A TRUSTEE’S GUIDE TO ALTERNATIVE INVESTMENTS, PART 7

WHAT IS 130/30?

BY TONY ELAVIA, STEVE LANDAU AND MONA PATNI

130/30 strategy is essentially an equity strategy benchmarked to an equity index. As the name suggests, it invests 130% of its assets in long positions—which intend to produce investment returns based on the potential for a security to increase in value over time while 30% is sold short. Short selling (or “selling short”) is a technique used by investors who try to profit from the falling price of a stock. If a short sale is successful, the profit is the difference between the price at which the stock was sold and the cost to buy it back, less transaction costs.

The proceeds from the short sales are then used to fund the purchase of the additional 30% of the long positions. The net investment is 100% exposure to the equity benchmark. In addition to maintaining a full “dollar” exposure to the benchmark as indicated by the net 100% exposure, 130/30 strategies are also designed to have betas of, or close to, one, relative to the corresponding benchmark. Beta is a quantitative measure of the volatility of a given investment, relative to the market, such as the S&P 500. A beta above one indicates that the investment is more volatile than the market. A beta below one indicates that the investment is less volatile than the market.

THE LONG AND THE SHORT OF IT

Pension funds are exploring the new 130/30 strategy in order to maximize alpha returns.

ALTHOUGH institutional interest in and demand for many types of hedging strategies have significantly increased, pension funds in general have been hesitant to commit large asset pools to these strategies due to their perceived lack of transparency, more complex structure, fee arrangements and limited liquidity. For these investors, a 130/30 strategy may be an appropriate alternative.

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WHY USE 130/30?

With the size of the 130/30 market currently estimated at $50 billion, awareness has been building. The institutional community is more familiar with the approach and track records of the traditional long-only managers who manage the bulk of U.S. pension assets in 130/30 strategies. The strategies’ growing popularity is likely attributed to several features.

1) Preservation of strategic asset allocation Since 130/30 portfolios target a beta of approximately one, they can and should be classified as equity as opposed to alternative investments. The source of funding for those mandates typically comes from termination of passive or enhanced index mandates with similar benchmarks. As such, the introduction of 130/30 strategies as a replacement for traditional long-only mandates does not necessarily require a change in asset allocation.

2) Consistency of holdings within the investment universe With 130/30, alpha is generated through securities that reside within the investment universe, not moved from another universe. Alpha measures the volatility of a fund and compares the risk-adjusted performance to a benchmark. Any excess return above the benchmark is the fund’s alpha. A high value for alpha implies that the stock or mutual fund has performed better than would have been expected given its beta (volatility). For example, an alpha of one means the investment outperformed the market by 1%.

3) Simplicity of structure Because they are offered via traditional mechanisms such as 1940 Act mutual funds, collective trusts or separate accounts, 130/30 strategies can be easily structured to suit a plan sponsor’s specific needs.

4) Reduced risk of adverse tax ramifications Unlike hedge funds, which can generate significant levels of unrelated business taxable income (UBTI), 130/30 strategies—when structured properly—do not require offshore UBTI blocking mechanisms.

5) Attractive return potential Through short selling and applying modest amounts of leverage, 130/30 strategies have the potential to generate higher information ratios than traditional active long-only strategies and, therefore, may be able to achieve higher returns for the same amount of risk relative to the benchmark. Leverage is the use of credit or borrowed funds to improve one’s speculative capacity and increase the rate of return from an investment.

6) Capitalize on managers’ ideas 130/30 strategies will continue to attract the best management talent because they allow investment professionals to allocate client capital more freely to their best alpha-generating ideas, whether positive or negative. 130/30 strategies, benchmarked to an equity index with shorting and leverage, may offer an ideal solution for investors and trustees interested in “testing the alternative investment waters” without moving aggressively into hedge funds.

WHAT TO CONSIDER

Before implementing a 130/30 strategy, sponsors and trustees not only need to consider the rationale for short selling but also several logistical factors, including relaxing the long-only constraint, risk controls, manager selection, the role of prime brokerage and tax mitigation.

1) Relaxing the long-only constraint 130/30 strategies differ from traditional long-only strategies because one, they relax the long-only constraint, allowing the manager to short stocks, and two, they permit the use of leverage, which allows the manager to maintain full exposure to the equity benchmark and overweight stocks with positive alphas.

Research has shown that relaxing long-only constraints is an efficient way to increase tracking errors resulting in a potentially higher information ratio. Tracking error is the standard deviation of excess returns (the difference between a portfolio’s returns and the returns of the benchmark) over time. Tracking error is sometimes called active risk. Low tracking errors indicate that a portfolio is closely following its benchmark; high tracking errors indicate the opposite.

Under an unconstrained approach, managers can capitalize on their research and fully
express views on stocks with negative alphas through shorting. At the same time, they can increase exposure to stocks with positive alphas through increased leverage.

Long-only mandates may limit the alpha potential that can be realized from exploiting underperforming stocks in an equity portfolio. Long-only constraints prohibit managers from fully capitalizing on stocks that research indicates will significantly underperform. This is especially true for securities that represent a small percentage of the benchmark weight, where the underweight is limited to the stock’s weight in the benchmark.

2) Risk controls and implementation considerations

Relaxation of constraints, however, should not imply lack of risk controls. Skilled managers can deliver risk characteristics that are similar to long-only strategies by imposing portfolio limits on sector and industry exposures, as well as specific constraints on individual security holdings.

Because shorting and leverage potentially increases a 130/30 strategy’s risk if not properly monitored, management of risks from shorting is imperative. Managers should use disciplined risk management tools to ensure that 130/30 strategies achieve desired tracking errors comparable to active long-only strategies. The same risk controls employed under a typical traditional large-cap mandate can also be applied to a 130/30 mandate. The tracking error for a 130/30 strategy, which is the amount of risk the strategy takes relative to the benchmark, can be customized for each portfolio to meet an investor’s specific needs.

3) Quantitative or fundamental managers

To generate alpha from shorting or limited-shorting strategies, investors should choose a manager with investment discipline, trading skills, risk management and expertise in long/short investing to handle the additional challenges that these strategies impose. This is particularly important as managing short positions requires a different skill set.

Many long-only managers can execute the research and trading disciplines demanded by 130/30 approaches. Investors should be aware of the differences between a quantitative and fundamental investment approach as it relates to implementing short-extension strategies.

Fundamental managers spend time researching companies, in terms of analyzing financial statements, visiting management teams, interviewing competitors and building discounted cash flow models in the expectation that careful, bottom-up research will help them pick winning stocks over the long term. Before making an investment decision on any individual stock, fundamental managers need to apply this time-consuming process on that specific security.

Given the benchmark composition and the long-only constraint, fundamental managers will focus their efforts and research on securities that they expect to outperform the benchmark since they have the ability to significantly overweight those securities.

Given the short restriction and the inability to significantly underweight most of the benchmark’s securities, fundamental managers typically do not devote resources on securities they expect to underperform.

Quantitative managers generate risk-return forecasts for all securities that comprise their benchmark universe. As part of existing data-driven research models, quantitative managers generate both positive and negative forecasted alphas for each individual security.

Because quantitative ranking methodologies can be easily applied to short extension mandates, executing 130/30 strategies can be a natural extension of quantitative managers’ capabilities, in that the managers are simply permitted to relax model constraints to potentially capitalize on negative as well as positive insights.

Bridging the mismatch

Few pension plans with long-term perspectives expect equity markets will continue to deliver the type of returns experienced over the past two decades. A review of the excess returns generated by a universe of large-cap core equity managers over the past five years illustrates that a more modest relative return environment may already be at hand, since only a limited number of these long-only constrained managers have delivered consistent excess returns of 2% or more during this period.

Looking forward, there is a significant potential mismatch between assumed and expected returns facing today’s pension plans. Expected annualized returns are notably lower than the required return by approximately 3%.

In seeking diversified sources of excess return, some pension plans have increased allocations to non-traditional mandates such as absolute return strategies, real estate, private equity and portable alpha. However, investors who have hesitated taking these steps may find 130/30 investing more suitable because the introduction of 130/30 strategies does not require a change in the asset allocation policies for most plans—a decision that carries its own set of procedural and political headaches. And, despite rapid growth in assets held in hedge funds, some institutions are not yet comfortable with alternative investing or authorizing the use of derivatives.

That said, most pension funds need a simple and cost-effective way to solve the capital market dilemma, and for these plan sponsors and trustees a 130/30 approach may solve several challenges.

First, 130/30 strategies are designed to generate superior returns with similar amounts of risk relative to a given benchmark than typical long-only strategies. Short-extension strategies are seen more properly as extensions of long-only active strategies, with the key difference that the active bets are more pronounced.

Second, by relaxing constraints on shorting securities, managers can capitalize on their research and more fully express their views on stocks, whether positive or negative.

Finally, because they retain much of the discipline and risk controls associated with long-only investing, 130/30 strategies may be an efficient way to improve equity returns for a broad spectrum of public and private investors.

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