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## Global Long-Short Strategies

In the current market environment, long-short strategies can minimize the fluctuation of pension plan assets.

High volatility, disappointing returns from many world equity markets, and lacklustre return forecasts have increased interest in long-short strategies. These strategies, when properly implemented, can generate strong positive absolute returns with little or no market correlation. This paper addresses both the theoretical and practical benefits of long-short strategies as well as their risks.

Critical success factors for any long-short implementation include a good stock selection capability coupled with a disciplined portfolio construction process that properly allocates and monitors risk. A global long-short mandate, whether or not it is market-neutral, allows for the widest possible array of

securities in both the long and short portfolios, thereby facilitating the maximization of return relative to risk.

One theoretical appeal of a long-short strategy is that it removes the “long-only” constraint imposed by more traditional strategies and, if it is market-neutral, it remaps the return characteristics of the strategy from an equity-relative benchmark to one of absolute returns. This is an important characteristic when overall cap-weighted indices are expected to have low or negative returns. The ability to short stocks also changes the efficient frontier characteristics so that, at higher levels of risk relative to an equity benchmark, long-short portfolios can potentially realize more excess return than their long-only counterparts.

In a long-short strategy in which a manager is able to short individual securities and equity index futures, the manager can better utilize alpha forecasts for all the stocks within the investment universe. They can do this by selecting stocks expected to appreciate for the long portfolio and stocks expected to depreciate for the short portfolio. As with the con-

struction of a traditional long-only portfolio, the manager must not focus exclusively on return but must also consider the risk characteristics of the portfolio. Within the context of a long-short strategy, the risk components become more pronounced since one must consider their “net exposure” and not just the long and short portfolios in isolation.

It is also critical to consider the implementation realities of transactions costs (commissions, taxes, and market impact) within the portfolio construction process since these costs reduce the overall return of the strategy. Furthermore, for the short portfolio, it is also important to include the likely cost of borrowing stocks that are short portfolio candidates, since the cost to implement the position must be netted with the forecasted return. The cost of borrowing a stock can be significant, ranging from approximately 30 basis points (annualized) for a large-cap index stock to more than ten per cent (annualized) for an illiquid or “hot stock.”

Without a structured and disciplined portfolio construction process, it is very difficult to create an effective portfolio of long and short positions that incorporates each stock's risk and return expectations while considering transactions costs and the cost of borrowing. This is especially true when the investment universe is broad. For example, the countries in the Morgan Stanley Capital International Europe, Australia, and Far East Index (MSCI EAFE) currently have nearly 12,000 investable securities.

In the current market environment, where absolute returns are less certain and volatility is higher than its historical average, absolute return strategies such as long-short can play a significant role in minimizing the overall fluctuation of pension plan assets. ■

