The New Core Allocation: Long/Short Equity

361 CAPITAL

With uncertain equity markets, the potential for subdued-to-negative economic growth looming, and a bleak outlook for fixed income, advisors are challenged to rethink foundational portfolio elements of investor portfolios—which means seeking out strategies that bolster the core going forward.

In investing, the “core” has traditionally consisted of developed market equities and investment grade debt. Increasingly over the last decade, investors—both retail and institutional—have introduced a growing number of diversifying elements to that core, including commodities, floating rate and high yield debt, emerging market assets, and hedge fund strategies, to name a few. Those asset groups have, in portfolio construction lingo, been termed “satellite” allocations.

KEY TAKEAWAYS

- With uncertain equity markets, the potential for subdued-to-negative economic growth looming, and a bleak outlook for fixed income, advisors are challenged to rethink foundational portfolio elements of investor portfolios.
- Over multiple market cycles, long/short equity strategies have outperformed the 60/40 core on a risk-adjusted basis
- Going forward, long/short equity should be thought of as a core position, not as a minor ‘alternative’ satellite allocation

But not all satellites are distinctly different from core assets. Of all of the satellite strategies, the one that most closely resembles the foundational components of a typical portfolio is long/short equity. It is after all a strategy, not an asset class, which invests in equities, and more often than not, does so with net exposure well below 100%; and that ends up looking quite similar to a combination of equities and cash or bonds.

As an aside, for those new to long/short equity, you may be wondering at a conceptual level why you should even consider investing in such a strategy. Our response is that portfolio managers and analysts, whether discretionary or quantitative, expend tremendous effort in identifying securities with higher expected risk-adjusted returns than the market at large. Through these efforts, they likewise come across securities with lower expected risk-adjusted return profiles. Long-only managers utilize such information primarily to avoid stocks with poor outlooks. Long/short equity managers, on the other hand, are afforded greater flexibility to fully express their views on all securities that they research, improving investment efficiency. Greater efficiency is achieved because more of the information uncovered during the research process is acted upon. A security identified as having superior characteristics is purchased, a security with a poor outlook is shorted, and a security with a market-like payoff is put aside until such time that either valuation or fundamentals turn it into a higher conviction long or short position.

By exploiting a larger opportunity set while reducing market exposure, long/short equity has historically generated compelling risk-adjusted returns. But let’s continue with the idea that long/short equity has characteristics similar to core assets. A correlation analysis of the

Historical returns of long/short equity strategies have been comparable to those of long-only strategies, with half of the risk.

return stream for equities, as represented by the S&P 500 Index, and long/short equity strategies, as represented by the Credit Suisse Long/Short Equity Index, reveals that from January 1994 through March 2020, equities and long/short equity strategies exhibited a correlation of about 0.59. As alluded to earlier, this fairly high correlation is to be expected given that long/short equity strategies derive the bulk of their return from equity beta, albeit in a lessened form relative to long-only constrained portfolios. Consider the following risk and return characteristics.

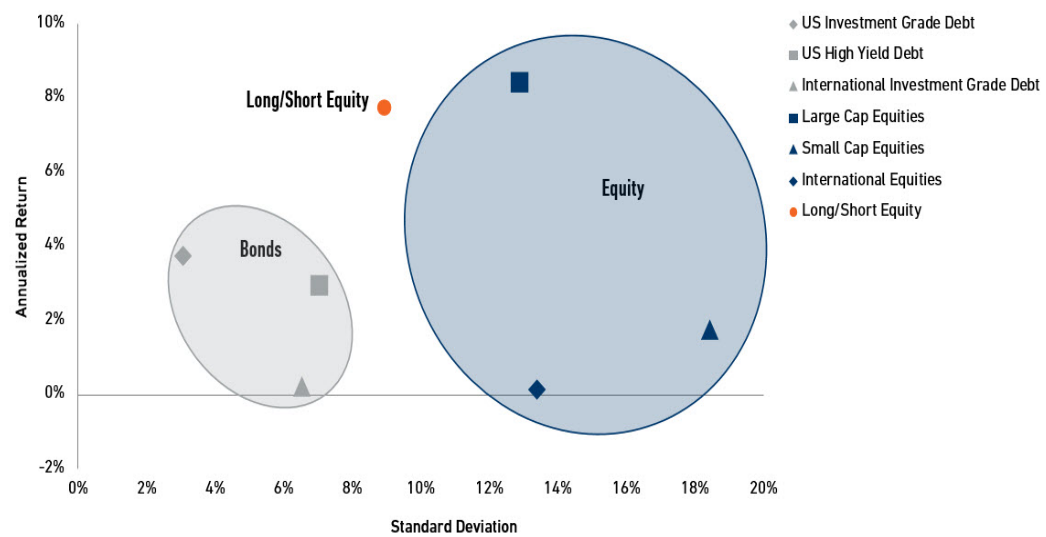
	Annualized Return	Standard Deviation	Sharpe Ratio	Maximum Drawdown
S&P 500 Index	9.11%	14.69%	0.49	-50.95%
Barclays US Aggregate Bond Index	5.47%	3.49%	0.79	-3.83%
60% S&P/40% Barclays Aggregate	7.94%	8.92%	0.60	-32.54%
Credit Suisse Long/Short Equity Index	7.23%	6.73%	0.61	-19.68%

Source: Morningstar 01/01/94 to 03/31/20

Long/short equity strategies have come close to matching the performance of equities with a lower level of volatility than the 60/40 stock/bond portfolio, and with smaller drawdowns. (Note that this over a time period when the yield on the 10-Year Treasury went from 5.75% to 0.68%, which was unquestionably beneficial to the performance of investment grade debt.)

Enhanced Risk/Return Profile

Historical returns of long/short equity strategies have been comparable to those of long-only strategies, with half of the risk.



Source: Morningstar 02/01/14 to 03/31/20

To be fair, point-in-time statistics can hide a lot, both good and bad. There have been many periods over the last 22 years when investors would have been better off in a 60/40 portfolio, most notably in 2011 when the Credit Suisse Long/Short Equity Index fell by -6.97% and a 60/40 portfolio returned almost 5%.

But here's the question. Could even the most astute investment professional determine in advance when such time periods will be more conducive to a 60/40 core than for a long/short equity strategy? We are not stating that long/short equity should completely replace the traditional stock/bond core, but rather it could replace a portion of that core and potentially improve overall performance through an increased number of alpha sources, while dampening volatility, among other things.

Choosing the Right Long/Short Equity Fund

Of course, in order to implement such a change, one must be able to identify a good long/short equity fund. Due diligence on long/short equity managers is indeed more complex, and size is undeniably the enemy of all investment strategies (i.e., the more assets raised, the harder it is to put those assets to work without incrementally lowering the return potential of the portfolio).

On the question of how to evaluate long/short equity managers, we offer a few suggestions. For one, in order to properly analyze any investment strategy, it's imperative to identify the risk factors embedded in the portfolio. All returns come from bearing risk in some form, so what risks are prevalent within long/short equity portfolios? At the most basic level of course, investors in long/short equity strategies take on equity risk, and therefore garner the lion's share of their return from the equity risk premium. In addition, investors may be compensated for exposure to other risk premia, such as size, value, or momentum. With the proliferation of cheap passive strategies that provide exposure to these same factors, investors should not pay up for these exposures, and should not mistake them for sources of alpha, unless of course the manager can demonstrate skill in varying exposure to these factors in a consistent manner.

At the most basic level of course, investors in Long/Short Equity strategies take on equity risk, and therefore garner the lion's share of their return from the equity risk premium.

Additionally, it is important to measure the manager's ability to add value through stock selection on both the long and short books. Of the two, short alpha seems to be the hardest to come by. If the short book is intended to be a source of alpha, then the short book should be held to the same standard as measuring alpha within the long book. If, however, the short book serves merely as a hedge, then the question turns to whether or not the manager can add value by varying the net exposure over time through the use of its hedges. A manager who maintains a relatively static simple hedge to keep equity beta in line with other long/short funds isn't adding any value, and investors shouldn't be paying for this service.

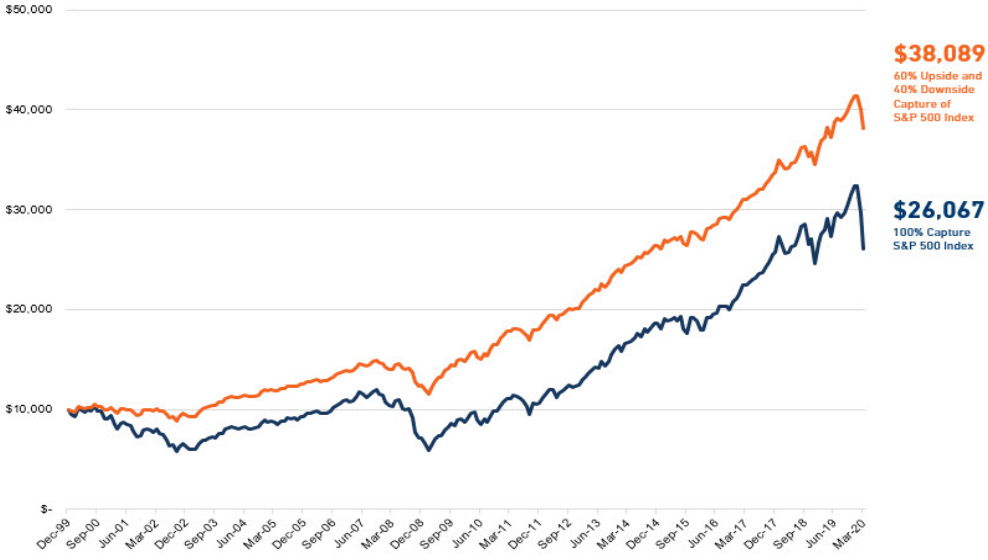
The Importance of Upside/Downside Capture

Often correlated to alpha, another hallmark of a strong long/short equity manager is the ability to deliver disproportionate upside and downside capture ratios. In fact, realizing more of the upside and less of the downside is what leads to market or better returns with less risk. Consider the hypothetical chart on the next page. Just by capturing 60% of the upside and 40% of the downside of the S&P 500 Index over the last 20 years, one return would realize 46% more return with less than half the risk.

The hallmark of a strong long/short equity manager is the ability to deliver disproportionate upside and downside capture ratios.

Hypothetical Growth of $10,000

The Importance of a Disproportionate Upside/Downside Capture



Source: Morningstar 12/31/99 to 03/31/20

In an environment where uncertainty is high, leading to sideways volatile markets, a disproportionate capture ratio is paramount.

Fixed Income Rates in a Low Real Return Environment

While equity market uncertainty can (and does) lead to increased equity volatility for an extended amount of time, bond valuations expressed in current yields tend to be more predictive of near-term returns for investment grade debt, a key component of the typical core portfolio. With that in mind, let's explore potential pathways for rates.

What if rates remain relatively flat for the next few years? Over the medium term, say five years or so, the best predictor of bond market returns, as measured by the U.S. Barclays Aggregate Bond Index, is the yield at the time of investment, which isn't surprising given that the duration of the Index is about six years. Currently, the yield on the U.S. Barclays Aggregate Bond Index is about 1.75%. Further, our estimate of future inflation, which is based on a simple model that combines the inflation forecast from the Philadelphia Fed's Survey of Professional Forecasters, and the implied breakeven rate of inflation between nominal Treasuries and TIPS (adjusted for the liquidity premium), suggests that inflation will run around 2.20% over the next five years. (We will see if that holds with record amount of fiscal stimulus in the first quarter of 2020).

Therefore, even without a much-feared rise in interest rates, the best investors can reasonably hope for from their U.S. investment grade bond holdings over the next five years, is a return of very close to zero on a real basis.

Of course, the math will likely be worse if rates rise, although reality might not be as bad as many investors believe. In a rising rate environment, investors can recycle coupons into higher yielding assets, which can offset some of the price declines suffered by existing holdings. Having said that, in a prolonged environment of increasing rates (and presumably, increasing inflation), things do get ugly.

Long-term corporate bonds and long-term government bonds experienced four consecutive decades of negative real rates of return beginning in the 1940s. Forty years is an entire investment horizon for the typical investor, who begins saving at age 25 and retires at age 65. While it would seem highly unlikely that history would repeat in such a way, investors at least need to be cognizant of the fact that it isn't outside of the realm of possibility.

Importantly, most retail investors, as opposed to institutions investing into perpetuity, don't have the luxury to wait to earn the "average" returns offered by the long term. With only a few decades over which to save and invest for retirement, a prolonged period of low real returns can be quite detrimental, as that reduces the time over which compounding can work its magic. And in these low return environments, the solution cannot be to throw caution to the wind, increase risk and hope for the best, as the math of a big loss can be very difficult from which to recover (see chart on next page).

Ultimately, we believe long/short equity should replace, at least in part, core assets rather than being lumped in with the amorphous "satellite" bucket because of the dangers inherent in the latter approach. Too often, asset allocation and manager selection are conducted independently, rather than in an integrated and iterative fashion. And if, for example, an investor determines that the optimal asset allocation is 50% equities, 30% bonds and 20% "alternatives", and then proceeds to fill the alternatives allocation with long/short equity managers (versus true diversifiers), the unintended result will be a portfolio with far more equity than originally desired. The risk/return profile of such a portfolio will be entirely different from one where the alternatives bucket delivers truly uncorrelated return streams, as would be the case with managed futures or convertible arbitrage, for example. Manager selection aside, it is our belief that the need for long/short equity strategies may be greater today than it's been in decades due to the market environment in which we find ourselves. The benefits to including long/short equity in an otherwise traditionally diversified portfolio are many.

Manager selection aside, it is our belief that the need for long/short equity strategies may be greater today than it's been in decades due to the market environment in which we find ourselves.

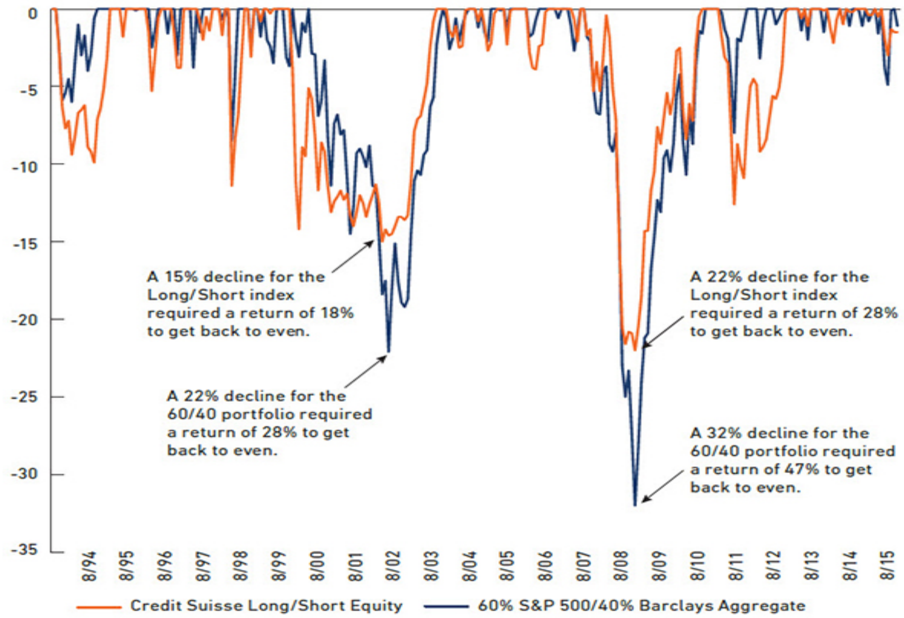
For one, alpha generation at a time of low expected returns for both fixed income and equities becomes even more important. When markets are delivering strong returns, as was the case in 2017 or 2019 when the S&P 500 Index was up 22% and 31% respectively, 100-300 basis points of alpha would be nice, but not hugely impactful. If on the other hand, a manager can add that level of alpha on top of 4-6% market returns, it's a game changer. But perhaps of greatest value to most investors is the ability of long/short equity managers to dampen volatility and help mitigate the possibility of a large loss, as we demonstrated earlier.

Related Funds:

361 Domestic Long/Short Equity Fund (ADMZX)

361 Global Long/Short Equity Fund (AGAZX)

Rolling Drawdowns & The Math of a Big Loss



For illustrative purposes only.

Conclusion

The bottom line is that investors need to improve upon the return potential of an investment grade debt portfolio without taking on too much equity risk, and it's our belief that adding long/short equity while reducing both long-only equity and investment grade debt does just that.

We encourage investors to think of long/short equity as a core position, not as a minor alternative allocation floating out among the satellites. It's clear that over multiple market cycles long/short equity strategies have outperformed the 60/40 core on a risk-adjusted basis, and the need for such strategies may be even greater today, especially given this new norm.

For additional viewpoints:
Call 866.361.1720 or visit 361capital.com.

About 361 Capital

361 Capital is a leading boutique asset manager focused on alternative solutions that seek to deliver meaningful alpha, manage risk and offer diversification potential to investor portfolios. Founded in 2001, we offer a suite of investment products including Long/Short Equity and Managed Futures.

Investing involves risk, including possible loss of principal. The potential loss from a short sale is theoretically unlimited since the appreciation of the underlying asset also is theoretically unlimited. Foreign investment entails additional risk from adverse changes in currency exchange rates, tax regulation and potential market instability. Frequent trading by the Fund may reduce returns and increase the number of taxable transactions. Concentration of its portfolio in relatively few issuers may make the Fund more volatile than a diversified fund.

You should consider the Fund's investment objectives, risks, charges and expenses carefully before investing. For a prospectus, or summary prospectus, that contains this and other information about the Funds, call 1-888-736-1227 or visit our website at www.361capital.com. Please read the prospectus or summary prospectus carefully before investing.

US Investment Grade Debt is represented by the **Barclays Aggregate Bond Index** which is a broad bond index covering most U.S. traded bonds and some foreign bonds traded in the U.S.

US High Yield Debt is represented by the **Barclays US Corporate High Yield Index** which measures the USD-denominated, high yield, fixed-rate corporate bond market.

International Investment Grade Debt is represented by the **Barclays Global Aggregate Index** which is a flagship measure of global investment grade debt from twenty-four local currency markets.

Large Cap Equities is represented by the **S&P 500 Index** which is a commonly recognized, market capitalization weighted index of 500 widely held equity securities, designed to measure broad U.S. equity performance.

Small Cap Equities is represented by the **Russell 2000 Index** which measures the performance of the small-cap segment of the U.S. equity universe.

International Equities is represented by the **MSCI EAFE Index** which is a free-float adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets.

Long/Short Equity is represented by the **Credit Suisse Long/Short Equity Hedge Fund Index** which is a subset of the Credit Suisse Hedge Fund Index that measures the aggregate performance of long/short equity funds. Long/short equity funds typically invest in both long and short sides of equity markets, generally focusing on diversifying or hedging across particular sectors, regions or market capitalizations.

Alpha measures the difference between a fund's actual and expected returns, based on beta, and is generally used as a measure of a manager's added value over a passive strategy. **Beta** measures a fund's sensitivity to market movements. The beta of a market is 1.00 by definition. **Sharpe Ratio** is a ratio developed to measure risk-adjusted performance. **Drawdown** is the peak-to-trough decline during a specific record period of an investment, fund or commodity. A drawdown is usually quoted as the percentage between the peak and the trough. **Basis Point** (bp) is a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% (0.0001).

The views expressed are those of the authors at the time created. These views are subject to change at any time based on market and other conditions, and 361 Capital disclaims any responsibility to update such views. No forecasts can be guaranteed. These views may not be relied upon as investment advice or as an indication of trading intent on behalf of any 361 Capital portfolio.

This 361 Capital article is not intended to provide investment advice. This paper should not be construed as an offer to sell, a solicitation of an offer to buy, or a recommendation for any security by 361 Capital or any third-party. You are solely responsible for determining whether any investment, investment strategy, security or related transaction is appropriate for you based on your personal investment objectives, financial circumstances and risk tolerance. You should consult your legal or tax professional regarding your specific situation.

Data and other materials appearing that are provided by third-parties are believed by 361 Capital to be obtained from reliable sources, but 361 Capital cannot guarantee and is not responsible for their accuracy, timeliness, completeness, or suitability for use.

The 361 Funds are distributed by IMST Distributors, LLC.
May 2020

361 Capital | 4600 South Syracuse Street, Suite 500, Denver, CO 80237 | 866.361.1720 | 361capital.com | Follow us: