

Equity Long/Short in uncertain times

For this month's Tapestry SPOTLIGHT, we focus on managers in the Equity Long/Short space. It is an area we choose to reflect on, since the markets, to some degree seem to be in a reflection mode. It is a space where there are considerable differing opinions with respect to the future shape of the equity markets.

We present a simple case and suggest some ideas that ought to be manifested within a portfolio's L/S exposure.

Factors under consideration:

- A strong global equity rally has been under way from the equity lows reached in Mar-09. For the period 9-Mar-09 to 18-Sep-09 the SPX is up 55.1%. From the most recent market high on 12-Oct-07, the SPX thru 18-Sep-09 is down approx -31.6%; the MSCI World (US\$) was down -32.0% and has bounced 65.5% during that same period. This gives both the bulls and the bears a decent case to present.
- Equity Volatility as reflected by the VIX has traded down over a one year time period from an intra-day high of 90 in Oct-08 to a present level of 24 in Sep-09. This is often (if not always) the case in a bull market run but could also indicate complacency.
- If one were to consider stock valuations over the last three years, the current P/E of the S&P500 has gone from a low of 9.9x in Mar-09 to a high of 19.9x in Sep-09, breaching it's 15.8x average for the sample period. The MSCI World (US\$) has gone from a low of 9.0x in Nov-08 to a high in Sep-09 of 28.0x versus the average of 15.7x. This begs the question - is the margin expansion story over or muted going forward? How much scope is there for top-line growth?
- The months of September and October generally tend to bring seasonal and cyclical headwinds that can last through the remainder of the calendar year. Will this year's effect be more subdued?
- From a technical perspective, the market is equally mixed on the prospects of a continued rally or "bear" market correction.
- The US Dollar continues to trade down to levels not seen since September of last year (DXY at 76). What does this pose for the move to higher yielding assets? Has this resulted in global investment flows becoming more volatile and short term in nature?
- In the Western economies, the unemployment picture is still bleak and it seems Government instituted stimulus packages are being cut back, reduced, and in some cases removed. What does this do for assumptions about sustained liquidity in the markets and global GDP expectations?

The picture is in many senses confusing and visibility seems to be becoming less clear. Hence, how does one navigate one's exposure to equity markets? Our Research and Portfolio Management team at Tapestry share some of their thoughts on how to steer these choppy waters.

Implications for Equity Long/Short selection:

- It is our belief that managers employing more nimble investment approaches may be better positioned to benefit from changes in market direction versus buy and hold strategies.
- We believe a global markets approach to manager selection gives an equity portfolio more depth as correlations break down regionally and on a sectoral basis.
- We like managers with the ability and experience to short stocks given that, not all boats will continue to rise with the tide, and the tide could also guide some out.
- We would suggest taking a balanced approach between thematic and stock picking managers. We believe this is necessary in order to navigate both the top-line sentiment and bottom up prospects of equity markets.
- Basis risk and beta management are also key factors to be considered and benefit those hedged strategies not wanting to take on added anticipated volatility and market risk.
- We would like to highlight the Emerging regions beyond BRIC (Brazil, Russia, India & China). Areas like Indonesia, Taiwan and South Korea (the other Asian tigers) should be considered but investors have to account for potentially less liquidity in these markets.
- As some of you know, we have always maintained that diversification amongst managers physically located in different regions around the world is of critical importance. These managers are attractive because they provide diversification at different dimensions.
- Finally, in terms of further diversification, it is potentially more beneficial to have a portfolio comprised of large, mid sized and small managers since there is less likelihood of position and risk replication being manifested within portfolios. Furthermore, it may be beneficial at the portfolio level to try and minimize the commonality of roots amongst the constituent managers i.e. are they all spin offs from the same organization.

Equity L/S managers can be a good source of returns in a diversified portfolio and the real challenge is to construct and manage the component in such a way that one is not just inadvertently leveraging the inherent equity beta of this strategy but actually trying to complement each manager's alpha through sizing, manager selection, etc.

After all, managing beta is also a source of alpha and good Equity L/S managers know this.

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Data sourced from Bloomberg

TAM Compliance No: MR-09-122