Demystifying long-short funds

By Perpetual Asset Management

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Long/short funds are a type of fund that aims to maximize the upside of markets, while limiting the downside risks. To do this, these funds take both long and short positions in investment positions, often from a specific market segment. Here we look at long / short funds in more detail, specifically how fund managers go about shorting what they perceive to be overvalued stocks.

Traditional long-only funds

Fund managers analyse an investable universe created according to certain investment criteria, for example, sound management, quality of business, conservative debt and recurring earnings. They then rank stocks on valuation metrics. With the discretion of the portfolio manager, these highest-ranking stocks are generally included in the portfolio. Importantly, nothing is done with the low-ranking or rejected stocks.

Shorting low-ranking stocks

Fund managers employ teams of analysts to evaluate risks and opportunities. This means assessing a great deal of both positive and negative factors impacting both sectors and individual companies. Most fund managers do nothing with the bad news, other than avoid certain stocks. But long/short funds provide investors a way to potentially profit from the bad news, as well as the good. This is done by actively utilising the low-ranking stocks by shorting them. Taking this view can benefit a long/short fund in the following ways:

- It increases the opportunity set for the fund manager
- If the stock declines in price, a profit is made when the short position is closed
- Profit from short positions can be used to increase exposure to high conviction, long stocks
- Gross exposure to markets increases, increasing the opportunities for the fund manager.

These opportunities are particularly valuable in volatile or sideways-trading markets.

The importance of risk management

Shorting is not without its risks. The Perpetual view is that shorting requires a specific skill set and a prudent risk management process to achieve a favourable balance in its funds that allow shorting. While the ability to short stocks is periodically criticised in the mainstream media, the main issue for investors is the nature of the risk involved. When an investor buys a share, the worst-case scenario is that he or she loses all the money they paid for it. However, when an investor shorts a share, the investor could lose more than their initial investment.. There is no limit on the maximum loss because there is no upper limit on the share's price. In other words, the loss will continue to increase as the security's price rises. While well-chosen short positions can generate returns, especially during periods of market uncertainty, taking short positions does involve higher levels of risk than taking long positions only.

The benefits of a shorting strategy

1. **Source of return diversification**
   Shorting allows investors to profit from declining share price. Not only can this boost portfolio return, but it can also provide diversification from the traditional 'long only' portfolio. If the investor's assumptions are correct and the share falls in value, the short investor can actively generate a return.

2. **Increased opportunity**
   Being able to short stocks increases a portfolio manager's opportunity set. If a 'long' investor finds a share to be unattractive, their only option is to sell the share if they own it, or not buy the share.

How does it work?

Profiting from a falling share price takes a great deal of stock picking skill. This example demonstrates how it works in practice:

On those occasions where an investment manager finds a company that they believe will decrease in value, rather than increase, they can take a 'short' position in this company. This involves borrowing shares from a broker and selling them at the current price. The investment manager will be required to purchase the shares to return the borrowed stock to the broker in the future. If the share price decreases, the investment manager buys back the share at the lower price and returns it to the broker, keeping the difference as profit. If the share price increases, the investment manager buys back the share at the higher price incurring a loss.

Six shorting misconceptions debunked

While shorting strategies have the potential to generate returns in both up and down markets, there are several myths about shorting that may leave some investors reticent to pursue this investment strategy in their portfolio. And some who are overly enthusiastic!

"Shorting can make a company go bankrupt"

Shorting a share is no more sinister than selling a share for less than you paid for it. Assuming a company has a reasonably strong balance sheet, even if its share price fell to zero, it would still be worth the value of its balance sheet.

"Shorting was a major reason for the GFC"

rior to the Global Financial Crisis, there were a lot of companies with over-stretched balance sheets that were exposed during this period. Shorting did not create the downward pressure on these shares during the GFC. However, during the extraordinary circumstances of the GFC, it can certainly be argued that it compounded the pressures already at play.

"Shorting is the secret sauce for positive returns"

While shorting provides the opportunity to profit in both rising and falling markets, not all short positions generate a positive return. In fact, shorting is a specialist skill, as picking companies that will decline in price can often be much harder than picking companies that will rise in price.

"Shorting is not transparent"

Since June 2010, the Australian Securities and Investments Commission (ASIC) has required all stockbrokers to report their total short sale positions daily. This information is released four business days after the trade on ASIC’s website.

"Shorting is not ethical"

In 2021, Elon Musk described shorting as “a scam legal only for vestigial reasons", echoing a view that shorting a company is tantamount to wanting it to fail. This is not the case. In fact, shorting can be a benefit to the overall market because it adds liquidity, improves trading efficiency and helps to highlight where poor company management is not delivering on its promise to shareholders.

"Shorting doesn’t work"

The positive long-term performance of market indices may lead some to believe that shorting does not work. However, the aim of short selling is to profit from shorter-term factors, such as negative news or earnings downgrades, and can be used as a complement to a long portfolio that benefits from share price gains over the longer term.