INTRODUCTION

130/30 BAND WAGON POWERS INTO EUROPE

European fund houses are waxing lyrical about the potential of 130/30 funds, with the ability to short offering enhanced performance. However, with the plethora of new products flooding the market, some private bankers may adopt a wait-and-see approach. Christine Senior reports

A bandwagon is rolling on 130/30. Asset managers are falling over themselves to offer these new style funds, which have emerged in Europe in the wake of the Ucits III regulation. But with the momentum of the launches it would be easy to get carried away by the hype.

Though 130/30 funds are still in their infancy in Europe, everywhere the talk is of their inherent potential. Citi's figures put the size of the current investments in the market at $2bn-$5bn (€3.7bn) by European pension funds which equates to 80 per cent of the market, with the remaining 20 per cent taken up by retail investors, including high-net -worth individuals.

But Citi estimates the market could be worth $30-$40bn by the end of the year if the products' US success is replicated this side of the Atlantic. Quick off the launch pad have been funds from Barclays Global Investors (BGI), Fortis Investments, Goldman Sachs, Investec, State Street and UBS, but by the end of the year the space is likely to be somewhat more crowded with many new launches in the offing.

130/30 funds (or 140/40, or whatever the ratio) are essentially enhanced equity funds. They take a 100 per cent long position, while giving the manager the freedom to take a 30 per cent short position in stocks they are bearish on, and then adding further exposure on the long side to the same 30 per cent extent. And under Ucits III rules, the shorting is achieved using contracts for difference (CFDs) rather than by using borrowed securities.

Traditionally, long-only portfolio managers have only had the option of underweighting those stocks they do not favour. With the ability to short, managers can potentially achieve higher performance through having greater scope to express their views. Underweighting a stock which has a weighting of less than 1 per cent in the index will have little effect, but shorting it by say 5 per cent can make a significant difference to performance, if the stock does indeed lose value.

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For Thierry Rigoulet, head of French sales at Fortis Investments, these products allow investors to improve performance while staying close to the market. "It is for high-net-worth individuals who want to be in the market,

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but not take risk to be invested with a value or growth bias, who want to have something not so far from the market with the ability to increase the performance through the long and short element."

Goldman Sachs' Flex products, which at the moment come in European, US and Japanese equity versions, follow a 135/35 format. Nick Phillips, head of global partners, Goldman Sachs Asset Management, EMEA, compares the funds to a concentrated portfolio:

"You target similar alpha returns to a concentrated portfolio, but you still target a relatively low tracking error, between four and six. 135/35 strategies sit very nicely alongside a concentrated long-only product. Because typically to have a higher alpha target in a long-only product you probably would have 25 to 35 stocks, whereas in 135/35 our European Flex product has 247 stocks, so you target the alpha of a concentrated portfolio with the characteristics of a diversified core portfolio."

Mr Phillips finds private banks have been interested in using the products in two ways, both as part of fund of funds and multi-manager offerings and also on an advisory basis.

"Interest so far has been in two different places," he says. "In funds of funds or multi-managers put together by manager selection teams in private banks. These have been used as an alternative or complement to long-only European equity. Those funds of funds or multi-managers are distributed by the private wealth management financial consultants.

"In addition, because the product is new and different, and it gives access to managers with experience of shorting, and daily liquidity, it's something they have been enthusiastic about distributing on an advisory basis as well. It gives them an opportunity to talk to clients about a product which is different and which may enhance their portfolio."

But they also fit comfortably into a core-satellite approach, as either part of the core or the satellite, according to Michel Agou, business development director for fundamental asset management activities, at Société Générale Asset Management (SGAM). "On the core side we would propose a low TE equity fund to people wanting to give more impetus to their core investment, so 100 per cent would be very close to the benchmark plus 30/30 being the alpha generator," comments Mr Agou. "Or on the satellite side people would have 100 per cent in active equity management plus enhanced equity management with the 30 long 30 short."

There is still confusion on just where they sit in the funds universe – are they really long-only funds with that bit of extra power to add alpha, or should they be regarded as hedge funds lite. Essentially as beta 1 products, their risk comes from market exposure. Nevertheless their ability to go short lines them up alongside hedge funds, though they also display considerable divergence from them. The main differentiator is they are relative value, not absolute return, products, and their ability to short stocks is limited.

DIVERSIFICATION AND VOLATILITY

They are about diversification and reduction of volatility, says Blair Pollock, director of equity finance at Citi. "It's about the chance to get better returns for the same level of risk or the same return for a lower level of risk. It's a different market from hedge funds. Some investors who already invest in hedge funds might also find these attractive."

But high end high-net-worth individuals will be unlikely to find any use for these types of funds, having years of experience and familiarity with hedge funds.

"The multi-billionaires of this world have been investing in hedge funds for the last 20 years," says Fredrik Nerbrand, global strategist at HSBC Private Bank. "This is not particularly new for them. The ultra-high-net-worth individuals have already got access to the best managers in the hedge fund space, so their appetite is probably going to be less than from the high-net-worth or mass affluent. From a private banking point of view there is probably going to be more interest coming from those clients who don't have sufficient threshold to have a bespoke hedge fund mandate we can run for them."

Given that many high net worth individuals are already comfortable with hedge funds, what can these funds

offer that could not be achieved via a combination of a traditional long-only equity fund or an exchange-traded fund (ETF), plus a market neutral hedge fund? They are not a replacement for hedge funds, but some might view them as a kind of halfway house between long-only funds and hedge funds. Many investors may feel uncomfortable with hedge funds on a number of scores: they lack transparency, managers keep their activities under a cloak of secrecy on the pretext of keeping a competitive advantage; they lack liquidity, with lock in periods; and their fees are high.

Mark Samuelson, head of UK institutional business at Investec Asset Management, which has just launched a global equity product not limited to a 130/30 ratio, says the secretive nature of hedge funds makes investors nervous.

"People have no idea how the hedge fund process operates," he says. "That has scared a lot of people off. What our product does is it brings both worlds together in a very transparent fashion. In our product people know what we bought what we sold and why we've done it. In addition to that the fees aren't ridiculous like in a hedge fund."

Nevertheless for those investors with experience of hedge funds, a portable alpha strategy using a combination of long-only fund plus market neutral hedge fund does offer greater potential for alpha generation. Here the manager has much greater flexibility to identify sources of alpha. But these types of strategies are more the preserve of investors with larger investment portfolios. The 130/30 fund is one step along this road for smaller investors.

"The concept of portable alpha I have been working with for a long time," says Mr Nerbrand. "If you do it by way of a long-only fund, or ETF then a market neutral hedge fund you can chose where you want the alpha to be generated. For example, if you don't think there is the opportunity to generate a lot of alpha in US large caps but you think a better way is in emerging market debt you can then chose to source alpha where that is found and manage your beta independently. That is what we do for larger portfolios; for smaller clients the 130/30 funds is good stepping stone toward that."

Some private bankers are yet to be won over by 130/30 funds. The reaction from Nordea in Sweden is caution in the face of an onslaught of these new products.

"We have been looking at those funds as a way for portfolio managers to increase the possibility to create alpha," says Inga-Lill Carlberg, head of private banking with Nordea in Sweden. "We always look into new alternatives and these funds are among those alternatives but it's a matter of how should we communicate them and where do they fit in. Our view is this is higher tracking error fund where there is an opportunity to increase returns. The customers aren't really asking for those funds, they are quite new, but our customers are always interested in new ways of increasing their returns."

Many investors look likely to adopt a "wait and see" approach to 130/30 funds. With so many launches hitting the market in a short space of time, some will obviously be more successful than others. Quantitative investment houses, with a mass of historical data at their disposal to mine for shorting ideas, look to have a built-in advantage, as do those houses with hedge fund capabilities. It remains to be seen who the winners as providers of most successful products will be. All the more reason for investors to be cautious.

Nerbrand: 130/30 is a good stepping stone to alpha

TESTING THE WATER

"Some high-net-worth individuals may only be willing to invest in these strategies after having observed a minimum period of track record," says SGAM's Mr Agou. "For one reason they have been used to investing directly in long-short funds and for them they need to see a real performance track record of the traditional industry over these funds to be sure that the traditional fundamental managers are able to provide alpha with these new techniques, recently made available to them by the regulators, which used to belong exclusively to alternative asset managers."

Another reason to be wary is that alongside the possibility of increase returns is the flipside: there is also the chance that the bets will go wrong. Higher risk means a greater possibility of losses; with shorting there is no limit on the downside.

HSBC's Mr Nerbrand sounds a note of warning: "There is more scope for a portfolio manager to significantly underperform as well as significantly outperform. There is a greater uncertainty about the potential returns these funds are likely to generate compared to those of long-only funds."