

# The 130/30s are coming

What you need to know when they get here

BY AL KELLETT

There may soon be a new name to add to the growing list of trendy investment vehicles designed to invigorate our portfolios.

The arrival of 130/30 funds in the mainstream (U.S.-only, for now) is a positive development; the structure has merit and investors benefit from having this option available to them. Institutions and high-net-worth individuals have already started using funds that employ this structure, and if indeed it has real benefits it should be open to everyone.

But it's important to not be taken in by marketing hype; this is not the holy grail of investing. There are some real issues bubbling below the surface, and investors would be wise to consider them. Furthermore, not all 130/30 funds will be created equal. You'll have to do some research to weed out the dogs.

First, let's take a look at how these funds work. The numbers in the name refer to gross exposure: for every \$100 you invest in units of the fund, the manager will buy \$130 worth of stock and sell short \$30, for a net market exposure of \$100, which is what your exposure

would be in a traditional mutual fund. "Shorting" stock is a bet that it will fall in price, and the tactic for making this bet is to borrow the stock and sell it now, then buy it back later at a lower price (if all has gone according to plan) and return it to the lender.

The basic idea with these funds is that the manager is making \$160 worth of decisions with your \$100 without increasing your exposure to general market movements. Sometimes the 100 will be a passive index exposure and only the 30/30 will be actively managed. Either way, you're getting a leveraged-up dose of the manager's influence, whether it's positive or negative.

A well-known shortfall of the traditional mutual fund is that you don't quite get the full benefit of the portfolio manager's insight. If she likes a stock she will buy it, but if she feels just as strongly that another stock is a sell, the most she can do is give it a zero weighting. A long/short structure like 130/30 addresses this limitation and allows a more complete expression of a manager's best ideas.

Investors in 130/30s also get

the benefit of non-recourse leverage. Despite essentially borrowing money to get enhanced gross exposure, the investor's liability is limited to the amount originally invested in the fund. By contrast, do-it-yourself investors who wanted \$130 in long positions and \$30 short would be on the hook for at least \$160 if everything went wrong.

Moreover, there are structural reasons why the short side may offer even greater opportunities to add value. Because fewer investors actually short stocks, the terrain is less picked over. As well, there are market dynamics that artificially inflate stock prices. For example, since the management of a company gets paid more if their stock rises, aggressive accounting practices are more likely to inflate value on the upside. And sell-side analysts, for a host of well-documented reasons, are more prone to issue a "buy" than a "sell" rating, which further augments prices. Should these chronic inefficiencies subside over time, the downward pressure will benefit short-sellers.

Nevertheless, there are issues at play when shorting is added

to the mix. For one, there is a big difference between underweighting a stock and actually selling it short. Unlike long positions, which diminish in size when they move against you, short positions grow as they get further offside – short a stock and the sky's the limit on what you can lose.

Another problem with shorting a stock is the need to borrow it in the first place. The amount of stock available for borrowing is a small fraction of the outstanding float, since not every shareholder agrees to lend out their holdings. As more long/short funds spring into existence, the competition – and therefore the cost – to borrow stock rises dramatically. This effect is exacerbated by the fact that smaller stocks are shorted more often. After all, large stocks have large index weights so managers can express a certain degree of bearishness by simply not owning them.

In addition to concerns with shorting, there are important issues inherent in the 130/30 structure itself. The beefed-up dose of alpha cuts both ways: if the manager underperforms, you have an enhanced exposure to that negative alpha as well.

When you buy a 130/30 fund you're making a leveraged bet on the manager and her ability to make successful stock picks, so you need to be pretty confident in

that manager's abilities before taking the plunge. Look for managers with long track records that show evidence of skill, as well as some experience with short-selling.

Also important is the extra layer of costs. In a frictionless world the proceeds from short-selling could be used to fund the additional long position, but in reality collateral must be kept at the broker. Since fund managers can't use the short proceeds to buy the extra \$30 on the long side, they need to borrow that money, and do so at a price. Add in the expense of having to replace any dividends that occur during the period you've borrowed the stock and there is a significant cost hurdle for 130/30s to overcome. Examples from the U.S. are telling: UBS U.S. Alpha last year had expenses of 0.38% for "dividend expense and securities loan fees for securities sold short." Mainstay 130/30 Core fund had 0.53% in similar expenses.

Clearly this is a complex investment, and there are still many broad issues to consider such as determining appropriate benchmarks and deciding whether to charge fees on the \$160 that is being actively managed, or the \$100 investors have bought in for. It's important that investors know what questions to ask.

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