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Advantages of active investing

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By Anuj Gangahar in New York
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Equity long/short investment has often been considered the “standard” hedge fund strategy. It is still the one that is most common among hedge funds and is generally what wealthy investors wishing to test the waters of the hedge fund market tend to opt for first.

For the year to date it is one of the best-performing strategies, with a return of 9.25 per cent, according to figures from Credit Suisse Tremont. This is ahead of the 7.86 per cent average return for hedge funds across all strategies and handily beats the 6 per cent year-to-date return on the S&P 500 index. Long/short managers are therefore among the few groups in the hedge fund industry, alongside event-driven and multi-strategy managers, who can make a convincing case that their often hefty performance fees are justified.

Long/short covers a range of strategies. There are generalists, managers who focus on certain industries, and those featuring sectors or regions. Managers may specialise in a type of stock, for example value or growth, small or large. There are many trading styles, with frequent traders and some longer-term investors.

The other two stand-out hedge fund styles this year are multi-strategy funds, many of which have equity long/short at their core, and event-driven funds, which would have been hard pressed not to beat the S&P, given the glut of mergers and acquisitions and endless kerfuffle about impending buyouts that have characterised this year.

This outperformance by equity long/short over equities is fodder for those who suggest this approach should be viewed not as a category within the alternative investment space but as a legitimate replacement for pure equity investments.

According to ABS, a Greenwich, Connecticut-based fund of hedge funds, which has produced a study on investing in the equity markets using a long/short strategy, equity long/short should be considered as a replacement for a portion of any equity allocation.

It is a widely held belief among a broad range of investors that most portfolios should maintain a long-term weighting of between 40 and 60 per cent in equities. But a glance at historical figures shows equity long/short produces superior risk-adjusted returns in comparison with long-only equity in both bull and bear markets. The ABS study attempts to analyse the reasons for this out-performance.

First, it points out that while a diversified asset allocation should provide long-term benefits for institutional and high-net-worth investors, equity investing involves a significant degree of so-called market timing risks, which are not adequately measured by most investors.

Market timing may have negative connotations, particularly after the improper mutual fund trading scandals of recent years in the US, but it remains a crucial factor for investors seeking to generate absolute returns.

For many wealthy investors contemplating equity long/short, and hedge fund strategies in general, the primary concern is transparency. Many managers choose not to disclose their positions in order to protect their strategic advantage and for fear that investment opportunities are already worryingly thin on the ground and arbitrage opportunities are fleeting.

One of the potential advantages of equity long/short investing is that it provides active management. According to ABS, the differentiation between active managers such as hedge funds and semi-passive managers – including mutual funds and long-only accounts – has been one of

the main factors driving hedge fund growth.

As professional investors and wealthy individuals realise they can obtain a better risk-adjusted return from a truly active manager, they will become less inclined to invest with semi-passive managers, whose portfolio construction is closely tied to a particular benchmark.

A study last year by Martijn Cremers and Antii Petajisto of Yale School of Management shows equity mutual funds that closely track an index significantly underperform those that provide more active management. Laurence Russian, principal of ABS, said this argument could be extended to hedge funds because the vast majority of equity long/short funds do not manage to an index. Therefore, the ability of hedge funds to provide active management should result in higher risk-adjusted returns and fewer drawdowns over long time horizons, in spite of their higher fees.

Russian added that flexible portfolio management is another factor allowing long/short portfolios to generate superior risk-adjusted returns. The equity long/short strategy gives investors access to both amplified alpha and flexible beta. Alpha is defined as the excess return over the benchmark as a result of stock selection after stripping out the portion of the return attributed to beta, or market exposure.

Flexible portfolio management and its advantages manifest themselves primarily in periods of negative returns or increased volatility. The ability to shift exposure and change from aggressive to defensive stocks allows fund investors to capture the upside of an upward-trending market while protecting capital in down periods.

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