ACTIVE TRADING STRATEGIES

Understanding Long-Short Equity

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In a long-short equity strategy, investment managers seek to identify overvalued and undervalued securities simultaneously. The manager takes long positions in the stocks that are expected to increase in value and short positions in stocks that are expected to decline in value allowing them to potentially profit from both upward and downward movements in the market.

For most stock investors, their objective is to buy a company's stock at a low price and sell it later at a higher price for a profit. This is known as "going long." A less common way investors can profit is by "going short." To go short, an investor borrows the company's shares from a broker and immediately sells them in the market with the expectation that the share price will decline. If it does, the investor can buy the shares back at the lower price, return them to the broker, and keep the difference as profit.

Short selling is often misunderstood but it actually plays an important role in stabilizing stock markets by providing liquidity, revealing information, and facilitating price discovery.

Short selling is often misunderstood but it actually plays an important role in stabilizing stock markets by providing liquidity, revealing information, and facilitating price discovery. Short sellers tend to do extensive research to uncover mismanaged or overvalued companies and their trading activities can provide balance and stability to the stock market. Short selling increases market liquidity by increasing the number of market participants willing to buy and sell a particular security.

Short selling contributes to price discovery by incorporating the views and expectations of investors who believe that the price of a security is overvalued and can help correct mispricings and bring the market closer to equilibrium. It also can act as a counterbalance to overvaluation. If a security becomes significantly overvalued, short sellers may step in to

sell the security short, putting downward pressure on its price and potentially preventing a speculative bubble from forming.

Short selling can be risky because the potential losses from a short sale are unlimited. When you go long, your maximum loss is the amount you invested. However, when you go short, your losses are theoretically unlimited. If the stock price rises significantly, you must repurchase the shares at a much higher price, leading to substantial losses. If the stock price keeps rising, your broker may issue a margin call, requiring you to deposit more funds into your account as collateral. In theory, there is no limit to how high the price can go, so your potential losses are technically unlimited.

Key Components Long-Short Strategies

The primary goal of most long-short strategies is alpha generation. Alpha is a measure of the excess return of an investment compared to its benchmark. It indicates how much value a portfolio manager has added (or subtracted) through their investment decisions, after adjusting for the risk involved. An investment manager who is adding alpha is adding value above and beyond what would be expected given the risk level. Risk management is another important component of a successful long-short strategy. Using risk management techniques, such as diversification, careful/skilled stock selection and position sizing, managers seek to mitigate potential losses.

Hedging, of course, is fundamental to long-short equity strategies. The short positions act as a hedge against market volatility. While long positions provide the potential for gains in a rising market, short positions help offset losses during market declines.

Most long-short strategies are not exactly market neutral, but many, through hedging and careful stock selection, come close to being market neutral, meaning the impact of overall market movements on the stock portfolio is minimized. The goal is to generate returns primarily from the skill of the manager and the performance of individual securities rather than relying on the direction of the overall market.

Common Types of Long-Short Investment Strategies

Long-short equity strategies seek to deliver positive returns by taking both long and short positions in equity instruments that are deemed to be relatively attractive or unattractive based on fundamental investment and/or technical criteria.

Many strategies are designed to have net long exposure to the equity market and may consider various board factors to determine which industries, sectors or specific stocks to allocate long or short exposure. Some strategies are broad in scope positioning long-short anywhere in the world and some funds narrow their focus to specific market segments.

> *Market Neutral Strategy*: This strategy aims to minimize exposure to overall market movements by maintaining equal long and short positions. The goal is to profit from the relative performance of individual securities rather than the direction of the overall market.
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> *Factor-based Strategies*: These strategies involve taking long and short positions based on specific factors such as value, growth, momentum, size, quality, or volatility. The objective is to capture the returns associated with these factors while hedging out broad market risk.
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> *Event-driven Strategies*: Event-driven strategies involve taking positions in anticipation of corporate events such as mergers, acquisitions, spin-offs, bankruptcies, or regulatory changes. Long positions are taken in companies expected to benefit from the events, while short positions are taken in companies expected to be negatively impacted.
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> *Pairs Trading*: Pairs trading involves simultaneously taking long and short positions in two correlated securities, such as two stocks from the same sector, with the expectation that the spread between the two securities will converge. The strategy aims to profit from relative price movements between the two securities while hedging out broader market risk.

Statistical Arbitrage: Statistical arbitrage involves using quantitative models to identify mispricings or deviations from historical relationships between securities. Long and short positions are taken based on these statistical anomalies, with the expectation that prices will revert to their historical norms.

Global Macro Strategy: Global macro strategies involve taking long and short positions in various asset classes, including stocks, bonds, currencies, and commodities, based on macroeconomic trends and geopolitical events. The goal is to profit from shifts in global economic conditions and monetary policies.

Long/Short Equity Funds: Long/short equity funds combine long positions in stocks expected to increase in value with short positions in stocks expected to decline in value. These funds often have flexibility in their investment approach and can employ various strategies to generate alpha while managing risk. Long-short stock funds may focus on company size (e.g., long small-cap stocks and short large-cap stocks), sectors (e.g., long banking and short utilities) or geographic (e.g., long India and short Europe.) An unconstrained fund may be long companies with strong fundamentals and short companies with weak fundamentals.

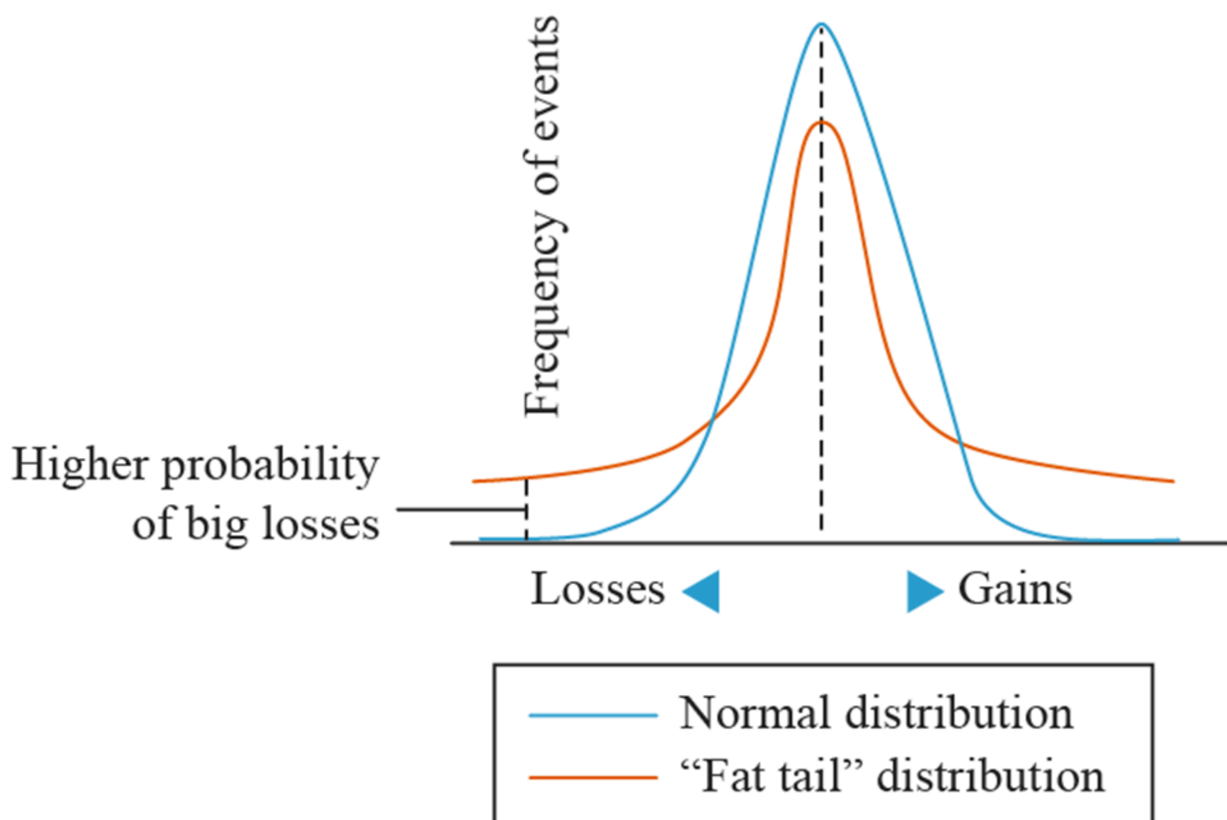
Long-Short Credit: Focuses on taking long positions in undervalued debt securities and short positions in overvalued debt securities, attempting to capitalize on discrepancies in credit markets.

How Long-Short Strategies Can Add Value

Long-short strategies can provide a valuable contribution to portfolio diversification because the return structures tend to be different (uncorrelated) than return structures from traditional, long-only investments. In fact, due to the unique characteristics of many long/short equity funds, they tend to have low correlations to most other asset classes.

Most of the time, stock market returns are relatively smooth; returns tend to cluster, and volatility is modest (i.e., stocks go up a little, then down a little). Less frequently, returns are far less predictable; returns vary drastically, and volatility is high (i.e., stocks spike higher, and loose value quickly).

The graph below shows both market conditions; a normal (smooth) distribution of stock market returns and an extreme (volatile) distribution of returns, also known as a "fat tail" distribution. During periods of extreme volatility, the mispricing of stocks is more common, presenting opportunities for managers with short positions in undervalued stocks. Long-short equity strategies, due to their short exposures, may offer investors opportunities to profit during periods that are otherwise unfavorable to a portfolio made up of long-only investments.



Long-short strategies are less dependent on markets that exhibit positive momentum and provide investors with the potential for positive returns in both rising and falling markets. A manager with a long-only portfolio *must sell* existing positions if they wish to raise capital for new investments, whereas a manager with a long-short portfolio may choose to *monetize* (i.e., cover short positions) in a down market to obtain fresh capital for new long opportunities.

Long-short equity is a popular strategy among hedge fund managers. Hedge fund investors typically must be accredited or qualified, meaning they must meet certain net worth thresholds, or have institutional qualifications before they can invest, according to government and/or industry regulations. However, today there are a growing number of long-short equity mutual funds available to all (i.e., non-accredited and non-qualified) investors.

It's important to understand that long-short funds have a unique set of risks that must be carefully considered before investing.

Weighing the Risks of Long-Short Funds

There are two primary types of risks for stock investors.

Market risk, also known as ***systematic risk, refers to the risk of overall market fluctuations*** affecting the value of investments. Factors such as economic conditions, interest rates, political events, and market sentiment can influence market risk. By maintaining both long and short positions long-short funds generally reduce systematic risk.

Company-specific risk, also called ***unsystematic risk, pertains to risks that are unique to a particular company.*** These risks may include management issues, operational problems, lawsuits, competition, or changes in the industry that affect a specific company's performance. Long-short funds are subject to unsystematic risk.

There are additional risks to consider helping you determine whether long-short funds align with your risk tolerance, investment objectives, and overall portfolio strategy.

Leverage Risk: Some long-short equity funds may use leverage to amplify returns. While leverage can enhance gains, it also increases the potential for losses, as losses on leveraged positions can be magnified.

Liquidity Risk: Short-selling involves borrowing shares to sell, with the intention of buying them back at a lower price. If the borrowed shares become difficult to obtain or expensive to borrow, it can limit the fund's ability to execute its short positions effectively.

Manager Risk: The success of a long-short equity fund depends heavily on the skill of the fund manager in selecting stocks for both long and short positions. Poor investment decisions or ineffective hedging strategies can lead to underperformance or losses.

Concentration Risk: Long-short equity funds may have concentrated positions in certain sectors or stocks, which can increase the fund's vulnerability to adverse developments within those sectors or companies.

Counterparty Risk: Short-selling involves borrowing shares from a broker, which introduces counterparty risk. If the broker fails to deliver the borrowed shares when needed, it can disrupt the fund's short-selling strategy.

Tracking Error: Long-short equity funds may not, and by design, likely will not perfectly track the performance of traditional equity markets due to the short positions and other factors.

Fees and Expenses: Long-short equity funds often charge higher fees compared to traditional equity funds. These fees can impact returns, especially if the fund's performance does not justify the expenses.

Regulatory Risk: Changes in regulations governing short-selling or other investment strategies employed by long-short equity funds could impact the fund's operations and performance.

Is Now a Good Time to Invest in Long-Short Funds?

In our view, yes. In the current environment, traditional portfolios with heavy, long-only allocations to domestic stocks and bonds may expose investors to too much risk and may not offer enough upside potential in return for that risk.

Domestic stocks, the cornerstone of a traditional portfolio, are extremely expensive based on almost any measure of valuation. We believe fair market value for the S&P 500 is about 3,225, which would put the price-to-earnings ratio of the index at 17.6, the median over the last 60 years. The current median PE ratio is about 25. A return to a ratio close to the historical median would present investors with a much more attractive opportunity. A decline of more than 30% in the S&P 500 from February 2024's month-end closing price is required to reach the median fair market value target of 3,225.

In *On My Radar* and *Trade Signals*, we report on updated PE ratios and a variety of other valuation metrics, including price-to-sales, price-to-book, price-to-cash flow and several others. Currently, every metric we report on is in the "extremely overvalued" category.

The S&P 500's cyclically adjusted price-to-earnings ratio, better known as the CAPE ratio, is trading around 34, the highest level ever outside of the dot-com bubble and 2021.

Another valuation measure we monitor is the Buffett Indicator, also known as the market capitalization–to–GDP ratio. It's a long-term valuation indicator for stocks measuring the total market value of all publicly traded stocks in a country, divided by that country's gross domestic product. Popularized by the success of Warren Buffett, the indicator assesses whether a country's stock market is undervalued, fairly valued, or overvalued. In 2001,

Buffett told Fortune Magazine this indicator is "probably the best single measure of where valuations stand at any given moment."

The Buffett Indicator suggests that current valuations, while still lower than their 2021 highs, are still higher than any other period dating back to the early 1950s, including the peak of the dot-com bubble.

The risk of deteriorating economic conditions and an overvalued stock market is compounded by the dreadful fiscal condition of the U.S. government. According to U.S. Debt Clock, government debt now exceeds $34 trillion and total unfunded liabilities exceed $213 trillion. The estimated annual interest expense is approaching $1 trillion.

In a recent interview on 60 Minutes, Jerome Powell warned that the U.S. is on a dangerous path after running up a $34 trillion national debt, saying, "In the long run, the U.S. is on an unsustainable fiscal path. The U.S. federal government is on an unsustainable fiscal path. And that just means the debt is growing faster than the economy."

Rather than buying and holding stocks and bonds in this environment, we favor investment strategies that employ active trading, hedging and long-short exposure. To complement these strategies, we favor asset classes that we believe have favorable risk/return frameworks such as private credit, private equity, energy, commodities, certain emerging markets, and hard assets. Exposure to these areas can be expressed using exchange-traded vehicles, mutual funds, interval funds, private funds and private direct investments.

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In conclusion, long-short strategies may provide investment flexibility beyond traditional long-only investments. Long-short can provide a different return structure and an added layer of diversification to compliment your long-only investments and provide the potential to protect a portion of your investments in the event of a market correction.

When added to a portfolio mix of various assets and investment strategies, well-selected long-short equity strategies may enhance diversification and reduce overall portfolio volatility over time.

Thank you for reading. If you have any questions, you can email us at blumenthal@cmgwealth.com or call us at 610-989-9090.

See Appendix for additional information on long-short equity.

See important disclosures below.

Learn more about CMG at www.cmgprivatewealth.com.

Appendix

The Bloomberg Long-Short Index vs. the S&P 500 Index

A long-short strategy may not be the best standalone investment, but that perspective can shift when thinking about the strategy from a portfolio perspective.

The Bloomberg Long-Short Index (BHEQLS) has significantly underperformed the S&P 500 (total return basis) since its inception (Jan 2014); however, this index has shown outperformance in two of the last three bear markets.

Bear Market (monthly dates)	S&P 500 Index (total return)	BHEQLS (total return)
5/31/2015 – 2/29/2016	-6.8%	-10.9
1/31/2020 – 3/31/2020	-19.6	-13.9
12/31/2021 – 9/30/2022	-23.8	-13.7

Source: Bloomberg

A long-short strategy will typically have a lower beta (due to short positions). Within a portfolio the beta of the investments becomes a key component of the overall risk/return profile. This lower beta is why investment in hard assets (e.g., real estate, precious metals, commodities) provide a diversification benefit to the portfolio; the low correlation to the overall equity market helps offset downside long-only equity performance.

Related to beta, one can look at downside volatility, the S&P 500 had 11 occurrences of monthly returns less than -5%, while the Bloomberg Long-Short Index had only 1 occurrence of less than -1% (since January 2014).

Long-Short: Value vs. Growth Strategy

While there is an upward bias in the public stock markets, they don't move in one direction. Markets can zig-zag for long periods of time and investment styles and factors go in- and out of favor. Companies can take on too much debt or make bad business decisions, lose market share to competitors or be forced out of business.

Today, the market capitalization of the “Magnificent 7” (Microsoft, Amazon, Meta, Apple, Google, Nvidia and Tesla) accounts for almost 30% of the S&P 500. These stocks posted a median return of over 90% in 2023. So, why would anyone want to have value stock exposure in their portfolio when ‘Growth’ stocks clearly outperform?

Did you know, the only back-to-back years when the Russell 1000 Growth Index has outperformed the Russell 1000 Value Index by more than 2000 basis points (i.e., >20% spread in returns) was 1998 and 1999. In the three years that followed, value outperformed growth by a wide margin.

In 2023 the Russell 1000 Growth Total Return Index was up 42.7%, while the Russell 1000 Value Total Return Index was up 11.5% - a growth / value spread of 31.2%.

Let’s put the growth / value relationship in more perspective. Since 1979 the Russell 3000 Growth total return index is up 11.7%, while the Russell 3000 Value total return index is up 11.5% - a virtual match. However, if you look under the surface there are some interesting findings:

Index	# of times Spread > 15% (R1G-R1V) and (R2G-R2V)*	Spread between -5%/+5%*	% of Time Style had Best Annual Return*
Russell 1000 Growth	8	18	35.6
Russell 1000 Value	3		15.6
Russell 2000 Growth	5	13	15.6
Russell 2000 Value	10		33.3

Source: Ned Davie Research, Inc.

For long-short managers, the current mismatch in recent growth / value relationships may provide attractive opportunities (e.g., long undervalued value stocks and short overvalued growth stocks). Long-short managers may employ a strategy to short certain growth stocks where the fundamentals do not support the current high prices and selectively buy certain value stocks, with relatively low prices, where the fundamentals are more attractive.

Please note that this is not a recommendation to short growth and buy value. We are simply showing how a long/short fund manager might consider positioning a portion of their portfolio. This is not an evaluation of the magnificent seven stocks, which may continue to perform well.

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NOTHING IN THIS PAPER IS A RECOMMENDATION FOR YOU TO BUY OR SELL ANY SECURITY. ALL INVESTING INVOLVES RISK. NO GUARANTEES ARE MADE.

Investors should carefully assess their risk tolerance and investment goals before allocating capital to these funds, as the risk ranges from low to high; thus, certain funds may not be suitable for some investors. We encourage you to work with an experienced investment advisor.

Diversifying a portfolio with a combination of both types of investments may also be a strategy to balance risk and return.

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