

130/30s Seen as Rafts In the Whitewater Rapids: But Benchmark Indexes Could Constrain Growth

John Morgan

1,003 words

12 May 2008

Money Management Executive

English

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NEW YORK-Cautious investors will be watching 130/30 funds over the next few years to see how the new products perform.

Many investors are attracted to these active-extension strategies capable of hedge fund gains. But with higher fees than regular mutual funds and short-term track records, even though they are often under the supervision of well-established financial services companies, 130/30 funds are still very new and considered a gamble.

"If you do have a track record, it's a tremendous advantage," said Yin Luo, managing director and head of North American quantitative research for Macquarie Capital at the National Investment Company Service Association's Alternative Investments Conference last month at the New York Athletic Club.

Their popularity could launch into orbit if these strategies are able to meet their promise of producing alpha, especially during a market slump, but if they barely beat or fail to meet benchmark indexes, investors will question whether they're worth the cost.

Fees for 130/30 funds are often higher than the typical actively managed mutual fund, potentially cutting into performance. Furthermore, their long-short strategy can act as a double-edged sword if the markets move in the wrong direction, magnifying both gains and losses.

Selecting the right sales channel and primary broker to sell 130/30 funds is also key.

For the time being, at least, the attention and assets flowing to directionally long strategies has exploded recently-estimated to be in excess of \$100 billion-but money managers should be careful not to misclassify these products, said Russell Kamp, CEO of the global structured products group at Invesco.

"There is an unfortunate new movement among a handful of academics and financial firms to classify these strategies as hedge funds or market-neutral strategies, and develop actively managed indexes to benchmark their performance," Kamp said. "A 130/30 is like market-neutral lite.' A 130/30 fund is not an alternative investment product; it is an alternative approach to investment management, because it maintains the beta."

Benchmarking investment performance can be a critical tool for measuring the skill and risk of an active approach, but it also has its limitations, Kamp said.

"The benchmark is forcing you to be sub-optimal," Kamp said. "A benchmark constrains your allocations. Hedge funds, on the other hand, are unconstrained.

"Traditional portfolios are, by their nature, not linear because of the inability to express one's underweight convictions to the same extent as overweight convictions," he said. "Active managers have the opportunity and flexibility to significantly overweight their highest-rated stocks, but they are prohibited from underweighting their lowest-rated stocks to the same extent because of the long-only constraint."

With a directionally long strategy, the manager shorts a certain percentage and reinvests that in their highest-rated stock, such as 110/10, 120/20, 130/30, 140/40, 150/50, etc.

A 130/30 strategy is the most popular because the alpha range takes a steep jump between 120/20 and 130/30, then levels off, Luo said, adding that, "in theory, a 130/30 fund can get alpha at any level."

You're never going to offer a product that's right for everybody, Luo said. A conservative investor will likely have little interest in taking on so much risk, but the funds can play a diversification role among institutional investors and pension funds.

"I believe [130/30 funds] can add value and are an effective tool for a balanced portfolio," Kamp said.

The funds are good for clients who are comfortable with them, but there is a big difference in client preference, said Jason Segal, managing director and co-head of 130/30 strategies for Citi Prime Finance.

For 130/30 specialists like Segal, there are exciting new tools and tricks for chasing alpha without sacrificing the transparency, simplified tax reporting, lower fees, daily valuation and liquidity that is lost when investing in hedge funds.

Investment methods like shorting from within, enhanced leverage and rehypothecation (the process of lending a security that has already been used as the collateral for another loan) are risky, but can be extremely successful in the right manager's hands.

Those non-hedge fund managers who can master the alpha will be able to command higher fees.

"As more managers desire to borrow or short stock, costs will go up," Segal said. "With higher costs of borrowing, more pension funds will be willing to step up."

Long positions need to be held at a custodial bank, and short positions need to be held at a prime broker, but both these positions need to be consolidated for reporting, he said.

"Your prime broker can make or break you, so you need to make sure you're comfortable," Segal said. "Does your prime broker have diversity in the underlying client base?"

Firms will also need to improve reporting efforts to meet '40 Act requirements such as Regulation T and Rule 431, which define margin securities and margin, respectively.

It's also imperative to train and educate your investment manager, said Steve Slessor, managing director of client services and manager of hedge fund services for **Fulcrum Fund Administration**.

Their complexity and high risk may be a turn-off for less sophisticated investors, but that doesn't mean they're a bad product. For the right investor, a 130/30 fund could be the perfect way to help break out of a market slump.

Ultimately, the success of these products will depend on their performance and the willingness of investors to take risks. If they are successful, the strategy could expand to other investment products, like 130/30 exchange-traded funds, Kamp said.

"The majority of future equity products will have some sort of long-short aspect," Segal said. "The question is when."

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