Long-Short Factor Investing
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Factors can be captured via both long-only and long-short investing approaches. See which key considerations can determine the right strategy.

In Perth, Australia, where I grew up, swimming pools and beaches are an important part of the lifestyle. Kids learn to swim in school and I still remember being proud when I was awarded my Junior Swim and Survive certificate! I’ve enjoyed swimming ever since. And yet it was only after I took up scuba diving that I realized what a completely different experience it is to swim under the surface observing fish and coral reefs from inches away.

Factor investing is like that. I think of long-only as swimming with my head above the water. Long-short investing, which seeks to take advantage of factor risk premiums in a new dimension, is akin to a scuba diver traveling under the water. You need specialized equipment and skills to go scuba diving, just as investing long and short simultaneously requires a very different perspective.

The long and short of it

Factor investing involves pairs: for every stock that has positive factor attributes, there must be a stock on the other side. For every value stock that is cheap relative to its intrinsic value, there must be a stock that is relatively expensive. For every firm producing high-quality earnings, there is a firm with more volatile, less cash flow–based earnings. For every name trending up, there is a name trending down.

Long-only factor investing involves taking just one side and tilting the portfolio toward stocks exhibiting factors such as value, quality and momentum. Long-short factor investing allows investors to play both sides: going long value, short growth; long high quality, short junk; and long winners, short losers.

When should investors consider one strategy versus the other?

Relative return or absolute return?

First, the most critical decision is what you want to achieve.
- **Relative return** strategies track a benchmark, like the S&P 500 Index, with the aim to outperform that benchmark.
- **Absolute return** strategies are not compared to an asset-class benchmark and seek to generate a diversifying source of return.

Let’s use the value factor as an example.

A long-only smart beta value strategy has historically outperformed the market over the long run. But, holding a long-only value portfolio still retains a significant amount of broad equity exposure, even as it seeks to enhance returns relative to a market-capitalization index.

A long-short value strategy simultaneously holds long positions in the cheapest stocks while shorting the most expensive stocks. This is done with the aim of removing aggregate market exposure. The same strategy can be implemented across asset classes—going long cheap securities and short expensive securities in equities, fixed income and commodities. Thus, long-short factor strategies may be appropriate for an alternative allocation in an investor’s portfolio. Although it is important to note that long-short investing comes with some significant risks and is not suitable for all investors.

**For fans only**

This part is for factor geeks only. It turns out that a long-only factor fund already incorporates a small amount of a long-short strategy! For instance, a long-only fund with a value factor tilt holds a large amount of the market but is biased toward relatively cheap stocks. The latter is essentially an element of a long-short strategy. However, since the long-only smart beta fund can only maintain long positions, the long-short factor component is small relative to the market component. Consequently, it can only realize a small portion of the potential benefits of the long-short factor return.

A long-short fund seeks to remove the exposure to the market, or become market-neutral. The pure long-short factor return — highlighting the full differences between value and growth stocks — receives maximum weight. We estimate there could be meaningful benefits to some investors with this long-short approach.

**Other considerations**

Just as scuba diving requires specialized equipment—a **Self-Contained Underwater Breathing Apparatus**, or a tank of air, long-short factor investing requires special considerations.

Long-only value strategies do not, by construction, employ leverage. Long-short strategies use leverage with the aim of reducing correlation with market returns. Leverage may have explicit limits, say in a 130-30 mutual fund that may hold short positions up to 30% of the portfolio.

Unconstrained long-short strategies seek to eliminate market exposure by targeting a particular level of risk. For example, a long-short strategy may short as many growth stocks and go long as many value stocks to obtain a target level of volatility.
Long-short investing requires state-of-the-art risk management. Going short requires locating securities to borrow or the use of derivatives.

Another consideration is accessibility. Long-only smart beta ETFs can be accessible with a small initial investment — just a few dollars in some cases. Smart beta ETFs are easy to trade, like a stock. Initial investments in an unconstrained long-short fund are typically much larger and may not offer immediate liquidity.

**Putting it all together**

We can swim laps in a pool on the surface of the water. We can go scuba diving under the water to see a coral reef. Being good at both requires different skills, training and equipment.

Similarly, factor investing can be done long-only, or long-short. The strategies have different roles in investors’ portfolios. Some investors might consider doing both: upgrading core index exposures with long-only smart beta ETFs and holding long-short factor investing funds in alternative allocations.

For those investors experienced at swimming at the surface, perhaps you could take the plunge and also consider factor investing in a long-short way?

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