EXPERIENCE AND EXAMPLES OF NEW STRATEGY

130/30 INVESTING: JUST A CURRENT FASHION OR A VISIONARY INVESTMENT APPROACH?

The tremendous growth in the hedge fund industry over the past decade has encouraged many investment firms to consider the potential benefits of short positions as part of more traditional long-only investment strategies. 130/30 is one of the latest innovations in the asset management industry and has produced a lot of interest among German investors lately

Higher information ratios are the key to choosing the best managers. When considering using short positions in a traditionally long-only strategy, it is helpful to understand the concept of the information ratio.

Information ratio is the ratio of excess return to tracking error, effectively measuring a fund manager's skill. In simple terms, managers who deliver higher information ratios will ultimately test the investor's patience far less often. This is because higher information ratios increase the odds that a manager will outperform over any time horizon, producing greater consistency of outperformance.

Information ratios are highly sensitive to how effectively investors translate their insights into portfolio positions. When the portfolio's market value is concentrated in fewer investments, the quantity and size of negative positions from not holding the stocks that the manager finds somewhat attractive reduces the information ratio.

For example, imagine a manager with a particular set of information about a sector with 4 per cent of the capitalisation of the manager's benchmark. Figure 1 below shows that with a long-only mandate, the manager invests the entire 4 per cent in the name that has his highest expected return.

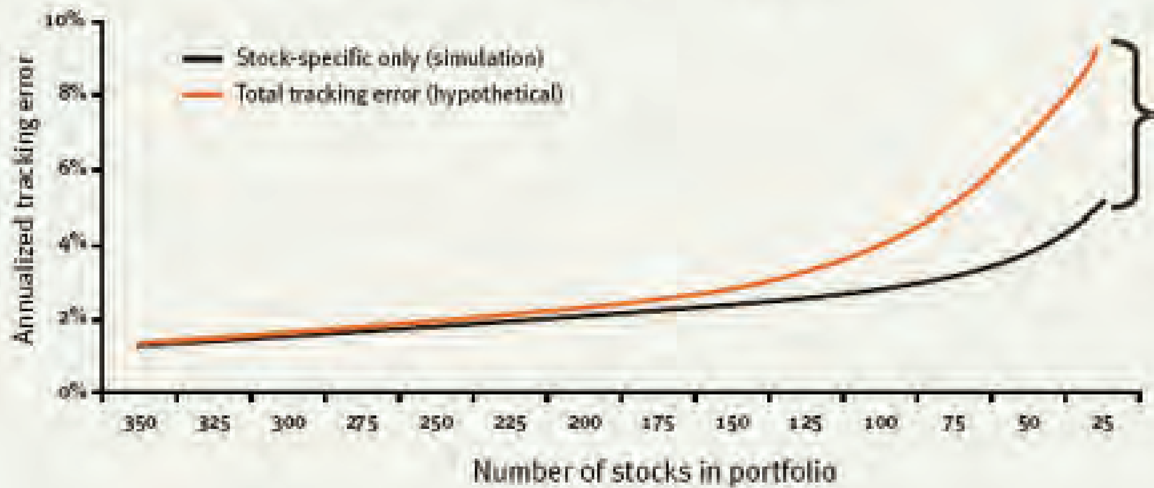
While this might make sense initially, making a large 3.75 per cent positive position in a long-only environment in the most attractive name – stock A – leads to many unintentional positions. Stocks B and C, which the manager also expects to outperform, have negative positions versus the benchmark. Stocks F and G, which the manager expects to significantly underperform, have only small negative positions, limited to their capitalisation weight.

If the constraint on short positions is lifted, however, the manager can align his positions more closely to his insights. This results in the same total amount of active positions as the long-only portfolio – 7.5 per cent.

FIGURE 1: ALTERNATIVE PORTFOLIO STRUCTURES FOR MANAGER WITH/WITHOUT A CONSTRAINT ON SHORT POSITIONS

Stock	Expected Return	Benchmark	Long-Only Portfolio	Long-Only Bet		Long/Short Portfolio	Long/Short Bet	
A	20%	0.25%	4.00%	+3.75%	Negative bets on stocks expected to be flat or outperform	2.50%	2.50%	Size and direction of bets consistent with expected returns
B	10%	0.50%	0.00%	-0.50%		1.25%	0.75%	
C	5%	1.00%	0.00%	-1.00%		0.00%	-0.60%	
D	0%	1.50%	0.00%	-1.50%		0.00%	-0.40%	
E	-5%	0.25%	0.00%	-0.25%	Small negative bets on stocks expected to significantly outperform	0.00%	-0.40%	
F	-10%	0.25%	0.00%	-0.25%		-1.25%	-1.25%	
G	-20%	0.25%	0.00%	-0.25%		-2.00%	-2.50%	
Total absolute bets (proxy for risk)				7.50%			7.50%	
Active return if expected returns realised:				[illegible]			1.25%	

FIGURE 2: THE EFFECT OF PORTFOLIO CONCENTRATION ON TRACKING ERROR



However, if the manager's forecasted returns are realised, the excess return from the long-only portfolio would be 0.74 per cent and the long/short portfolio 1.25 per cent. Therefore, lifting the constraint on short positions could enable a portfolio to achieve higher returns for the same level of risk and insight, thereby increasing the information ratio.

Allowing managers to take short positions results in a more efficient translation of insights into portfolio positions. Ideally, managers have equally insightful opinions on stocks they expect to perform well and those that should perform poorly.

Unfortunately a long-only portfolio limits the ability to exploit negative insights. Figure 2 (above) shows that only 16 stocks in the S&P 500 are large enough to allow a manager to take a 1 per cent or greater negative position by choosing not to own the stock. This constraint on long-only managers can result in a significant waste of investment insight.

Exhibit three shows portfolios of declining numbers of stocks. The thin red line shows a portfolio whose risk comes purely from stock-specific factors, what we normally think of as stock selection. As the portfolio becomes more concentrated, the power of diversification of these returns diminishes.

However, we can see that the observed tracking error of actual manager portfolios, the green line, rises much faster than this, illustrating the impact of non stock-specific risks in concentrated portfolios. This rapid increase in risk would not necessarily decrease the information ratio, if the resulting incremental excess return from this concentration increased just as rapidly. However, the payoff from many of these risks is lower than for the manager's equity insights, causing portfolio information ratios to fall.

Since most investors desire higher levels of excess return, and it would be unreasonable to believe that higher returns would not be accompanied by higher levels of tracking error, how can investors increase risk and return without suffering deterioration in the transfer coefficient and subsequently the information ratio? The answer, as we saw in Figure 1, lies in relaxing the constraint on short positions.

WHY 130/30 IS THE BEST PORTFOLIO SPLIT

Figure 4 (see page 28) shows portfolios with varying constraints on short positions – at 2 per cent and 6 per cent of tracking error against the S&P 500 Index. The long-only portfolio is a fully invested portfolio, with no other constraints. The '110/10' portfolio is 110 per cent of invested capital long, 10 per cent of invested capital short. Each of the subsequent portfolios to '150/50' have higher increments of gross market exposure, but a net 100 per cent market exposure and the same tracking error. The '100/100' portfolio is hypothetically market-neutral.

We can see from this example that relaxing the constraint on short positions has a significant positive impact on transfer coefficients and, by extension, information ratios. In addition, a '130/30' portfolio can theoretically achieve 88 per cent of the efficiency of the fully long/short portfolio at 2 per cent tracking error, and 82 per cent of the efficiency at 6 per cent tracking error, showing that adding some short positions goes a long way.

Does every manager have the tools to successfully take short positions?

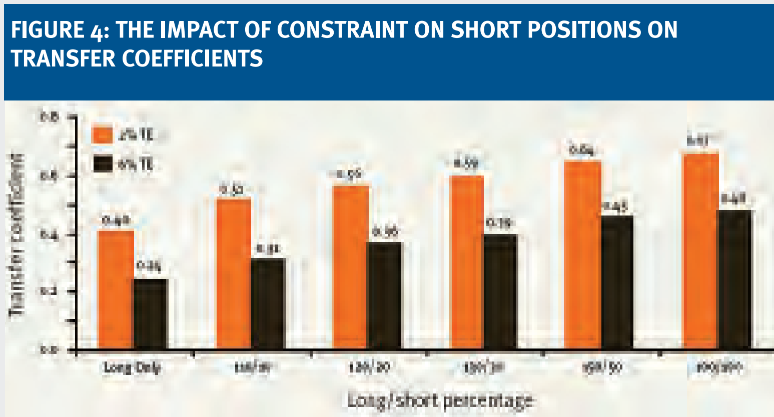
The potential for improved investment results by including short positions in portfolios with more traditional objectives warrants strong consideration, but may not suit many managers, including some with excellent

FIGURE 3: 30/30 STANDS THE PRACTICE TEXT

US Equity Returns	One	Two	Since June 2004
Large Cap 130/30	25.4%	17.6%	15.8%
S&P 500 Total Return Index	15.1%	12.2%	10.5%
Excess Return	10.3%	5.4%	5.3%

Performance of US-registered JPMorgan Large Cap 130/30 fund, since inception in June 2004.

FIGURE 4: THE IMPACT OF CONSTRAINT ON SHORT POSITIONS ON TRANSFER COEFFICIENTS



long-only track records. Several obstacles may hinder those attempting to take short positions.

- Some managers focus their research intensively on a handful of names. This suits running a concentrated long-only portfolio, but does not lend itself to finding and building short ideas. Those whose insights are spread wider are more likely to find good long and short ideas.
- A lack of experience in short position risk management. When a long-only manager holds a poor position, this position reduces as the stock loses relative value. With a mistake on the short side, the opposite happens – the position grows in size and the potential losses are unlimited. Actual experience of managing this risk is therefore a valuable skillset.
- Taking short positions is administratively complex. Managers must understand the various regulations and successfully deal with prime brokers who arrange the loan of stocks for short positions. These skills can be acquired, but managers with actual experience will have an advantage.

Not every manager has the appropriate alpha source and experience set necessary to support the taking of successful short positions. However, some managers have proven that their insights into underperformers are as powerful as those into outperformers.

Many have also proven that they have the risk management and logistical skills necessary to manage short positions. Relaxing the constraint on short positions for those managers who are able to responsibly and successfully utilise them can result in significant gains in risk adjusted returns.

The 130/30 investment strategy is a mainstream asset, providing the opportunity for fund managers to put more of their investment ideas into client portfolios, and it is therefore a tool that definitely deserves to be considered by pension plan trustees.

The key point to consider when searching for a suitable 130/30 fund is to find a manager in whose ability to generate alpha investors has strong conviction, who has experience in shorting stocks and whose investment process provides valuable insights into the least attractive stocks.

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CORPORATE STATEMENT

JPMorgan
Asset Management

JPMorgan Asset Management is part of JP Morgan Chase & Co, and is a global asset management leader providing world-class investment solutions to clients. With $1.2 trillion in assets under management and offices in 40 locations around the world.

JPMorgan Asset Management offers global coverage with a strong local market presence, and leadership positions in most asset classes. In Germany, JPMorgan Asset Management is active for more than 18 years.

With assets under management of more than $25bn, the company is one of the biggest foreign managers in Germany.

JPMorgan recently launched four 130/30 funds according to Ucits standards for European investors, covering our successful US and Europe equity strategies.