17.23	50.29	7.75	250,000
Kima Pan Asia (\$A)	Jul 09	14.6	8.64	5.42	13.21	11.4	7.75	250,000

Even when the market is going down you can still make money

JAMES DUNN
INVESTING

WITH the European debt crisis a thumping headache, the US economy threatening to double-dip back into recession and Chinese inflation data a concern, share-market investors are prone to more than the odd sleepless night.

The volatility is killing them. But for some investors, sleep is easy, and these volatile times are filled with opportunities.

Welcome to the world of long-short funds and market-neutral funds, both of which are active in Australia and doing very nicely.

Both kinds of fund are "absolute-return" funds in that they aim to deliver the highest possible positive return, no matter what the sharemarket is doing. They are similar, but not identical. A long-short fund will simultaneously go long (buy) undervalued stocks and short (sell) overvalued securities. In this way, the fund profits from falling and rising stock prices, and hopes for alpha (outperformance) on both sides.

A "market-neutral" manager tries to deliver above-market returns with lower risk by hedging out market risk. It does this mainly by matching bullish stock picks — the long part of the portfolio — with an equivalent number of bearish, or short, bets. The goal is to negate the impact and risk of general market movements, trying to isolate the pure returns of individual stocks. A market-neutral manager can also generate income by placing the cash proceeds of the short sales in a money-market account, and earning interest.

mark or hurdle rate. But people should always look at the after-fee returns, and they're still much better off," he says.

Certainly, some of the funds on Zenith's recommended list have produced some eye-catching returns (see table), especially in light of the travails of the market index since the GFC hit in earnest in 2007-08.

But when you talk to the managers, what they do is remarkably simple. "We choose a portfolio of stocks on the long side, and we have a portfolio of short positions. We don't hedge the individual trades, we ensure that the portfolio is beta-neutral — that is, it will hopefully go up irrespective of what the market does. That's done with close to an equal weighting of longs and shorts," says Philip King, chief investment officer at Regal Funds Management, whose Regal Tasman Market Neutral Fund last week took out the titles of Australian Hedge Fund of the Year and Best Market Neutral Fund at the 2011 Cure Our Kids Australian Hedge Fund Awards.

"We hedge a lot of that market risk away, but we don't aim to hedge away all our risk, because if you try to hedge away all of your risk, it's very hard to produce returns. We don't claim that we're low-risk, or no risk — we run risk.

'It's the risk-adjusted size of the positions that generates returns'

TIM HANNON,
CHIEF INVESTMENT OFFICER,
EVERGREEN CAPITAL

A market-neutral manager can also trade a pair of securities — for example, buy BHP Billiton and sell Rio Tinto, hoping to trade the relative strength of one of the pair.

As long as BHP outperforms Rio, it will not matter what the market index does. In this way the manager converts relative performance to absolute return. Or the manager might make its stock and sector bets, then hedge out market risk by using derivatives over the index.

At the moment, Daniel Liptak says, head of alternative research at Zenith Investment Partners, these kinds of funds are "about the only way for equity-based investors to get ahead".

"The best annualised returns for the last five years have come from Australian market-neutral funds and Australian long short equity funds," Liptak says.

"The ones on our recommended list have really lived up to the promise of absolute-returns, over cash. The worst place to have been invested, was long-only — and interestingly, short-only — global and Australian equities.

"In fact, from a risk-adjusted return perspective, investors have paid heavily for being in long-only investments."

All investors need to have access to these funds, because of the downside protection and non-correlated (to the market index) returns they provide, Liptak says.

"I think that is being realised more and more. The issue for many people is firstly, these funds are not cheap: they're normally 1.5-2 per cent a year plus a performance fee of 20 per cent of the amount of any outperformance over the bench-

But the important thing is that our returns are based on manager skill, not the market going up. We are very confident in our ability to add alpha on the short side as well as the long side, and that's what our investors pay us to do."

At any point in time, King says, his fund might have 50 long positions and 50 shorts, and a cash level that is quite close to 100 per cent of the fund at all times, because when it short-sells stocks, it uses that cash to fund its long positions.

Tim Hannon, chief investment officer at Evergreen Capital, says the ability to "play both sides of the equation" by going long and short is a major plank of the strategy, but Evergreen also likes to take "decent" risk-adjusted positions.

"It's not just the directions of your trades, long or short, it's the risk-adjusted size of the positions that generates returns. When we like a stock enough, we'll put 10 per cent of the fund in it. Very few funds will take that level of risk, but we're nice and small (\$40 million), so we can take that sort of risk, and if we get a position wrong, we can liquidate it quickly.

"You generally find that most fund managers will not take decent risk-adjusted positions, because most of them want to mirror a benchmark. Most large-cap managers end up mirroring the index: they have 60-70 per cent of their portfolio in BHP, Rio and the four big banks. We don't even look at the banks. It's just a different way of thinking," Hannon says.

Hannon is happy to take stock and sector risk, but hedges out market risk by using put options over the index and SPI (Share Price Index) futures contracts. "We don't know the direction of the market; we make our money by

picking the right sectors and stocks to be in, and we have a lot of protection in place. If we can't find a decent short against a long position, we will use index puts to hedge out the market risk. We're happy to take risk where we think we can add value, rather than trying to pick the direction of the market."

At the moment Hannon only holds eight stocks, and has pushed the cash holding to almost 70 per cent cash. "I'm pretty bearish at present, but I do think there could

be a huge opportunity coming up, and we want to be cashed-up to exploit it," he says. Mark Burgess, portfolio manager of the Benelong Kardinia Absolute Return Fund, is also operating his fund on bearish settings, holding 21 stocks — his range is 20 to 50 — and with a net sharemarket exposure (long positions netted off against shorts) of 20 per cent. "Our maximum net exposure — with our risk parameters — is 75 per cent exposure to equities, but if we're really nega-

tive, we can have zero exposure to equities or even be net short the market. "In the current market environment, and in periods like 2008, we're able to be very defensive and have very little exposure to equities. We have more exposure to cash and fixed-income investments and protect the capital. Returns are clearly important, but they're almost secondary to the desire to protect capital."

Burgess is also holding a lot more cash than normal. "We're

effectively close to 80 per cent. That gives us huge flexibility, but obviously investors pay us higher fees and wouldn't want to see 80 per cent cash for too long, but that's part and parcel of what they're buying — they're backing our judgment. While you could say it's a bearish view, it also means we are cashed-up for when opportunities emerge. The further the markets fall, the more attractive valuations become, and the more opportunities we can identify."