Long and the short of shares

Despite global uncertainty, there are fund managers who are outperforming the market by using long-short strategies.

Bina Brown

Having the necessary skills to sell shares that are overvalued and/or unloved by the market has been a definite boon for so-called long-short fund managers.

While there is plenty of talk about blue sky for Australian companies, the bottom line is that investors have been leaving the market in droves.

The result is that more stocks have gone down than up and the overall market as measured by the S&P/ASX 200 Index in the year to October 31 was down 3.65 per cent.

Among those managers able to beat the broader market in recent years are those who adopt a long-short strategy. This is where they sell shares they think are overvalued and buy them back at a later date. Or they may hold a large portion of their portfolio in cash rather than risk holding stocks in a falling market.

Provided they pick stocks that subsequently fall or sell out of the market at the right time, they will do better than the market overall.

Being able to short shares mean they borrow them from an existing shareholder and sell them in the market. Then at a later date they buy them back and return them to the shareholder. It allows them to generate a profit when the shares fall and thus double the opportunity available to the fund. Long-short managers generally use one of two strategies, says Lonsec's senior investment analyst Sam Morris.

"There is the 130/30 strategy where the funds carry a net market exposure of around 100 per cent. As such, 130/30 funds are likely to enjoy a similar ride to the broader market," says Morris.

How it works is the fund manager short sells shares against about 30 per cent of the total assets and invests the cash generated from shorting in additional long positions. This leaves the fund about 130 per cent invested on the long side, with the net market exposure being reduced by the short positions.

The other strategy is the variable beta strategy, where managers can move a portion of their portfolio to cash where they foresee risk in the economic outlook or valuations.

Ideally the variable beta manager lowers the equity exposure before the sharemarket falls and then reinvests again later to take advantage of lower valuations.

These funds typically run a net market exposure of between 30 and 90 per cent. Morris says this flexibility may give variable beta managers an advantage over 130/30 managers in a downward market.

But timing the market has proven to be extremely difficult for variable beta managers in the past 12 months and the 130/30 strategy has generally performed better over this relatively short time period. Most long-short equity funds have a recommended time period of at least five years, although only about half the funds in this space go back that far.

One relative newcomer that stands out as having nous for shorting the right stocks is Regal. The Regal Long Short Australian Equity Fund returned 1.01 per cent after fees and taxes for the year to October 31.

Investment officer Philip King attributes much of the fund's success since its inception in August 2009 to its short positions but says the fund made money both buying and selling. "Some sectors in the Australian economy have been more challenged than others," King says.

"The two-sided economy – mining and resources versus retail, media and manufacturing – lent itself to managers with a short strategy."

Traditional long-only investors, which "hold and hope" have been exposed to the market going backwards and have not been as diversified as they thought, he says.

Morningstar says other managers in the long-short space, which have outperformed the broader market in the year to October 31 include Blackrock's Equitised Long Short Fund with an 11.31 per cent return; Perpetual's Share-Plus Long Short Fund with 3.3 per cent, and the Mathews Capital Velocity Fund with 2.42 per cent return.

Scorecard

Top 10 performing long short funds over five years

Name	Fee %	Return 1 yr %	Return 3 yr %pa	Return 5 yr %pa
Mathews Capital Velocity	2.00	2.42	33.86	32.07
Naos Emerging Companies Long Short Eq	1.18	2.15	46.08	12.32
Arnhem Long Short Australian Equity	1.08	-6.60	12.36	5.38
K2 Australian Absolute Return	1.54	-4.46	10.36	4.64
Aviva Investors Long/Short Equity	1.00	0.01	9.20	4.53
Grant Samuel Tribeca Alpha Plus	0.85	-9.08	10.94	3.55
OC Concentrated Equity	1.03	-4.24	24.21	2.69
Perpetual Wsale Share Plus Long Short	0.99	3.30	10.74	2.67
Perpetual WFIF Perpetual SHARE-PLUS Long Short	1.95	2.24	9.63	1.65
Acadian Wholesale Aus Equity Long Short	1.20	-3.34	3.26	-2.10
S&P/ASX 200 Accumulation Index		**-3.65**	**6.94**	**-0.18**

Net performance data to Oct 31,11

SOURCE: MORNINGSTAR

Taking notes of risk and returns

Hybrid securities offers have been launched by AFIC and Origin, each with very different attributes.

Debra Cleveland

Investors choosing between the Origin Energy and Australian Foundation Investment Company (AFIC) hybrid securities offers have some homework to do. The former's $500 million notes issue offers a variable rate from a cash-hungry energy company ploughing resources into Queensland's Australia Pacific LNG Project, while the $200 million notes issue from AFIC offers a fixed rate of 6.25 per cent and potential capital gains upside in Australia's largest listed investment company.

Both offers opened to investors on Wednesday, and close on December 12. The Origin offer is "fairly priced with the higher income reflecting the added risk", says Sulieman Ravell, founder of discount broker Funds Focus. It will pay quarterly interest 4 to 5 per cent above the 90-day bank bill rate. Ravell is, however, much more excited about the AFIC offer, dubbing it "the best hybrid I've ever seen on a risk-return basis".

Included in this offer is a conversion option allowing notes to be converted to shares in AFIC at 25 per cent above the share price as at December 19 this year. AFIC manages $4 billion and has been in operation for 80 years.

"[These are] a really good example of two hybrids at the opposite end of the spectrum," Ravell says. "AFIC notes are about as low risk as you can go, but are not as well known as a company and are only paying 6.25 per cent per annum. Origin Energy notes are higher risk and the expected yield of 8.7 per cent per annum reflects that. But because it's an ASX 20 company, investors are reassured by the brand awareness and so retail investors have a preference to Origin Energy despite AFIC offering the better deal."

The head of research at IOOF Advice, Peter Hilton, says the AFIC notes will suit investors seeking certainty of income with the upside of capital gains, while the Origin offer will appeal to those wanting higher interest rates but are able to cope with rate movements.

> **AFIC notes are about as low risk as you can go.**
> Sulieman Ravell, Funds Focus

The Origin offer is a 60-year bond although it's expected the issue will be repaid in five years. Written into the offer is a clause that interest or coupons can be deferred if the company's Standard & Poor's credit rating falls below investment grade. Analysts say this is unlikely as it will mean the credit rating will have to fall three notches. But holds on distributions are a potential problem for any note holder and should be taken into account.

"With AFIC's share price sitting at 10 per cent below net asset value [NAV] and historically trading at a premium as high as 13 per cent over the NAV, you can imagine the board expects a recovery and a return to trading at a premium," Ravell says.

"In effect, investors are receiving a free option over a fund that is generally considered to be index exposure."

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