An Alternative Viewpoint: A Case for Long/Short Investment Strategies

We believe long/short equity strategies today may offer extraordinary benefits to investors, including greater diversification, stronger risk-adjusted returns, and protection from drawdowns. Long/short equity strategies can serve as core holdings for investors with low risk tolerances, or they can complement other portfolio assets. In this paper, we explain how managers implement long/short equity strategies. We describe the strategies' potential strengths and weaknesses and discuss how they can help investors achieve their long-term goals.
A Superior Alternative: Long/Short Investment Strategies

Alternative investments are a broad category of investment strategies that can include hedge funds, derivatives contracts, real estate, commodities, and exotic assets such as art (as opposed to traditional assets such as equities, bonds, or cash). Until recently, alternative investments were largely inaccessible due to their complexity and liquidity constraints. Over the past decade, however, an increasing number of alternative strategies have been offered in more liquid and transparent investment vehicles. In particular, their availability as mutual funds has helped move alternative investments into the mainstream.

One of the oldest and most well-known alternative strategies is long/short equity (referred to as “long/short” through the rest of this paper). Long/short strategies can be implemented in many ways, but they all share a common goal: to profit from both rising and declining securities prices. Employed correctly, the long/short manager’s ability to short stocks may offer a competitive advantage versus long-only managers, who can only express a negative view of a stock by not owning it. While not holding a stock can have a positive impact on relative returns, it is likely to be marginal because most stocks in major equity indices have small weights (e.g., in the S&P 500 Index, more than half the stocks have a weight of less than 0.1%). Long/short managers, on the other hand, have an opportunity to generate significant alpha through short positions.

Long/short investment strategies have historically protected principal in downturns while offering exposure to rising markets (see Exhibits 3 and 6). Over the long term, this has enabled long/short strategies to outperform major equity indices on average with substantially lower volatility. Given this performance record, long/short strategies have the potential to fulfill a number of roles in portfolios: as a core equity allocation, a portfolio diversifier, and a potential buffer to equity market downturns.

In this paper, we explain how managers implement long/short portfolios and manage risk in seeking to outperform over a full market cycle. We also describe the strategies’ strengths and weaknesses, as well as the factors investors should consider when selecting a manager. Finally, we present Lazard Fundamental Long/Short Equity, which has historically delivered strong risk-adjusted returns and downside protection.

A Source of Risk-Adjusted Returns

Long/short managers have more opportunities to generate returns than long-only managers, and they can also provide superior risk-adjusted returns. Long-only managers typically seek to outperform a benchmark while controlling for risk, but this can be challenging for fully invested portfolios. While long-only portfolios will typically benefit from a rising market, they will also likely be hurt by a falling market—a roller coaster ride in performance that most investors would prefer to avoid. Extreme stock market downturns have occurred a number of times over the past two decades, e.g., the tech bubble, the global financial crisis, and the correction of 2015. For long-term investors, market declines are not a matter of if, but when (Exhibit 1).

Long/short strategies, however, generally offer relatively low correlations to the markets. During downturns in the equity markets, long/short portfolios should offer protection because the long holdings may lose value as the market declines, but the shorts should gain, potentially offsetting the losses. A way to judge a manager’s exposure to the markets is to calculate the difference between the portfolio’s long and short positions—called net exposure. A portfolio long 70% and short 30%, for example, has a net exposure of 40%.

A manager’s net exposure is often considered a proxy for his or her willingness to take on risk. A portfolio with net exposure of 50% should theoretically move at roughly half the rate of the market during broad moves. Some managers hold long and short positions that effectively cancel out their exposure altogether—“market neutral” strategies.

One indicator of skilled stock selection is when a manager delivers strong performance over the market cycle with low net exposure. These managers demonstrate an ability to accurately judge strong and weak companies relative to their stock prices as little of their performance is driven by the markets. Thus, investors in long/short strategies can benefit more fully from the managers’ stock-selection skills than investors in long-only strategies.

[Exhibit 1: Market Drawdowns Are a Normal Part of the Cycle]

The performance quoted represents past performance. Past performance does not guarantee future results.

Source: FactSet, J.P. Morgan Asset Management, Standard & Poor’s
Low net exposure, however, does not always indicate low risk. Managers can add market exposure on both the long and the short side, which is captured in the portfolio’s gross exposure. Two managers, for example, may both have net exposure of 20%. The first manager may be long 60% and short 40%, for gross exposure of 100%. The second manager, on the other hand, could be long 100% and short 80%, for gross exposure of 180% (Exhibit 2). The second manager would have a higher degree of risk if his stock selection is poor in any given period. The greater weights in both the long and short positions would increase returns for better and for worse. Some managers can adjust market exposure—both gross and net—based on their outlook.

Downside Protection

Downside capture in long/short strategies has historically been better than long-only strategies, which can be partly attributed to the ability of long/short managers to short stocks, sectors, or the market itself. This can help investors who need to generate long-term returns, but who don’t have the risk tolerance to remain invested when volatility spikes. The peak-to-trough decline of 2008–2009, when US large cap stocks lost more than 50%, caused many investors to sell out at or near the bottom, undermining their long-term investment plans. Investors in long/short managers, however, experienced smaller losses during these and other down periods (Exhibit 3).

This is important because investors often underestimate the importance of capital preservation. In addition to avoiding emotion-based decisions, investors with lower exposure to market downturns don’t need to take the outsized risks necessary to rebuild wealth after significant losses. After all, a 50% decline in a portfolio cannot be recovered through a 50% gain. Rather, the value of the remaining investment will have to double—or rise 100%—to make the portfolio whole again (Exhibit 4).

While a strategy’s downside capture offers one historical view of performance and risk, other statistics—such as Sharpe and Sortino ratios—offer more perspective on risk/return. By these measures, long/short strategies have also been relatively effective. The more well-known Sharpe ratio measures the amount of excess return the investor receives for the extra volatility taken on by holding a riskier asset. The Sortino ratio only factors in negative volatility (defined as downside standard deviation), rather than total volatility (which is used in the Sharpe ratio). This distinction is important as downside volatility harms portfolios, but upside volatility is desirable. The Sortino ratio provides an indication of the probability of a loss when comparing assets—the higher the Sortino ratio, the lower the probability of a loss. By these measures, equity hedge funds have been superior to the S&P 500 Index over the long term (Exhibit 5).
The impact of downside protection is evident over the long term. By generating stronger risk-adjusted returns, long/short managers have delivered outperformance (Exhibit 6).

Diversification
One of the most important roles long/short strategies can fulfill in portfolios is as a potential diversifier to other asset classes. Over a twenty-year period through 30 September 2015, long/short managers, in aggregate, have generated low correlations to the S&P 500 Index and the Barclays Global Aggregate Index of bonds, of 0.76 and 0.14, respectively. As a result, adding a long/short strategy can raise a portfolio’s efficient frontier (Exhibit 7).

The Importance of Due Diligence
Investors in long/short strategies should be aware that each manager is different and that market exposure can vary significantly. Some managers follow a bottom-up approach, focusing on individual company fundamentals, while others use quantitative methods to select securities and/or sectors. Within these categories, managers have differing levels of gross and net exposures. While gross and net exposures may be determined by the manager’s bottom-up process, it may also result from top-down views about trends in the economy or market.

Long/short managers also employ a wide range of investment instruments to build exposure to the markets. Some managers simply buy securities for their long portfolio and short stocks they believe will decline, but others may use futures, options, swaps, or passive vehicles such as ETFs. It is also common for managers to combine approaches by purchasing individual stocks for their long portfolios and ETFs and derivatives for their short portfolios.

It is important to know the manager’s net and gross exposures to the markets. A manager may have a low net exposure but through leverage have high gross exposure, making the manager’s potential risk significantly different from a manager with low net and low gross exposures.

Finally, manager goals also vary—some may focus on downside protection, while others emphasize market participation in all environments. In fact, during the market drawdown in August 2015, long/short equity funds, as well as multi-alternative funds, generated some of the widest performance dispersion within the mutual fund universes. In part, this is due to the greater investment flexibility available to long/short managers compared to other more traditional categories.

Given the range of long/short strategies available, proper due diligence is critical. Investors should have a thorough understanding of the role they want the long/short manager to play in their portfolio—as a source of diversification, downside protection, or market exposure. They should therefore carefully examine a manager’s objectives, philosophy, process, and performance, particularly in regards to volatility, beta, and correlation. Afterwards, the strategy should be closely monitored to ensure that it remains consistent with its stated objectives. Finally, long/short strategies are more complex than traditional strategies, requiring extensive investment, infrastructure, and risk management resources.
Our Approach

Lazard manages a diversified long/short strategy—Lazard Fundamental Long/Short Equity—that seeks to achieve superior risk-adjusted returns through bottom-up stock selection. The strategy takes long positions in equities of companies that we believe have strong and/or improving financial productivity (e.g., return on equity, free cash flow, cash flow return on investment, etc.) and short positions in companies that have deteriorating fundamentals, negative catalysts, unattractive valuations, or other qualities that warrant shorting.

Our approach is strictly bottom-up. We analyze each company within the context of its competitors, regulators, suppliers, and customers. We identify each company’s drivers of profitability and capital requirements, and consider the company’s management, its effectiveness, and how that may influence profitability. Our assessment of the company’s cash flows, and their sensitivity to key drivers, forms the basis of our view on returns and valuation.

Each company is then valued according to three scenarios: base, bull, and bear. This broadens our understanding of the company’s risk/reward profile and highlights the company’s sensitivity to key variables. We believe this approach is more comprehensive as it considers a stock’s potential upside and downside performance according to three scenarios rather than just one.

We often short positions that were previously held long in other Lazard portfolios because the company, the environment, or its financial productivity has changed. The firm’s deep research capabilities, which enable us to identify companies that are opportunities, also determine when they are fairly valued or are no longer attractive.

Early loss mitigation is a focus, and we believe that our sell discipline has been critical to the strategy’s success. Action is taken by the team if any position, long or short, detracts 50 basis points (bps) or more from overall performance. If a loss reaches 100 bps, the security is eliminated.

Our strategy’s gross exposure is generally less than 200%, and the strategy’s net exposure has mostly ranged between 30%–70%. Our bottom-up approach means that we do not have minimum allocations for sectors, although the portfolio will usually have less than 25% net exposure to any one sector. We do not target our gross or net exposures—rather it is a consequence of our bottom-up approach.

Our focus on financial productivity is an approach shared throughout the firm. Our team of 23 dedicated US equity investment professionals can draw upon the insights of the firm’s more than 250 investment professionals, and they are supported by the firm’s extensive risk management and operational resources.

Conclusion

We believe an allocation to long/short strategies can benefit investors by providing greater portfolio diversification, stronger risk-adjusted returns, and protection from drawdowns. Long/short strategies can serve as a core holding for investors with low risk tolerances, or they can complement other portfolio holdings. Given the broad range of long/short managers and their objectives, it is critical that investors understand what role the long/short manager is fulfilling in their portfolios. They should conduct due diligence before selecting a manager and then regularly monitor the manager’s performance. Managers that are transparent and supported by strong processes and cultures, in our view, should be favored and are more likely to help investors achieve their long-term goals.
Notes
1. Alternative investments generally have low correlations with equities, bonds, and cash.
2. We use the HFRI Equity Hedge Total Index as a proxy for long/short manager performance, unless otherwise specified. The HFRI Equity Hedge Total Index is an index of investment managers who maintain positions both long and short primarily in equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations, and valuation ranges of typical portfolios. Equity hedge managers would typically maintain at least 50%, and may in some cases be substantially entirely invested in, equities, both long and short.

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Diversification does not guarantee profit or protect against loss in declining markets.
Investments denominated in currencies other than US dollars may experience a decline in value, in US dollar terms, due solely to fluctuations in currency exchange rates. The portfolio manager does not intend to actively hedge the strategy’s foreign currency exposure. Small-and mid-capitalization stocks may be subject to higher degrees of risk, their earnings may be less predictable, their prices more volatile, and their liquidity less than that of large-capitalization or more established companies’ securities. Large cap securities may underperform because such companies may be less responsive to competitive challenges and opportunities and may be unable to attain high growth rates in times of market expansion. Short selling can, in some circumstances, substantially increase the impact of adverse price movements on the strategy’s portfolio. A short sale creates the risk of a theoretically unlimited loss, in that the price of the underlying security could theoretically increase without limit, thus increasing the cost to the strategy of buying securities to cover the short position.

The strategy invests in stocks believed by Lazard to be undervalued, but that may not realize their perceived value for extended periods of time or may never realize their perceived value. The stocks in which the strategy invests may respond differently to market and other developments than other types of stocks. Swap agreements and other derivatives transactions, including those entered into for hedging purposes, may reduce returns or increase volatility, perhaps substantially. Over-the-counter swap agreements, forward currency contracts, over-the-counter options on securities (including options on ETFs), indexes and currencies and other over-the-counter derivatives transactions are subject to the risk of default by the counterparty and can be illiquid. These derivatives transactions, as well as the exchange-traded options in which the strategy may invest, are subject to many of the risks of, and can be highly sensitive to changes in the value of, the related security, index, commodity, interest rate, currency or other reference asset. As such, a small investment could have a potentially large impact on the strategy’s performance. Use of derivatives transactions, even when entered into for hedging purposes, may cause the strategy to experience losses greater than if the strategy had not engaged in such transactions.

The S&P 500 Index is a market capitalization-weighted index of 500 companies in leading industries of the US economy. The index is unmanaged and has no fees. One cannot invest directly in an index. The HFRI Equity Hedge Index tracks the strategy, also known as long/short equity, that combines core long holdings of equities with short sales of stock or stock index options. Equity hedge managers generally increase net long exposure in bull markets and decrease net long exposure or even net short in a bear market. Generally, the short exposure is intended to generate an ongoing positive return in addition to acting as a hedge against a general stock-market decline. Stock index put options are also often used as a hedge against market risk. Profits are made when long positions appreciate and stocks sold short depreciate. Conversely, losses are incurred when long positions depreciate and the value of stocks sold short appreciates. Equity hedge managers’ source of return is usually similar to that of traditional stockpickers on the upside, but they use short selling and hedging to attempt to outperform the market on the downside.

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