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PARTNERS

# MEASURING UP

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DELIVERING  
THE PROMISE

IN THIS  
ISSUE

The equity long/short approach and potential applications for clients' portfolios.

## The Long and the Short of It

# Optimizing Equity Portfolio Management

During recent years, Yanni Partners has advised its clients about the prospects for modest capital market returns. Our Fall 2003 *Measuring Up* titled "Capital Market Expectations" documented the reasons why future equity and fixed income returns are likely to lag returns from recent decades.

Yanni Partners has responded to these modest capital market expectations by seeking methods to help our clients earn incremental returns.

One potential technique to add value is a more efficient method of equity portfolio management. Several equity managers have developed "long/short" techniques to exploit their research and portfolio construction capabilities more effectively. A long/short approach couples long positions with short positions in proportions to neutralize overall exposure to the equity market. A long/short portfolio provides direct access to a manager's active management skills. Hedge fund managers have accumulated an extended history of employing long/short techniques. In recent years, several traditional managers have developed long/short strategies to broaden these managers' product lines.

This edition of *Measuring Up* explains the equity long/short approach and discusses potential applications for clients' portfolios.

## Description

A long/short approach combines long positions with short positions in portfolios. Long positions represent the outright holdings of equities. All investors are familiar with long positions because traditional investment management is limited to these positions.

A short position represents the sale of stock that the investor does not own. The investor needs to borrow stock to short it. The motivation for selling a stock short is the expectation that it will decline. An investor terminates the short sale by buying the stock back, thereby closing out the stock loan. If the investor buys the stock back at a lower price than

the price on the date of the short sale, the investor will achieve a profit on the transaction. For example, if an investor executes a short sale of stock of Company ABC on April 1 at a price of \$50 and then buys back the stock at \$45 on April 30, the investor will earn a profit of \$5 per share on this transaction.

Both types of transactions, long and short positions, will be profitable if the sale price exceeds the purchase price. In the case of a long position, the sale occurs after the purchase. For a short sale, the sale occurs before the purchase.

There are several differences between long transactions and short transactions. A long investment limits the investor's risk to the purchase amount. If an investor buys a stock for \$50 per share, the maximum loss is \$50 per share, assuming the price falls to zero. A short sale exposes the investor to unlimited losses because the upside potential for a stock is unbounded. If the investor sells a stock short at \$50 per share and then the price surges to \$400 per share when the investor buys the stock back, the investor will sustain a severe loss of \$350 per share.

The combination of long positions and short positions serves to neutralize the portfolio's exposure to the overall equity market. Long/short managers strive to eliminate market exposure by selling stocks short in sufficient quantities to equate the dollar value of long with short positions. The resulting portfolio contains company specific risks. Some long/short managers seek to neutralize industry and style exposures as well. For example, if a manager owns only technology stocks and initiates short sales only in the utility sector, the portfolio will harbor significant industry exposures. The manager can neutralize industry exposures by matching industry exposures on both the long and short sides of the portfolio. The same concept holds for other types of factors such as value/growth and size. A manager will attempt to eliminate or minimize style exposures based on the manager's risk control philosophy and valuation insights. Some managers have developed a policy of structuring a

portfolio to eliminate overall market, industry and style exposures to the maximum extent possible.

## **Investment Rationale**

The fundamental premise that supports a long/short approach is the freedom to allow the manager to exploit the full extent of the manager's valuation insights. A traditional long only approach precludes the manager from taking full advantage of insights regarding issues that the manager considers overvalued. This phenomenon is very pertinent because traditional managers are accountable to a market benchmark. The manager's charter is to outperform the benchmark, net of fees. Many issues have a very small weight in the benchmark due to the large number of constituent holdings and a concentration of market value among few issues. For example, the S&P 500 Index has an average position weight of 0.2% (1/500). The top 2% of the issues (names) in market value constitute 22.8% of the value of the S&P 500. The median position weight is 0.09%.<sup>1</sup> If a manager has negative outlooks on several S&P 500 issues, it is likely that many of these issues have very small weights in the Index. In a traditional long only mode, the only way to implement a negative outlook on overvalued issues is to avoid (or underweight) such issues in the portfolio. If a manager has a high degree of conviction regarding negative prospects for certain issues, it is difficult to exploit such insights effectively if these issues have very low weights in the benchmark. A long/short mode frees the manager from the constraints of a long only mode. A long/short format enables the manager to execute short sales for issues that the manager deems most overvalued. This freedom enables that manager to capitalize on the best ideas for the long and the short positions.

The long/short mode constitutes a "pure" form of active management, provided that the manager has successfully eliminated all equity market exposure from the portfolio. The manager assumes long and short positions solely in response to valuation considerations, not because the manager feels compelled to hold issues in an effort to control

<sup>1</sup> Source: Standard & Poor's

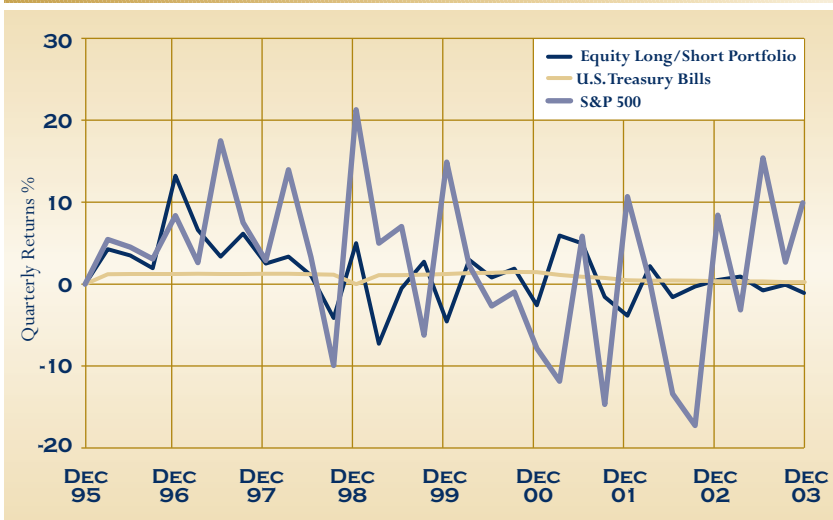
active management risk relative to a benchmark. The appropriate performance benchmark for a long/short strategy is a riskless investment of cash equivalents such as U.S. Treasury Bills or LIBOR. A long/short portfolio will display some measure of variability. This variability stems from the fluctuations from the long and short positions. The overall level of variability for many long/short portfolios is likely to approximate the variability of a fixed income portfolio. Unlike fixed income, a long/short portfolio does not produce a “contractual” stream of cash payments. Because a long/short portfolio generally lacks exposure to the equity market, it is not likely to track the overall equity market. An investor can convert a long/short portfolio to an equity-like portfolio by purchasing stock index futures.

## Research Survey

The availability of data for equity long/short approaches is fairly limited. There are relatively few managers with lengthy track records. Several researchers have performed simulations to test the potential benefits and risks of equity long/short. Yanni Partners has evaluated this research. We have summarized key findings in this edition of *Measuring Up*. It is difficult to render a definitive conclusion about the results of long/short approaches due to the limited number of managers with long track records. If the universe of managers that offer long/short strategies grows significantly, it will become possible to perform a rigorous quantitative analysis by conducting a “controlled” experiment. In such a controlled experiment, one can compare the performance of traditional and long/short portfolios (in pairs) across a large universe of managers in order to isolate a single variable – the efficacy of the long/short approach.

Despite the paucity of empirical data on long/short approaches (within the realm of traditional managers), researchers have evaluated long/short approaches on conceptual grounds. Researchers have advanced several reasons why long/short approaches offer more effective applications of

FIGURE ONE  
Quarterly Returns of Equity Long/Short Portfolio: Dec '95-'03



managers’ skills. Several researchers have simulated results of long/short strategies to evaluate the potential benefits and risks of such approaches. Yanni Partners believes that several of these researchers have provided sound support for long/short approaches based on simulated data and conceptual grounds.

Roger Clarke, Harindra de Silva and Steven Thorley have estimated that the imposition of a long only constraint has the effect of reducing a manager’s information ratio by 44%.<sup>2</sup> The information ratio measures a manager’s risk-adjusted active management performance. This analysis suggests that a long only constraint reduces a manager’s effectiveness by roughly one half. Richard Grinold and Ronald Kahn estimated that a long only constraint reduces a manager’s information ratio by approximately 50%, given various assumptions, such as an investment universe of 500 issues and tracking error of 4.5%.<sup>3</sup> Grinold and Kahn concluded that long/short strategies become particularly effective when the investment universe contains a large number of issues and when the manager assumes a high level of active management risk. Grinold and Kahn assert: “... the most skillful active managers should offer long/short strategies: Such strategies allow them the freedom to implement their superior information most efficiently.”

Annualized Returns	
Equity Long/Short:	5.5%
U.S. Treasury Bills:	3.8%
S&P 500:	9.4%

<sup>2</sup> Clarke, Roger, Harindra de Silva, and Steven Thorley, 2002, “Portfolio Constraints and the Fundamental Law of Active Management,” *Financial Analysts Journal*, Volume 58, Number 5, (September/October): 48-66.

<sup>3</sup> Grinold, Richard C., and Ronald N. Kahn, 2000, “The Efficiency Gains of Long-Short Investing,” *Financial Analysts Journal*, Volume 56, Number 6, (November/December): 40-53.

# MEASURING UP

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Hedge funds have employed long/short strategies for decades. The hedge fund field has attracted many skilled investment professionals because the hedge fund format enables managers to provide a highly concentrated form of active management with minimal market exposure.<sup>4</sup> Several traditional investment management firms have started to offer long/short approaches to leverage the managers' stock selection skills. Traditional managers that offer long/short approaches provide an alternative to investors that are not able or willing to consider hedge funds due to liquidity constraints and concerns about limited transparency.

### Results

Figure One plots quarterly returns of a representative equity long/short portfolio from Yanni Partners' GRID® database. This portfolio has exhibited a pattern of returns that one would expect from a long/short portfolio: greater stability than the equity market and a low correlation with the equity market. During this sample period from December 1995 to December 2003, this long/short portfolio earned a premium return relative to U.S. Treasury Bills.

### Potential Drawbacks

The long/short mode is likely to amplify the effects of the manager's valuation judgments. If the manager makes poor decisions, a long/short portfolio might sustain losses on both the long and short sides of the

portfolio. Short positions will inflict losses if the issue prices advance. In addition, short positions expose managers to significant challenges, including:<sup>5</sup>

- Numerous regulations govern short sales, such as the up-tick rule.
- Short sales are subject to operational risks, such as the possibility of a short squeeze – the need to close out a short position when the stock price is rising.
- Many companies with poor fundamentals seek buyers, thereby exposing the short seller to a sudden rise in the stock price.
- Successful short investments diminish in value; therefore, a short portfolio requires a constant influx of new ideas.

### Conclusion

The long/short approach allows an equity manager to exploit its valuation insights more effectively than a long only mode. In concept, long/short constitutes a pure form of active management. A long/short portfolio is generally not correlated with the equity market. The appropriate benchmark is a risk-free investment, such as cash equivalents. A long/short portfolio can serve as a beneficial source of diversification if the manager adds value. The long/short mode exposes an investor to the risk of losses if the manager's decisions prove faulty. The long/short approach also imposes operational challenges. Yanni Partners will work with its clients to seek appropriate applications for long/short strategies.

## Calendar of Events

**June 7, 2004**  
**Yanni Partners Corporate Golf Outing**  
**Sewickley Heights Golf Club**  
**Pittsburgh, PA**  
*Attendance by invitation only.*

Yanni Partners provides a full range of consulting services vital to the management of various portfolios. Our ultimate goal is to offer a basis for improved investment monitoring and performance.

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<sup>4</sup> Yanni Partners, Fall 2002, "Hedge Fund Investments," *Measuring Up*, Volume 15, Number 4.

<sup>5</sup> Ainslie III, Lee S., 2002, "Portfolio Construction and Risk Management: Long/Short Portfolios," *Hedge Fund Management*, AIMR, 47-49, 55-57.