Evaluating the Performance of Long/Short Equity Funds

Among the truly alternative mutual fund categories tracked by Morningstar, Long/Short Equity is by far the largest, with approximately $56 billion in assets under management. As we stated in the Long/Short Equity Usage article, this is understandable, as the investment argument is intuitive and compelling, liquidity is a lower order concern than for many alternative strategies, and investors need not radically shift their thinking around asset allocation and portfolio construction in order to take advantage of these strategies. But there is one complicating factor, and that is identifying skilled managers in the space, which is no small task. How should investors evaluate their long/short equity managers?

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. As an aside, because most long/short funds are systematically long biased (and few ever get remotely close to being net short), we believe long/short equity should be allocated to as part of the equity allocation, and not the amorphous “alternatives” bucket. Ultimately, long/short equity delivers equity beta, even if in a lessened form from long-only funds.

Returning to the drivers of return in a long/short equity portfolio, in addition to the equity risk premium, 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. A potentially effective way to measure exposure to not only the equity market as a whole, but to style factors, is to employ returns based style analysis (“RBSA”), which can isolate alpha, if it exists. Importantly, for long/short equity, the RBSA must be freed from the long-only constraint.

In conjunction with RBSA, and because of the inherent limitations of such analyses, investors should confirm exposures with holdings based analysis (“HBSA”), which additionally allows for even more granular factor analysis. Examining actual positions in turn is a starting point for attribution, which, if done properly, answers the question of whether or not the manager is adding value through either sector bets or stock selection. This is important because it isolates the last major source of risk from a long/short portfolio - manager specific risk. We define manager specific risk as the risk associated with a manager’s ability to properly identify mispriced risk at the factor or security level, since “alpha” is essentially excess compensation for the risks borne.

It is important to measure the manager’s ability to add value through stock selection on both the long and short books. If a manager cannot generate alpha on the long book, there is no question that investors should look elsewhere. But what about the short book? Our answer is that it depends. If the short book is intended to be a source of alpha, then the short book should be held to the same standard. If however, the short book merely serves 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 hedge simply 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”.

In addition to RBSA and HBSA, investors can get some insight into a manager’s ability to vary net exposure by comparing results to the broader peer group of long/short managers. Since the intent of attribution is to judge a manager’s decisions against all of the other decisions that he/she could have made, peer group analysis can serve as a proxy for the latter. However, too many investors use peer group analysis as their primary evaluation tool, and given the wide range of approaches within the long/short category, we think this is flawed. Peer group analysis has its place, but only as one tool among those we’ve already covered.

Long/short equity strategies have the potential to provide superior risk-adjusted performance compared to long-only fare, but there is additional complexity to these strategies. While that complexity provides the opportunity, complexity too often obfuscates the manager’s true impact, and investors who shortcut the quantitative elements of the due diligence process may suffer as a result.

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