

# The case for long/short equity strategies

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## The case for long/short equity strategies

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### Our position in brief

We think long/short equity strategies should be an integral part of institutional and individual investors' diversified portfolios for two reasons. One, long/short equity strategies can produce equity-like returns over time, with a lower level of volatility than that of long-only funds and the stock market. Two, they can provide diversification and deliver downside protection to bolster investors' resolve to stay invested in stocks throughout a full market cycle.

Large institutions have the ability to gain exposure to long/short strategies through separately managed accounts, which often provide structural advantages. Smaller institutions have mainly used limited partnerships to gain access to long/short investments. As more investment managers offer long/short mutual funds, we believe that all types of investors (including small institutions) will have the ability to benefit from the various advantages offered by long/short equity strategies.

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**M**uch has been written about the generally disappointing performance of hedge funds in the bear market of 2008. Even so, when investment history is written, the performance of hedge funds in 2008 may end up being viewed in more favorable terms.

While most hedge funds in the 2008 bear market came up short in producing positive returns (or "absolute returns," in the industry vernacular), they still fared much better than the major market indexes. In 2008 the average hedge fund (including all types of hedge funds) was down 19%, according to Credit Suisse, while the S&P 500 Index lost roughly 37%. For the two-year period ended September 30, 2009, the S&P 500 Index was down approximately 15% annualized, versus the HFRI Equity Hedge Index long/short equity category's 5% loss. In the final phase of the bear market in 2009, from January 1 to March 9, the Credit Suisse Long/Short Index lost

1.5%, compared with the much-sharper 24.6% loss of the S&P 500 Index.

So, as we will show in greater detail later in this paper, long/short equity strategies dramatically outperformed the broader market during the recent downturn and over the long term.

### An avoidable outcry

It's our belief that many long/short equity funds that were marketed only as absolute-return vehicles created false expectations among investors. Had they instead been marketed as seeking to provide equity-like returns with lower volatility, there would likely have been far less of an outcry about performance.

On top of the performance issue, the hedge-fund industry has been sullied by several much-publicized scandals -- most notably, Bernard Madoff's \$65-billion fraud and the recent insider-trading indictments against the Galleon Group.

Not surprisingly, on the heels of the Madoff affair, investors stampeded out of hedge funds in 2008 and early 2009 (or, to be precise, many investors who were actually *able* to pull their money out did so; some hedge funds barred investor redemptions last year by enforcing "gates"). In the 12 months ended June 30, 2009, investors withdrew \$330 billion from hedge funds, which at their height of popularity in 2008 had about \$1.8 trillion in assets under management, according to *The New York Times*. As a consequence of their poor performance, about 16% of all hedge funds went out of business last year, according to Hedge Fund Research, a firm that monitors the industry. However, despite all the negative issues, in recent months the industry appears to be stabilizing, especially with regard to net investment flows.

### Building wealth efficiently

All the negative issues notwithstanding, we believe long/short equity strategies can offer an efficient means of building investment wealth -- even if not all of them can deliver positive

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returns all of the time. We believe they can deliver downside protection in bear markets and the potential to provide superior relative results over the long term. Long/short strategies essentially can lower the volatility of the equity component of an institution's asset-allocation model. We believe long/short mutual funds can be of particular benefit to investors' diversified portfolios, including institutional defined-contribution plans.

As such, long/short equity strategies deserve an increasingly prominent role in investors' asset-allocations, in our judgment. We think long/short equity strategies -- and specifically, long/short equity mutual funds -- may gain prominence in the years ahead because they can provide equity-like returns, along with these characteristics:

- lower volatility;
- downside protection and diversification in bear markets;

and, specific to mutual funds:

- lower investment fees/expenses versus limited partnerships; and
- liquidity and transparency.

As 2008 showed, most long/short strategies failed to produce positive returns in all market conditions. But the record also clearly showed that they tend to be good at limiting losses in down markets and producing relatively low-volatility returns that can pay off in solid outperformance over time.

### Higher, less volatile results

Over the last 10 years ended September 30, 2009, the Credit Suisse Long/Short Equity Index generated an annualized return of 8.01%, with an annualized volatility of 9.96%, compared with the Russell 3000 Index's annualized return of just 0.73% and an annualized volatility of 16.57%. (Of course, it should be noted that the past 10 years were an unusually weak period for

stocks, and the next 10 years may bring markedly better results. Past performance is not a guarantee of future results.)

In terms of down-market performance, the table below highlights the performance of long/short equity funds during the 10 worst months of the last decade ending November 30, 2009:

<b>Month</b>	<b>S&amp;P 500</b>	<b>HFRX Equity Hedge Index</b>
Oct 2008	-16.79	-9.99
Sep 2002	-10.86	-0.10
Feb 2009	-10.61	-1.28
Feb 2001	-9.11	-0.31
Sep 2008	-8.90	-8.59
Jun 2008	-8.42	-1.06
Jan 2009	-8.42	-0.15
Sep 2001	-8.07	-0.51
Nov 2000	-7.88	-1.79
Jul 2002	-7.79	-2.11

Past performance is no guarantee of future results.

The S&P 500 Index return was negative in 50 of the last 120 months. During those 50 negative months, the S&P 500 Index outperformed the HFRX Equity Hedge Index in only four months, or 8% of the time.

Our performance-measurement team at Turner has constructed a simple, hypothetical global equity portfolio with a 75% allocation to the broad-based Russell 3000 Index and a 25% allocation to the MSCI World ex-U.S. Index. Additionally, 25% and 50% weightings of long/short funds, using the Credit Suisse Long/Short Index, were added to the allocation. Needless to say, we found that the larger the allocation to the long/short index, the better the risk-adjusted performance of the portfolio (*see table, first column, page 3*).

### Muting big losses

Over the 10-year period ending in 2008, the Credit Suisse Long/Short Index captured roughly 90% of the monthly up-movements of the Russell 3000 Index and just 71% of the monthly losses -- with the magnitude of those losses being much less. In absolute terms, the Russell 3000 Index gained an average of 3.07% in up

**Adding a long/short component to a global stock portfolio can enhance performance and dampen volatility**

**Annualized total returns and standard deviations: 10-year period ended September 30, 2009 \***

<b>Equity Exposure</b>	<b>Total Return</b>	<b>Standard Deviation</b>
75% U.S.  25% Foreign	1.46%	16.60%
56% U.S.  19% Foreign		
25% Long/Short 37% U.S	3.23	14.17
13% Foreign  50% Long/Short	4.91	12.11

U.S. stocks are represented by the Russell 3000 Index, foreign stocks by the MSCI World ex-U.S. Index, and long/short stocks by the Credit Suisse/Tremont Long/Short Equity Index. Hypothetical example for illustrative purposes only. The same examples, when applied to a different time period, may produce very different results. Investors cannot invest directly in an index.

Source: Turner Investment Partners

months, compared with the Credit Suisse Long/Short Index's 2.22% advance. In down markets, the Russell 3000 Index lost 3.94% on average, versus just a 1.99% loss for the Credit Suisse index.

Indeed, we think the chief advantage of long/short equity investing is that it can help negate what *The Wall Street Journal* characterized as "the cruel math of big losses" -- when you suffer a large loss, you need a much bigger gain to get to the break-even point. A long/short portfolio with decent returns and volatility less than that of a long-only portfolio can achieve a higher long-term return even if its average return is lower.

For example, if a portfolio loses 10% one year, it needs to make an 11.1% return the following year to recoup the loss. If the losses are even steeper, the amount needed to break even is still higher. To neutralize a 30% annual loss, a portfolio must return 42.9% the following year.

And for a 40% loss, a portfolio must produce a whopping 66.7% gain. If the returns are less than that, however, the impact on a portfolio's worth is even more deleterious; it can take a long time -- years -- for a portfolio to rebound. For instance, in the event a portfolio loses 40%, it would need to earn 10% for 5.36 years to become whole again, as shown in the table below.

**Negative returns can have a lingering impact \***

<b>If you lose this amount in one year...</b>	<b>You'll have to make this much the next year (after fees) to get back to even...</b>	<b>Or you'll have to make 10% annually (after fees) for this number of years</b>
-10%	11.1%	1.1 yrs
-20	25.0	2.3
-30	42.9	3.7
-40	66.7	5.4
-50	100.0	7.3
-60	150.0	9.6
-70	233.3	12.6
-80	400.0	16.9
-90	900.0	24.2

Source: Turner Investment Partners

If you invest in stocks, losing money in some years is inevitable. But if the cruel math of 2008 has done nothing else, we believe it has highlighted the importance of avoiding large losses -- and avoiding large losses is the forte of a good long/short portfolio. If a long/short portfolio controls downside risk by losing less in declining markets, it doesn't need nearly as big upside returns to beat the market over time.

**Delivering extra diversification**

What's more, long/short equity strategies can provide an extra dimension of diversification to a long-only strategy. The diversification benefits stem from the ability of long/short strategies to offer returns with lower correlations to the stock market than long-only strategies do. Because long/short strategies don't correlate perfectly with U.S. and global stocks, they can make good

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diversifiers in a portfolio, while dampening volatility, as indicated in the following table.

### ***Long/short investments tend to diversify an equity portfolio, dampening volatility***

#### **Cross-correlations: 1999- 2009 (ending 3Q)**

	<b>S&amp;P 500 Index</b>	<b>MSCI World Index</b>	<b>Credit Suisse Long/Short Equity Index</b>
<b>S&amp;P 500 Index</b>	1.00	0.96	0.54
<b>MSCI World Index</b>	0.96	1.00	0.66
<b>Credit Suisse Long/Short Equity Index</b>	0.54	0.66	1.00

Source: Turner Investment Partners

For example, in the period from January 1999 through the end of the third quarter of 2009, the Credit Suisse Long/Short Index had a correlation of 0.54 with the S&P 500 Index and 0.66 with the MSCI World Index. In effect, with each component of the portfolio behaving in a less correlated manner, a global long/short portfolio can achieve a smoother -- and higher -- return with less frequent, less harsh losses. We believe the degree of positive correlation has led many investors to include long/short strategies as a part of their overall equity allocation, not as a component of an alternative or hedge-fund allocation.

The diversification benefits of long/short investing can be so compelling that some consultants have indicated to us that they are recommending that corporate and public plan clients allocate more money to long/short portfolios (and alternative investments in general) as a way to help fund their pensions.

In response, investment managers appear to be increasingly focused on long/short strategies. A recent joint study by BNY Mellon and consulting firm Finadium forecasts that the amount of long/short assets managed by

traditional managers will increase 69% by 2012, to \$345 billion.

### **Distinctions blurring**

The BNY/Finadium study indicates that long/short equity mutual funds currently have \$27 billion in assets under management and concludes that a substantial growth opportunity exists for both hedge funds and traditional investment managers. The study notes that traditional managers are “increasing their presence in long/short strategies while hedge funds are launching mutual funds” and that “current levels of leverage make hedge funds and investment managers look more alike than ever.”

Against this backdrop, long/short equity mutual funds may hold a distinct competitive advantage: they typically charge lower fees than most hedge funds. “Two and 20” -- the traditional fee structure of hedge funds, which amounts to 2% of the assets managed and 20% of the profits generated -- has helped to transform “fledgling hedge-fund managers into instant tycoons,” *The New York Times* observed. At the same time, two-and-20 fees have raised the hackles of more than a few investors, in response to the losses that many hedge funds recorded last year.

Two-and-20 fees compare unfavorably with those of a typical long/short equity mutual fund, with management fees that are generally between 1% and 2% annually. All things being equal, the lower fees of long/short mutual funds can enable investors to receive a higher return for a given level of performance than the fees of hedge funds.<sup>1</sup>

### **Big fees diminish wealth**

The following hypothetical example illustrates how multiple layers of fees can be harmful to investors' wealth. Suppose that a long/short equity mutual fund, a hedge fund, and a fund-of-hedge funds each record a 10% return before fees on a \$1-million investment. And further suppose that the mutual fund charges a total

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expense of 1.5% on the assets under management, that the hedge fund's fees are 2% of assets and a 20% incentive fee, and that the fund-of-hedge funds charges a 1% management fee and a 10% incentive fee for a combined total of a 3% management fee and a 30% incentive fee (that is, a double layer of fees: one-and-10 and two-and-20).

Because of the various fee and expense structures, the long/short mutual fund, the hedge fund, and the fund-of-hedge-funds will produce returns after fees that are markedly different. The long/short mutual fund's fees and expenses resulted in the least erosion to after-fee results. The 10% before-fee return of the long/short mutual fund with a 1.5% management fee translates into an 8.35% return once all the fees have been deducted. The hedge fund's higher fees result in the 10% return shrinking to 6.25% after fees. And the fund-of-hedge-funds' still-higher fees slash the

10% return by more than half, to 4.69% after fees.

### Fees add up over time

For the fund-of-hedge funds, when you examine the impact of fees over three years, the results are even more striking. With a \$1-million investment in a fund-of-hedge-funds that returns 10% annually for three years, and with a combined total of a 3% asset fee and a 30% incentive fee, an investor at the end of the period will reap a capital gain of \$147,402 -- but pay \$166,888 in fees (*see the table below*).

We hasten to add that, in our judgment, some hedge-fund strategies can't be effectively adapted as mutual funds (i.e., those that invest in illiquid securities). However, we believe long/short equity strategies *do* lend themselves well to a mutual-fund format. In addition, we think many hedge funds, and a select number of fund-of-hedge funds, have proven deserving of

### ***Here's how fees can affect the after-fee returns that you receive on three \$1-million hedged investments gaining 10% in one year ... \****

	<i>Long/short mutual fund with 1.5% in total expenses</i>	<i>Hedge fund with a 2% fee on assets and a 20% incentive fee</i>	<i>Fund-of-hedge funds with a 3% fee on assets and a 30% incentive fee</i>
<b>Beginning portfolio value</b>	\$1,000,000	\$1,000,000	\$1,000,000
<b>Portfolio value after 10% gain</b>	1,100,000	1,100,000	1,100,000
<b>Asset fee</b>	16,500	22,000	33,000
<b>Portfolio value after asset fee</b>	1,083,500	1,078,000	1,067,000
<b>Incentive fee</b>	0	15,600	20,100
<b>Portfolio value after all fees</b>	<b>\$1,083,500</b>	<b>\$1,062,400</b>	<b>\$1,046,900</b>
<b>After-fees return</b>	<b>8.35%</b>	<b>6.25%</b>	<b>4.69%</b>

### ***And here's how fees can affect the capital gains you get and the fees you pay on three \$1-million hedged investments gaining 10% annually over three years ...***

	<i>Long/short mutual fund with 1.5% in total expenses</i>	<i>Hedge fund with a 2% fee on assets and a 20% incentive fee</i>	<i>Fund-of-hedge funds with a 3% fee on assets and a 30% incentive fee</i>
<b>Capital gains after three years of 10% returns</b>	\$271,999	\$199,124	\$147,402
<b>Total fees paid after three years</b>	\$53,748	\$119,985	\$166,888

Hypothetical example for illustrative purposes only.

their premium fees because they have delivered sterling performance to their clients.

### **Liquidity a concern**

Finally, we think many investors have two major concerns about hedge-fund limited partnerships: 1) the funds can make it difficult to redeem an investment and 2) the funds have a penchant for secrecy, which confounds efforts to monitor and assess them. In contrast, long/short equity mutual funds allow investors to redeem their money daily and offer a much higher degree of transparency -- two of their most distinguishing (and most appealing) characteristics relative to hedge funds, in our view.

Most hedge funds impose restrictions on when investors' money can be redeemed and on how long it must be invested initially. For their part, hedge-fund managers say such restrictions are necessary to prevent investor redemptions at the most inopportune times, which would imperil the effectiveness of the funds' investment strategies.

Granted, hedge funds must protect their ability to maximize returns for investors. As we see it, for many hedge-fund strategies, some restrictions make sense, but for more liquid long/short equity strategies, they make less sense. In our view, some hedge funds have opted to protect their investing interests rather than protect their investors. To some investors, what's particularly galling is that when their money is frozen in a hedge fund, they still are docked the 2% management fee. As one hedge-fund investor put it, "It's like telling guests at a hotel that they can't check out and then charging them for the privilege of staying."

### **Restrictions abound**

Last year hundreds of hedge funds charged investors for that privilege. What's more, many hedge funds not only retain the right to close a gate on part or all of investors' assets but routinely establish "liquidity" restrictions blocking investor withdrawals for periods ranging from one month to three years.

Conversely, long/short mutual funds by law have no such restrictions; you must be allowed to withdraw your money on short notice.

Long/short mutual funds are traded daily, at a price that's publicly available -- and although some funds charge redemption fees, they don't require investors to keep their money tied up for any set period.<sup>2</sup>

As for transparency, investors appear to have undergone a sea change in their attitudes since the bear market of 2008. Investors who were blasé about how close-mouthed hedge funds were about their holdings, investment strategies, and portfolio characteristics when returns were positive discovered that they cared a great deal about those things when returns soured.

### **Secrecy: a red flag**

Previously, the secrecy of hedge funds had a certain marketing cachet; it contributed to a cozy mystique. About that mystique, business journalist Jeff Brown observed, "Investors feel they are being admitted to an exclusive club, that they have arrived and will now be allowed to benefit from the manager's unique genius. The same in-crowd appeal drew people to Bernard Madoff." Increasingly, however, secrecy has become a red flag for investors considering putting their money into a hedge fund. Many hedge-fund limited partnerships aren't required to say much about their holdings or their investment strategies (and many in fact don't).

Long/short equity mutual funds, on the other hand, are *owned* by the shareholders and are required to provide frequent communication. For example, long/short mutual funds are required to report their holdings at least twice a year, must adhere to the investment strategies they describe in their prospectuses and marketing literature, and aren't permitted to employ excessive leverage.

In our judgment, the secrecy of hedge funds is largely unwarranted. Hedge funds, particularly those employing liquid strategies like long/short equity, should be able to provide enough detail

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about their holdings, risks, and strategies to satisfy investors without compromising performance.

**I**n sum, long/short equity strategies can combine equity-like returns with lower volatility and downside protection.

Long/short equity mutual funds offer the same potential benefits, but typically with lower fees and greater liquidity and transparency than most hedge funds. We think that in coming years small to mid-sized institutions will increasingly invest in long/short equity mutual funds as part of their diversified equity portfolios.

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Past performance is no guarantee of future results. All returns are calculated and expressed in U.S. dollars and reflect the reinvestment of dividends and other earnings.

Investors considering long/short strategies are encouraged to obtain the advice of an accountant, attorney, tax consultant, and/or business adviser with respect to the legal, tax, and business aspects of all long/short investment vehicles prior to investing.

There are various substantial risks associated with long/short investment strategies. The investment risks of the strategies are often increased by their ability to focus its investments in one or more economic sectors, to invest

in smaller and medium-capitalization companies, foreign companies, and IPOs. Also, the strategies use of short sales, option strategies, and leverage may result in significant capital loss. No assurance can be given that the strategies investment objectives will be achieved and there can be no assurance that the strategy will be successful in limiting volatility. Past results are not indicative of future performance, and the strategies performance may be volatile.

\* A note about hypothetical performance: the hypothetical examples presented are of a high-level and simplified nature, are for illustrative purposes only and do not reflect the actual performance of any portfolio. Fees and expenses associated with mutual funds and limited partnerships as well as their impact on performance will vary significantly. Hypothetical or simulated performance results have certain inherent limitations. Unlike an actual performance record, simulated results (1) do not represent actual trading, (2) do not reflect the actual expenses that investors may incur and (3) do not reflect the impact that material economic and market factors might have had on the investment adviser's decision making if the adviser were actually managing a client's money. Also, since the trades have not actually been executed, the results may have under- or over-compensated for the impact, if any, of certain market factors, such as a lack of liquidity.

Any comparison of long/short strategies performance or characteristics to an index is for illustrative purposes only and is being presented only to provide the reader with the context to evaluate the strategies relative to an index that is familiar to a broad audience. You cannot invest directly in an index. An index does not have an investment adviser and does not pay any commissions, expenses or taxes. If an index had expenses, its performance would be lower. The investment strategies and risk characteristics of the long/short strategies discussed are likely substantially different from those of an index. Unlike the index, investments in the strategies may be speculative, highly leveraged, illiquid and subject to a substantial risk of loss and as a result are not suitable for many investors.

The Credit Suisse Long/Short Index measures the performance of funds which invest on both long and short sides of equity markets, generally focusing on diversifying or hedging across particular sectors, regions or market capitalizations. Managers have the flexibility to shift from value to growth; small to medium to large capitalization stocks; and net long to net short. Managers can also trade equity futures and options as well as equity related securities and debt or build portfolios that are more concentrated than traditional long-only equity funds.

The HRFX Equity Hedge Index maintains positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be

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employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations, and valuation ranges of typical portfolios. Equity hedge managers would typically maintain at least 50%, and may in some cases be substantially entirely invested in equities, both long and short.

The Morgan Stanley Capital International World Index minus the U.S. is a market capitalization-weighted index that measures the performance of stock markets in 21 countries outside the U.S.

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The S&P 500 Index tracks the performance of 500 widely held large-cap US stocks in the industrial, transportation, utility, and financial sectors.

<sup>1</sup> In a period of negative returns, where no 20% hedge-fund performance fee is charged, it is possible for some mutual funds' total expenses to exceed the management fees of some hedge funds.

<sup>2</sup> Mutual funds can wait up to seven days to process a redemption request, but typically do not exercise this right. Some mutual funds may charge a fee if investors redeem shares before a certain amount of time has elapsed, and most funds limit the practice of excessive trading.

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