INVESTMENT EXECUTIVE
CANADA'S NEWSPAPER FOR FINANCIAL ADVISORS

Income with low volatility

Long/short strategies may be the way to go

November 2011 Print Edition

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Today's turbulent markets and dismally low interest rates have triggered a search for ways to moderate portfolio volatility without sacrificing return. One candidate is equity long/short funds. To obtain a picture of this strategy's performance, the portfolio research team at Tacita Capital Inc. has reviewed recent research on both U.S. and Canadian hedge fund performance and analyzed several U.S. hedge fund indices.

Equity long/short strategies combine three components: long equities, short equities and leverage. Stock selection varies, depending on the fund's portfolio manager, and can incorporate models based on fundamentals, valuation, momentum, liquidity, capitalization and sector exposure. Short strategies may incorporate short stock or exchange-traded fund positions, short call/long put options and short futures. Leverage levels, which can use the cash from the short sales to increase long exposure, outright external borrowings or notional leverage from derivatives, can vary tremendously.

Unlike long-only funds, equity long/short funds can fully capitalize on mispricing by shorting overvalued stocks. The short component of the portfolio also serves as a hedge against market declines, a critical characteristic in today's turbulent markets.

Long/short funds differ greatly in their net exposure to the market, which is calculated as the dollar amount of their long positions net of their short holdings as a percentage of capital. In Canada, several equity long/short funds focus on small-capitalization stocks with highly

leveraged, long-bias strategies that can have massive drawdowns. More characteristic are funds that have moderate net exposure in the 35%-40% range, although this can vary based on the portfolio manager's macro or opportunity assessment.

Evaluating hedge fund strategies is challenging because of the absence of a market-wide index that includes all such funds. However, a 2009 study entitled "Risk and Return in the Canadian Hedge Fund Industry," by Peter Klein, Daryl Purdy and Isaac Schweigert, undertook a comprehensive review of Canadian hedge fund strategies.

The authors' findings indicate that Canadian equity long/short funds had a monthly average return of 0.84% from January 2005 to June 2009, far outpacing the 0.55% return of the S&P/TSX composite index and the 0.19% loss of the S&P/TSX small-cap index. This higher return was earned despite lower volatility: equity long/short funds had a 4% monthly standard deviation, compared with 5% for the market overall and 6.4% for small-cap stocks. Canadian equity long/short funds also had a lower drawdown, with a maximum decline of 27.7% vs. losses of 43.4% for the market overall and 54.9% for small-cap stocks.

Longer-term data from the U.S. supports this picture of attractive risk-adjusted performance. One study, which corrected for the survivorship and backfill bias in hedge fund indices, calculated that equity long/short funds had an annualized return of 10% from 1995 to 2009, outpacing the 8% return of the S&P 500 composite index. On the important reward/variability metric measured by the Sharpe ratio, equity long/short funds had a ratio of 1.02, far greater than the 0.34 ratio of the market overall.

Unfortunately, the performance of most equity long/short strategies is highly correlated with the market.

Hence, although the lower volatility of these funds can contribute to improved performance, they are no panacea for bear markets. Financial advisors also need to complete extensive due diligence when selecting funds, as strategies can vary significantly in risk. Also, diversification into several funds is recommended. **IE**

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