A Long-Short Approach to Investing

By Ron Brounes*

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Many advisors believed diversified long-only portfolios would always serve their clients well, regardless of the market conditions. They expected certain asset classes would perform well even as others struggled. Unfortunately, many have learned hard lessons over the past year and a half, as virtually all classes have declined in value, causing sizable losses to their clients' (and their own) portfolios.

"This environment has exposed the flaws in traditional asset allocation theory, the Capital Asset Pricing Model (CAPM), or whatever label you choose to put on it," said Tom Samuels, managing partner of Houston-based Palantir Capital Management and manager of the Palantir Fund, a global all-cap long-short mutual fund. "While (Harry) Markowitz and (William) Sharpe still have their firm believers, sophisticated investors are realizing that they cannot achieve true diversification merely by being long a variety of asset classes."

Samuels believes the majority of long-only returns are influenced by the direction of the overall markets and that long-short strategies are one of the few ways to achieve true portfolio diversification and risk control.

"Long-short represents the only asset class that can effectively handle both sideways and bear markets," Samuels said. "The asset class allows investors an opportunity to systematically approach the markets and individual risk parameters differently than being long-only."

Brian Lipton, founder of Gaithersburg, Maryland-based YellowWood Financial Advisors, seeks out investments that are not correlated with traditional stocks and bonds. He views long-short products as another piece to the portfolio-construction puzzle, and he has incorporated hedged equity mutual funds as part of a tactical allocation and as a way to reduce exposure to long-only securities.

"We realized long ago that we cannot time the markets," Lipton said. "We typically allocate about 20% to 30% of our equity portfolios in a tactical manner. Hedged equity is a part of that allocation that helps satisfy certain risk elements, and, of course, allocations that reduce long-only exposure in this environment have been beneficial."

Lipton has found that hedged mutual funds have been a very good choice during periods of intense volatility and could also work well during other times. Lipton's firm, he said, uses one fund that goes long on favored positions, one that is short on out-of-favor, and another fund that buys equities and hedges them with short positions on various indexes. "While the latter fund is 100% hedged today, that percentage could change based on their views of the market environment," he said. "Security selection is still important."

Macro calls and hedges

At Palantir, Samuels attempts to take advantage of opportunities to hedge long positions while also seeking profits on the short side. In managing his long-short fund, he makes macro calls on the markets and economy, micro calls on companies he believes are under- or over-valued, and employs market-neutral arbitrage trades by pairing long and short positions in similar securities.

With short positions in an ETF that tracks long-term government securities, Samuels' fund is betting against US Treasury bonds. "Historically central banks have had mixed records of holding rates down, particularly when their currencies begin to fade," he said. "Shorting Treasury bonds provides an opportunity to make money on that macro call, while also serving as a hedge against certain long industrial and consumer-related domestic equities that may struggle in a rising interest rate environment."

Dave Walker, YellowWood's Director of Operations, says his firm has begun using a long-short commodities-based fund as a way to participate in this non-traditional asset class. "We have been allocating a portion of certain clients' portfolios into long-only commodities funds for years, but gains and losses have recently come so fast and furious that we chose to move into a hedged product," Walker said. "We realize we cannot time these markets on a daily basis by investing long or short."

Walker adds that based on the trends in the global economy and surrounding specific categories of commodities, a hedged commodities fund allows YellowWood's clients to participate in this alternative asset with lower risk and volatility. "We will trail indices when there is a quick rebound, but, more importantly, we expect to curb the downside," he said

Market-neutral pairs

Palantir's Samuels explains the pair-trading concept with a hypothetical example. "The market-neutral pair trades entail buying a high-quality security as measured by free-cashflow, low debt, and profitability, and simultaneously selling a security in the same sector that we perceive to be lower-quality based on these same parameters," said Samuels. "Let's say we liked Intel because of where the company is in its product cycle, its low debt position, and its positive cashflow. Conversely, we recognized that AMD maintains considerable debt and its last product introduction was underwhelming."

In this example, Palantir Fund may choose to go long Intel and short AMD. The firm would then be positioned well for an environment that has the overall equity market declining by 30%, with Intel and AMD dropping 25% and 35% respectively, he said. A properly executed paired trade would have returned 10% to the investor, even as the stock market as a whole lost 30%. According to Samuels, the long-short manager then has the opportunity to unwind the arbitrage, but only one side at a time if desired.

"We may believe AMD is more fairly valued after a drop of 35% and choose to cover our short, while still owning Intel, a high-quality stock that could appreciate should the market rebound," Samuels said. "The long-short approach provides us significant flexibility, while the long-only manager has to identify high quality stocks and then hope that the overall market direction cooperates."

Client reaction

YellowWood's Lipton said he did not see panic from his clients, even as the Dow recently fell below 7,000. He believes his clients understand their allocations and he has received very few distress calls. Still, Lipton realizes the concern is there.

"When the Dow broke below 7,000, some became worried about further significant slides without any apparent market support. We spoke with them more about increasing the hedged positions and they were happy to control the downside better while giving up a bit of appreciation potential. They were very interested in such investments, particularly given the uncertain environment we are in."

These days, a little peace of mind can go a long way.

** Ron Brounes, CPA, is a financial writer and president of Brounes & Associates, a Houston-based consulting firm that provides writing, communications and educational services for financial services professionals. His e-mail is ron@ronbrounes.com.*