The Long
And Short

Equity long/short hedge funds are not designed to be top performers, but they can deliver consistency with downside protection.

BY ERIC UHLFELDER

JULIAN ROBERTSON AND HIS PROLIFIC OFFSPRING of Tiger Cubs. David Einhorn's Greenlight Capital. James Simons' Medallion Fund.

These may not be household names to many financial advisors. But in the $400 billion universe of equity long-short hedge funds, these are a few of the demigods who have mastered stock investing, regularly delivering annual double-digit returns.

Unlike Peter Lynch and Warren Buffett, who have also made billions picking stocks, Robertson et al have achieved stardom by also betting on which stocks will go down.

If that extra strategy suggests long-short equity managers have a performance advantage over long-only investors, well ... that's simply not the case.

While virtually all long-short managers will maintain a net long bias—meaning that they will have more money betting their stock picks will go up than on stocks they think will go down—over the long term, most of these managers will underperform the market.

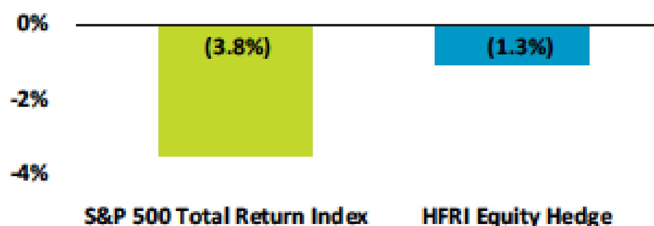
The reason is simple: A long-short strategy is designed to reduce volatility and, therefore, investment risk. They run their books with limited to no leverage, designed for equity investors seeking protection from shocks. A look back to pre-tech bubble days makes this point.

Before shares blew out in 2000, many hedged equity managers not only got out of overvalued stocks before they fell or shorted them, but smartly rotated into more stable industries. This independent thinking produced four straight years in which fund managers more than doubled market returns. From 1999 through 2002, long-short funds outperformed the market by an average of more than 20% a year (Figure 1).

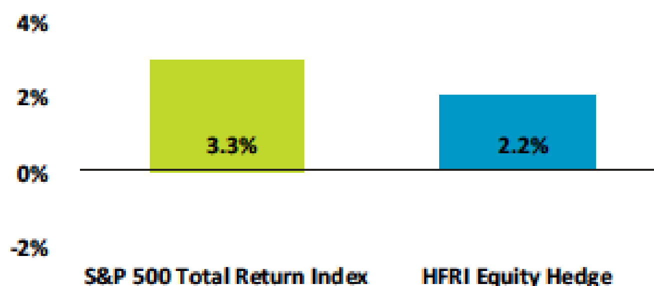
When the bear struck again in 2008, equity hedge funds stood out for their performance, declining less than 12% while the market was down nearly 37%.

Softening the Downside; Participating in Up Markets

Average Monthly Return for Months When S&P 500 TR was Negative[(1)(2)]



Average Monthly Return for Months When S&P 500 TR was Positive[(1)(2)]



1. Data Period: 1 April 1992 through 31 March 2012
2. Source: "Taking Stock," Blackstone, 2012.

But there's a rub. When there's smooth sailing, most long-short managers will invariably underperform the market. And this has been most evident since stocks started recovering from 2008 and as the hedge fund investor base shifted from more risk-embracing, high-net-worth and family office investors to more reticent institutional investors.

Between 2009 and September 2014, the S&P 500 has consistently outperformed long-short managers, sometimes by a great deal. In 2009, the market was up nearly 26%, outpacing funds by 11.5%. In 2013, the market more than doubled the average long-short manager when it returned more than 32%. And through the first three-quarters of this year, the average fund gained a paltry 2.44% versus the market's 8.34% return.

Among various hedge fund strategies, equity long-short is the most appropriate for advisors who want to maintain stock exposure—mindful of the age of the bull market and clients with low risk tolerance.

UNDERSTANDING THE STRATEGY

While there are variations, long-short managers construct portfolios in two basic ways. First, they find stocks that will likely appreciate and, to partially hedge risk, short a related, weaker individual stock or basket of stocks with negative outlooks. With the short typically being smaller in size than the long position, the hedge can only partially offset the impact of unforeseen negative events. The result of this construction will be returns that are more modest than the market when it rises, but reduced losses if the market falls.

The other long-short approach, more frequently employed by leading managers, is to invest in shorts with the same conviction a manager has with his longs—identifying where the market has misperceived corporate fundamentals, which has led to overvaluation and susceptibilty to correction. The manager isn't setting up the short to inherently hedge a long.

Accordingly, he is taking on more risk because his positions are constructed to move independent of one another. If his call is right, he may outperform other long-short managers. But without correlated hedging, he runs the risk of underperforming his peers if his thinking is wrong.

What makes this approach more risky for single-manager funds is that these two kinds of opposing trades involve different skill sets. Not many managers can simultaneously excel in both.

Jeff Osher, however, is one who has been able to consistently pull off this balancing act. His $418 million Harvest Small-Cap Partners fund, which started in December 2005, has been generating 16.37% annualized gains through July 2014. His five-year annualized standard deviation is half this rate of return, his worst drawdown (peak to trough and back to peak) was just 7.37%. When stocks lost 37% in 2008, Harvest rallied more than 19%.

Osher's commitment to his shorts is comparable to his longs, with his book generally running only 10% to 15% net long. This helps to explain why the fund has been able to outperform the Russell 2000 during the 10 worst-performing months the small-cap index has experienced.

Patience is a key to his strategy. "Because information flow about small caps tends to be less efficient than larger caps," Osher explains, "we're happy to get into a position well before other investors recognize the triggers we've identified that will send a stock higher or lower."

A recent long example was Sun Edison, formerly MEMC Electronic Materials, which comprised two unrelated businesses. Osher saw the potential of its solar solutions operations despite a break in its financing that threw a monkey wrench in its $8 billion pipeline of projects. When he realized the firm was divesting its polysilicon division, restructuring solar production, and creating a new yield company tasked with buying Sun Edison's finished solar projects to help recapitalize operations, Osher saw a more rational business model. His investment tripled in less than three years.

INCUBATION

When asked what he thought it meant to be a Tiger Cub—one of Julian Robertson's hedge fund offspring—Alok Agrawal, who had worked for the venerable manager for four years before setting up Bloom Tree Partners, succinctly replied: "It means never buying a bad business; never shorting a good business."

Tiger philosophy relies on extensive research and due diligence, understanding operations and finances, and investing only when one has crafted a strong conviction about a position.

This process has served the $304 million fund well since Agrawal started it in May 2008. He has churned out annualized returns of more than 10% with five-year annualized volatility that's running a full percentage point below that, and a worst drawdown of less than 10%.

This year, he has gained 26% in seeing the financial and operational benefits of the emerging business of privatized emergency room services provided by TeamHealth.

On the short side, Agrawal saw how market misunderstanding of corn production fueled the rise in the share price of pesticide maker American Vanguard (AVD). The ethanol mandate, drought and rising corn prices led to the overfarming of corn and corresponding boost in demand for AVD's pest-control products. This resulted in a quintupling of the company's share to $35 between 2011 and 2013.

Thinking that corn would continue to be heavily farmed, analysts forecasted further demand for these specialized pesticides and a subsequent rise in AVD's earnings. Agrawal, however, thought otherwise.

"Crop rotation is essential for keeping farmland healthy from infestations," he says, "and we saw that the rising price of soybeans was making this crop more attractive to plant." Accordingly, he thought demand for ADV products would falter. Analysts' 2014 projected EPS of $1.80 was more than twice his estimate.

The manager says he was the only institutional investor to short the stock in November 2013 at $28. As the price declined,

FIGURE 1

Long/Short Equity Funds Versus Long Market Exposure

YEAR	BH EQUITY LONG/SHORT AVERAGE	S&P 500 TOTAL RETURN	OUTPERFORMANCE OF MARKET OVER HEDGE FUND MANAGERS
1997	26.07%	33.100%	7.03%
1998	18.42%	28.340%	9.92%
1999	46.71%	20.890%	-25.82%
2000	16.39%	-9.030	-25.42%
2001	4.92%	-11.850%	-16.77%
2002	-1.78%	21.970%	-20.19%
2003	15.81	28.360%	12.55%
2004	6.56%	10.740%	4.18%
2005	11.47%	4.830%	-6.64%
2006	8.04%	15.610%	7.57%
2007	7.91%	5.480%	-2.43%
2008	-11.88	-36.550%	-24.67%
2009	14.42	25.940%	11.52%
2010	7.27%	14.820%	7.55%
2011	-4.58%	2.100%	6.68%
2012	6.35%	15.890%	9.54
2013	13.85%	32.150%	18.30%
2014*	2.44%	8.340%	5.90%

*Performance through September 30, 2014
Source: BarclayHedge

he added to his position, creating an average short price of $24. By May 2014, he was out of the investment at around $14.50.

Among the oldest long-short funds still extant is the SC Fundamental Value Fund. Having started in June 1990, Peter Collery's shop has generated returns of nearly 13% a year—three full percentage points a year better than the S&P 500, with volatility running at less than 7.5% over the past five years.

SC's list of former associates includes Greenlight Capital's David Einhorn, Lyrical Asset Management's Jeff Keswin and SAB Capital's Scott Bommer.

The fund scours the world for obscure value that the market has missed, not letting foreign language or unusual regulatory environments impede research. In February 2014, more than a third of its long positions were in Asia ex-Japan/China and nearly a quarter was in foreign property companies. Where the majority of investors were pouring into U.S. markets, SC was short one-third domestic shares. "Our shorts are not hedges," explains co-manager David Hurwitz, "but absolute convictions that a stock is mispriced."

Among the fund's more unusual longs is its exposure to regional banks owned by the major French financial Crédit Agricole (CA)—Europe's second-largest retail bank. Crédit Agricole du Languedoc (CRLA), Crédit Agricole de Normandie-Seine (CCN) and Caisse Regionale de CA Mutuel Alpes Provence (CRAP) all trade independent of CA.

"I would expect the immediate visceral reaction to investing in French banks to be "Are you crazy?" quipped Hurwitz. But given "ludicrously low valuations and an average yield of 6%," he felt the jurisdictional, regulatory and language challenges of venturing into this underexplored space presented a potential

FIGURE 2
Select Top-Performing Equity Long/Short Funds

HEDGE FUNDS	START DATE	FUND ASSETS (MILLIONS)	1-YEAR RETURNS	3-YEAR ANNUALIZED RETURNS	5-YEAR ANNUALIZED RETURNS	COMPOUND ANNUAL RETURN SINCE INCEPTION	5-YEAR SHARPE RATIO	FIRM ASSETS (MILLIONS)
Voloridge Trading Fund	Jun-09	367	41.17	34.30	28.54	28.67	2.37	508
Senvest Partners LP	Apr-97	595	29.24	24.18	28.15	20.13	0.97	663
Privet Fund LP	Feb-07	113	12.96	14.54	20.19	15.17	1.20	113
Global Infrastructure Securities L/S	May-08	181	16.15	11.54	16.65	13.74	1.45	216
Parametrica Global Master Fund	Jan-09	296	13.00	14.64	14.10	11.75	2.25	296
Harvest Small Cap Ptnrs.	Dec-05	418	30.26	15.27	12.51	16.37	1.49	884
Bloom Tree Partners LP	May-08	304	9.05	11.88	12.46	10.14	1.36	919
SC Fundamental Value Fund LP	Jun-90	97	19.56	12.48	10.69	12.79	1.42	106
MUTUAL FUNDS								
MainStay Marketfield I – MFLDX	Jul-07	18,938	-0.05	9.62	10.48	8.42	1.34	20,067
Robeco Boston Ptnrs. L/S Eq. – BPLSX	Nov-98	878	14.72	12.41	14.22	13.68*	1.41	7,000
BENCHMARK PERFORMANCE								
Barclay Equity Long/Short Index	Jan-97		7.38	5.22	5.82	10.01	1.13	
S&P 500 Total Return Index	Jan-80		16.94	16.84	16.79	11.69	1.28	

*Robeco return is for trailing 10 years. Data through July 2014. Sources: BarclayHedge and Morningstar

opportunity. After drilling into the structure and financials of these three regionals, SC established positions in fall 2013. A year later, they had rallied about 28%.

Where resource-rich Australia had been booming for years on the back of Chinese demand, SC felt shares of a leading mineral-oriented engineering group, Monadelphous (MND), got way ahead of themselves on soaring revenue and earnings growth since 2001.

Hurwitz saw vulnerability in the firm's heavy reliance on iron ore and coal industries—key inputs in the production of steel. He felt Chinese steel consumption, which had risen sevenfold between 2000 and 2012, was unsustainable. And the firm's claim of diversified services wasn't sufficient to make up for declining steel demand.

With the company having traded at five times book value in late 2012, SC began shorting the shares, establishing an average cost of A$18.37. The stock was trading at A$12.36 in early October.

'40 ACT

Financial advisors are increasingly enticed by alternative investment strategies available in the comfort of regulated 1940 Act funds. Equity long-short is a hedge fund strategy that may translate best into these vehicles. Not only can these funds short individual shares that are sufficiently liquid, but there's an abundance of ETFs that offer all sorts of inverse exposure.

From a fiduciary, due diligence and liquidity perspective, '40 Act funds appear to be a lot easier to deal with than hedge funds. Regulatory oversight suggests verification of these funds' legitimacy. Advisors, nonetheless, still need to do their homework.

Mainstay Marketfield (MFLDX) is the largest such player in the space, running $19 billion. It has generated nearly 8.5% annualized returns since it started up in July 2007, with annualized volatility that has run around 9% over the past five years.

"Our fund takes a different, top-down approach to investing than most hedged equity funds, which tend to invest bottom-up," explains manager Michael Aronstein, who has been running the fund since inception. The manager looks for broader macro themes to guide his long and short positions.

Between 2012 and early 2014, he played the European equity recovery, with a special emphasis on Irish stocks. "I was impressed by the government's commitment of keeping corporate tax rates low despite budgetary hardship," says Aronstein. As a result, the country appears to be emerging from the crisis economically stronger than many other European markets.

Aronstein does significantly alter his exposure; he ran a net long as low as 30% in 2011 to a net long peak of 75% in 2009. But typically his book is net long around 60%. And while 70% of assets are in equity, about a third could be in macro plays like commodities, currencies, interest rates and stock indices.

Hedge funds require more work to vet, their regulatory oversight is less robust, they are less liquid than '40 Act funds, and their operations involve more moving parts that can go wrong. Minimum investments are much higher, as are their fees.

But these managers tend to be a different breed, more aggressive, willing to explore more obscure spaces. For sure one can get burned. But the right long/short hedge fund managers can offer superior performance and risk management across most markets.