



Long/short investing strategies

Introduction

For most investors the concept of stock market investing is a fairly simple one: buy a share in a company for a reasonable price, hold the shares for a period of time and, if they have gone up in value, sell at a later date for profit. However, as the financial landscape has developed and more complex structures have evolved there is a much broader selection of potential investment solutions to consider.

For some, hedge funds have long been used as an alternative to traditional 'long only' strategies (see Investment Bulletin 2 – Hedge Funds). However, until quite recently, lack of accessibility has meant that they have been the domain of ultra high net worth individuals or institutional investors.

In February 2004, changes in legislation introduced new levels of transparency and flexibility to collective investment schemes, extending the scope of investments in which funds can invest to include deposits, certain types of derivatives, fund of funds and money market instruments in addition to permitting the use of index tracking techniques.

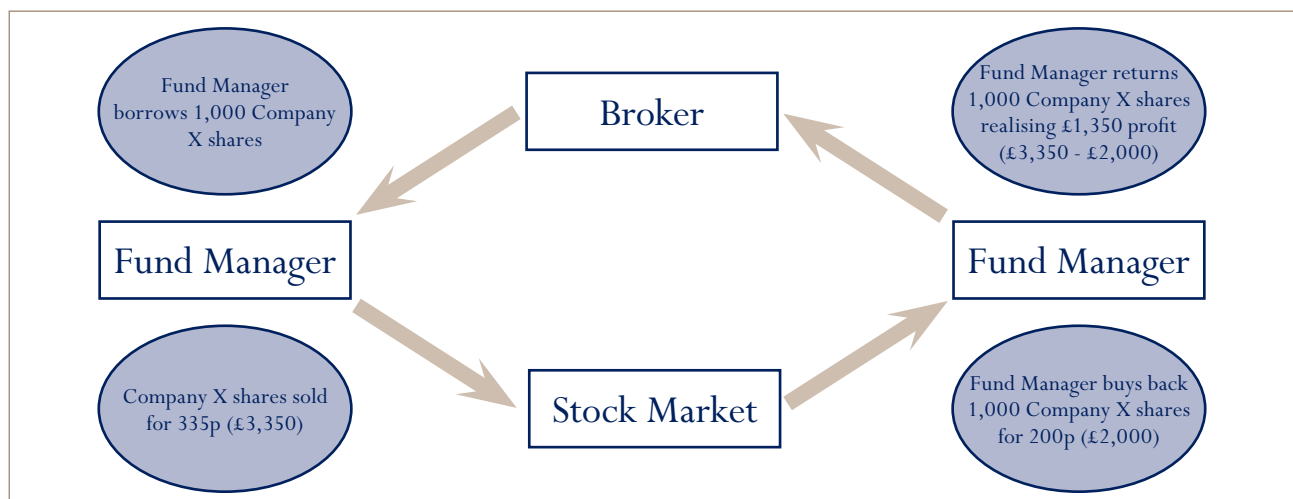
The new rules also gave traditional fund management companies the flexibility to use many of the same tools as their hedge fund counterparts, albeit with additional layers of protection for investors.

What is shorting?

A traditional long only strategy relies on buying shares in a company and selling, hopefully, for a profit at some point in the future – known as going long on a stock.

When an investor goes long on an investment, it means that he or she has bought a stock believing its price will rise in the future. The converse is also true, when an investor goes short, he or she is anticipating a decrease in the share price.

Short selling means you borrow a stock and sell it immediately. The hope is that the share will fall in value and that you can buy at a lower price than you sold it.



Consider this example; the fund manager believes that the share price of Company X is overvalued at 335p. By entering into a short selling agreement the manager would borrow say 1,000 shares in Company X from a broker and then sell them for 335p making £3,350. If the share price falls to 200p, the manager could subsequently buy 1,000 shares in the market for £2,000 to payback the broker having made £1,350 profit (£3,350 - £2,000).

However, if the fund manager 'shorts' on a share that rises in value then the potential losses will be mirrored. The risks, as are the gains, are unlimited – a rapid and dramatic rise in the value of the share will see the short seller exposed to big losses until the position is closed out.

Synthetic shorting

Under the new legislation, fund managers cannot physically short sell a stock within a retail fund but they are able to take 'synthetic short' positions through the use of derivatives (see Investment Bulletin 4 – Financial Derivatives). This enables the fund manager to generate profits from shares in companies where they believe the future growth and/or profits of that company are overstated.

The term *synthetic shorting* relates to the effect of using a combination of derivatives that provides the same result as physically shorting a stock.

What are the risks?

As with any investment strategy, there is always the risk that the value of the investment may go down as well as up. In addition, long/short strategies have some unique risks.

Being able to identify companies that display characteristics pointing to positive growth in the future is, in isolation, a difficult task. Fund managers employ a number of different styles and techniques (see Investment Bulletin 14 – Investment Styles) to achieve consistent, long-term growth within their portfolio. A successful long/short strategy also requires the managers to correctly predict the underperformance of companies.

Whilst the vast majority of investment funds available to retail investors operate on a 'long-only' basis, some industry commentators remain unconvinced that a single manager is able to create a portfolio to benefit from both winners and losers. However, the increased profile of these funds coupled with evidence of strong, sustained performance from some managers suggests that they are likely to continue to grow in popularity.

In a rapidly rising market, in which most stocks are increasing in value, a long/short fund will typically underperform a 'long only' manager.

The use of synthetic shorting also introduces default, or counterparty, risk. Default risk is the risk that the counterparty providing the derivative will not be able to pay the contractual interest or capital on their obligation. In current markets, default risk is a consideration for many investors and the high-profile collapse of several global banking giants, key players in the derivatives market, has highlighted this risk.

Summary

Whilst alternative investment strategies may not suit all investors, the additional flexibility provided under the new legislation offers the opportunity to increase returns in difficult market conditions by taking short positions.

Investors considering these strategies should ensure that the manager they select has a robust investment approach with strong risk controls to ensure the expected returns materialise at an acceptable level of risk.