Stock Market Superstars

Secrets of Canada's top stock pickers

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Bob Thompson

INSOMNIAC PRESS

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To my father, whose guidance, tireless dedication, and willingness to give his time have contributed significantly to my success.

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Preface

I wanted to be a doctor when I started at Simon Fraser University in Burnaby, British Columbia. I was good at science, and the sight of blood didn't bother me, so medicine was perfect. I wanted to be a doctor, right up until my family hit some really tough financial times while I was going to university. Money was so scarce that a dentist chased us for fifty dollars, and my barber, who felt bad for me, said my dad and I could have free haircuts until we "caught up." I finally started at a local grocery store for the grand sum of $11.60 an hour, thinking I was set. Well, that job came to a crashing end, so to speak, when the roof of the store, which had rooftop parking, collapsed. The roof brought twenty cars with it right into the deli counter and book department, all within fifteen minutes of the grand opening. No one was killed, which was a miracle, especially with so many people still in the store. That was the end of the high-paying job and the start of more financial strife, at least for a few more months. More delivering phone books on contract for three bucks an hour, and more money worries ensued.

When the store finally reopened six months later, this time with a reinforced roof, I was back in the money for $11.60 an hour. After living on next to nothing for a heck of a long time, I wanted to make sure that didn't happen again. I diligently saved, and studied how to make money work. I read that "money makes money" and that anyone could become wealthy if only they were patient, diligent, and, most important, they started young. I was on my way, and investing became my new passion.

Don't get me wrong, I still to this day browse through my anatomy books from time to time, but the financial business was where it was at for me. I don't think I would have pursued a career in finance if I had not gone through these financial woes, and I think in the end it was good for me. You always better appreciate what you have when you have been through some very trying times. As they say, it builds character.

Money was still tight after I started my job at the store, so I went for a student loan. I still remember my shock when the loan officer wouldn't give me

the loan I wanted. It's not what you are thinking. I wanted a $1,000 loan, and they said, "No way, the minimum loan you can take is $2,500."

"Excuse me?" I said. "I only need $1,000."

"Hey, kid, it's $2,500 or nothing."

Needless to say, I took the money and decided to invest the difference. I was going to be a value investor. I had done my reading and knew that value investing was the safest way to go. Buy beaten up, unloved, unwanted companies and reap the rewards when they came back into favour. I know you are wondering about the first stock I bought. Well, it was a Canadian institution in business since 1899, with a AAA credit rating, and it was one of Canada's largest financial institutions to boot. How could I go wrong? The stock was a classic value play at $10, having come down from a year high of $20. I impressed myself. I was pretty smart. Well, I dove in, buying 200 shares for a total of $2,000. Easy money, I thought.

Unfortunately, it turned out that the stock was called Royal Trustco, a holding company that eventually went bust going down to below $0.50 per share, finally changing its name to Gentra. I wondered whether the name Gentra was short for "general trash." Who cared? I lost my money. But it was another great experience in the grand scheme of things, as I learned that success never comes easy and learning only comes with a good dose of failure. I redoubled my efforts and invested my extra student loan money more wisely in the future, and I had eventually doubled my money by the time I had to pay it back.

This was my first lesson in the principle that money makes money. I started examining the traits of successful investors from Warren Buffett, to John Templeton, to a momentum investor (a.k.a. gunslinger) named Richard Driehaus. Fast forward twenty years, and here we are, trying to determine the traits, qualities, and secrets of some of Canada's best money managers.

A sad fact is that many, if not most, individuals who have invested with even the best money managers have not made a lot of money in the process. Why? Because most investors, high net worth or not, make the wrong decisions at the wrong time. They sell a great manager's fund because of short-term underperformance, without looking at their portfolio as a whole. Smart money managers don't suddenly become stupid; their style simply goes out of favour for a period of time. Almost without exception, the average investor sells a fund after a period of underperformance, and can be counted on to buy again after a period of short-term outperformance.

Eric Sprott, one of the best money managers in the country over the last

three decades, even discussed this in my interview with him. His firm usually loses assets after his performance has lagged for a short period, but the money comes flooding in again, right at the top, after his performance has been spectacular. This is the real reason why many investors get crummy returns from their portfolios. Most financial pundits, being self-acclaimed "champions for the average investor" blame investor underperformance on the high fees that money managers charge and the other evil-doings of mutual fund companies. Being "in the trenches" with the retail investing public, I can say that, generally speaking, this is hogwash. Investment returns are lousy because the average investor makes lousy decisions based on emotions instead of making good ones based on discipline.

Investment management is certainly not a science, and, in many ways, it's not an art—it's a combination of both. The problem is that few individuals have the attributes to be a scientist and an artist, and the ability to balance the two of them. That may be why many of the best don't even have finance degrees. Frank Mersch, one of the best managers in the country with an uncanny grasp of "the big picture," says that his degrees in philosophy and history helped him realize the importance of knowing history and being a non-linear thinker. His thesis in university was to prove that there were angels in the world! His having to learn to think outside the box was an understatement, but it was these experiences that helped him to outperform his peers.

I came up with the idea for this book for a few reasons. First, not many money managers actually do well over long periods of time. There are only a few that are stars in their field. This book, through interview transcripts, will highlight the common traits that some of the best money managers in the country have developed over the years. Second, I had an idea that investors could increase their investing skills through education. Third, I thought investors needed to hear, in money managers' own words, how their strategies, style, and success have developed over the years. Plus, it was just plain fun to sit down with all these personality types, some of whom were very humble and shy, and some of whom were a bit arrogant, and some of whom who were hilarious.

Oh, yes, and before you say, "Why isn't so-and-so in the book? They're better than these jokers," I have chosen all these great managers for a particular reason. They have all done a magnificent job in respect of their stated goals, whether it is beating their respective benchmark or generating absolute returns. I particularly picked managers that had achieved their great returns

by varying methods. Some are value managers, some are growth or momentum managers, some are hedge managers, and some can't be pigeonholed. All these terms are defined in future chapters.

Some good money managers come and go with the market cycles. Only a few "great" managers have achieved significant returns in good and bad markets. This is why I chose managers who have been doing it for a period of time with the shortest track record being ten years or so. This time frame still encompasses the great markets of the late '90s; the nasty, atrocious, and horrific markets of the first years of the new millennium; and the good markets of 2003 to 2007. I wanted to make sure that their track records at least covered these varying cycles because money management in many respects is based on adaptability of the money manager to differing times. They have to know whether it is different this time or the changing market dynamics are a trap, like the Internet run up in the late '90s. Nevertheless, the list of great money managers I have missed in this book will be long and distinguished, I'm sure. If you know of some of them, let me know…material for the next book.

There are as many investment managers and funds in Canada as there are stocks on the stock market. It therefore takes as much time and effort to research, pick, and follow a money manager that suits your goals as it does to pick a stock. For those of you who think that profitable investing is easy, it isn't. I read, and read, and read again to get insight into the world as a whole, from investment literature, to research, to the history of World War II. At the 2003 Berkshire Hathaway Annual Meeting, Warren Buffett's famous business partner, Charlie Munger, said, "I have said that in my whole life, I have known no wise person over a broad subject matter who didn't read all the time—none, zero. You'd be amazed at how much Warren [Buffett] reads. You'd be amazed at how much I read."

Will reading this book make you a better investor? I am sure of it, because it will highlight the insights, personalities, foibles, outlooks, and misgivings of some of the brightest minds in the investment world here in Canada. It will help you realize your strengths and weaknesses, and make you aware of what it takes to be a great investor over long periods of time. Remember, however, that the stock market is like a big auction. You compete with all these bright minds when you decide to be a do-it-yourselfer. Do you feel confident to go out and do brain surgery tomorrow? The brain surgeons reading this aren't allowed to answer this question. If you aren't a brain surgeon, and the answer is yes, then give it a shot. You will probably be responsible for someone's death.

Luckily, with your investments, you will only be responsible for destroying your own portfolio.

Last but not least, by writing this book and highlighting the managers that I have, I run the risk of causing overly inflated egos. One of the reasons I have chosen these "stars" is precisely because they are generally humble. This is a tricky subject because you won't do well at investing unless you are confident, but hubris will destroy you every time. Once you hear cockiness, arrogance, and the "I'm always right" mentality from a money manager, it is usually a good time to run for the hills, as this is definitely a contrary indicator of future performance.

Introduction to Investment Management Styles

Portfolio Structure: A Simple Guide to Building the Portfolio

There are many ways to manage money. Since the business consists of more styles, systems, and approaches to the art of trying to make money than you can imagine, this proves only one thing: There is no best way of doing it. If there were an unchanging foolproof system, everyone would use it. The problem is that if too many people use any one system or approach, it will soon be doomed to failure, as no one will have an edge over any other. This is why one of the most important traits of any money manager is adaptability. Even the vaunted value manager Sir John Templeton said that "if you are doing things the same way today that you were twenty years ago, you will most likely not be doing well." Adaptability is also the reason why the cockroaches survived the catastrophic climatic change that happened millions of years ago, while the dinosaurs did not. As with the dinosaurs, size is not that important in the money management business; it is the ability to react and change with varying circumstances.

Now that we are clear on cockroaches and survival, there are actually a few quantifiable ways of managing money. I will discuss them in detail in the following pages, but in summary, there are value managers, there are growth managers, there are equity long/short managers, and there are variations of the three styles. Some very smart people scoff at pigeonholing the various styles, but, either way, if you have a grasp of how different people manage money in different ways, your ability to manage your own money will take a quantum leap forward. I have taken the following three outlines from a piece issued by Synergy Mutual Funds, now a part of CI Investments.

1) Value Investing

Value Stock Picking

Value managers invest in shares that trade below the estimated true (or intrinsic) value of the underlying company. Over time, it is expected that the market will come to recognize the value of the business and the stock price will move up accordingly. Value investors do not pay a premium for a stock on the assumption that its intrinsic value will rise.

Value Portfolio Construction

Portfolio Characteristics – Value portfolios are expected to have a lower than average volatility. The portfolio's weighted average price/normalized earnings and price/book value multiples should generally be below the market average. Dividend yields will vary but are often above the market average.

Risk Management – The portfolio is consistently diversified by industry. By establishing downside risk targets and trying to purchase securities below intrinsic value, a "margin of safety" is provided to somewhat cushion the impact of errors and uncertainties. A quantitative model is used to manage risk factors and will influence weights of holdings.

Sell Discipline – A holding will be sold (1) when its price approaches intrinsic value, (2) to replace with a stock exhibiting better value characteristics, or (3) to improve the risk/reward profile of the portfolio.

2) Growth Investing

Growth Stock Picking

Growth managers invest in shares of companies that are exhibiting secular growth in excess of the market rate. This growth may be in the form of earnings, cash flows, revenues, or volumes.

Valuation parameters such as price/earnings and price/book value ratios do not define growth—underlying fundamentals define growth. Valuations will vary widely among growth stocks and should be a reflection of the predictability, sustainability, and quality of the growth.

Growth Portfolio Construction

Portfolio Characteristics – The weighted average earnings and revenue growth rates of the portfolio consistently exceed the growth rates of the market.

Risk Management – The portfolio is well diversified by industry, market capitalization, and valuation.

Sell Discipline – A holding will be sold (1) when an underlying company stops exhibiting superior growth potential, (2) if the valuation of a security goes beyond its fundamental merits, or (3) to improve the portfolio's risk/reward profile.

3) Momentum Investing

Momentum Stock Picking

Selection Criteria – Momentum managers invest in shares of companies that are exhibiting positive relative and/or absolute fundamental change. To that end, holdings selected for a momentum portfolio will generally display the best combination of the following four characteristics:

Positive Estimates Revisions – Analysts' forecasts for the stock's earnings, cash flow, revenues, production, etc., are rising.

Positive Surprise – Actual reported results exceed market expectations.

Positive Relative Strength – The stock's price is outperforming the market and/or the industry peers.

Positive Acceleration – The company's revenues and/or earnings are accelerating, or declining, at a slow rate.

Momentum Portfolio Construction

Portfolio Characteristics – The weighted average positive change characteristics of the portfolio consistently exceed those of the market.

Risk Management – The portfolio is well diversified by industry and risk factors. A quantitative risk model may be used to manage risk factors and will influence weights of holdings.

Sell Discipline – A holding will be sold (1) when the underlying company's fundamentals exhibit negative relative and/or absolute change as indicated by the four characteristics listed above, (2) to replace it with another stock that demonstrates better momentum, or (3) to improve the portfolio's risk/reward profile.

The styles seem to be favoured by the market in alternating periods of years. In other words, value investing outperforms growth for a period, and then growth investing outperforms value for a period. The key is to mix the two so that your overall portfolio return is achieved with lower volatility than

would otherwise happen. Inherently, heightened volatility should not be a problem, as many of the managers say you cannot achieve excellent performance without some significant volatility. In real life, excessive volatility is difficult for all but the most seasoned investors to take.

Let's take a look at some examples. From 1981 to 1986, value outperformed growth investing by a wide margin. Value generated 23 percent compared to growth at 12 percent. If you had invested from 1987 to 1991 based upon what had happened in the years previous, it would have been exactly the wrong move—growth outperformed value 18.9 percent to 11.9 percent. Leadership again changed from 1992 to 1996 as value-generated returns of 18.6 percent and growth-generated returns of 13.2 percent. Many of you will remember what happened next. The tech bubble happened from 1997 to 1999 and, subsequently, growth achieved 32.1 percent compared to value at 14.2 percent. As often happens after speculative blow-offs, market leadership changed over the course of the next few years. From 2000 to 2006, value did well as growth treaded water, but in 2007, growth had its best showing as compared to value in almost a decade. This is typical of peaks in economic activity. Growth often significantly outperforms value leading up to a recession. Both styles have done well historically, but leadership has changed depending on market conditions.

Annualized Return (%)

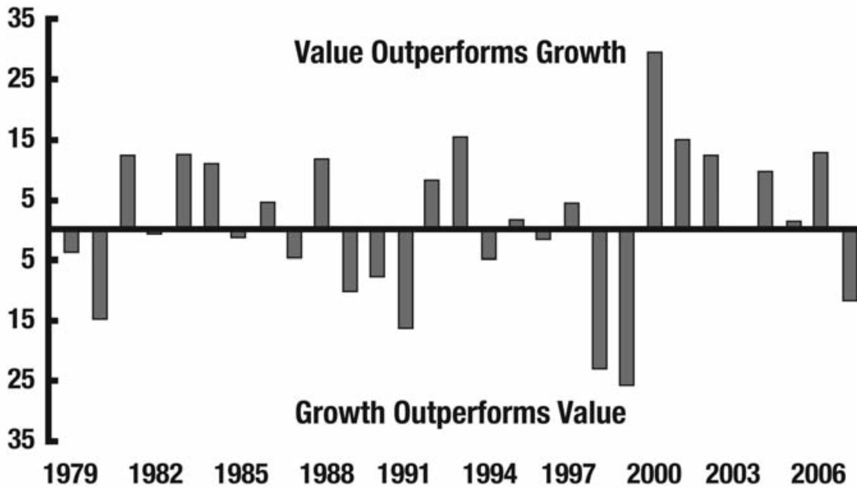
	Value	Growth
1981-86	23.3%	11.8%
1987-91	11.8	18.9
1992-96	18.6	13.2
1997-99	14.2	32.1
2000	29.5	-13.9
2001-06	7.9	-1.6
2007	-0.17	11.8

Source: Fama & French and Bernstein until 2000; Russell Value 1000 Value & Growth Index from 2001 to 2007.

Logically, the next question one should ask is, "Why don't I just invest in growth funds when they are doing well, and change to value funds when they are doing well?" A good idea in theory—usually lousy in practice. It's impossible to know which strategy will outperform, but we can always see it after

the fact. It's like recessions: we never know there will be one until we are already in it. The bottom line is that having a disciplined process and plan is usually much more important than making your investment decisions based on emotions and whims.

Styles Go In and Out of Favour



Annual difference between the Russell 1000 Value Index and Russell 1000 Growth Index for the period January 1, 1979, through December 31, 2007. The unmanaged Russell 1000 Value Index contains those securities in the Russell 1000 Index with a less-than-average growth orientation. The unmanaged Russell 1000 Growth Index contains those securities in the Russell 1000 Index with a greater-than-average growth orientation.
Source: Frank Russell Company.

Proper style management has proven itself over long periods of time. By actively rebalancing your portfolio to retain a particular style, you can increase your returns over time while reducing the overall volatility. For example, if, at the beginning of a value cycle, an investor has a 50 percent allocation to value and a 50 percent allocation to growth, that balance may be 65 percent value and 35 percent growth after a year. This would be caused by the relative outperformance of value versus growth. Rebalancing back to the 50 percent value, 50 percent growth model would result in an investor's adding to a position in a style that has recently underperformed. Historically, a style that has underperformed for a period of time will subsequently outperform.

Setting up a portfolio with the following parameters and actively rebalancing can help to achieve better returns with less volatility than either style can accomplish separately. Invest in:

- Funds with a pure, defined style
- Top-performing funds within each category
- Non-correlated funds that bear little resemblance to each other in various market environments

Alternative Asset Managers

In my quest to find some of the best stock pickers in Canada, I knew that this would take me to alternative asset money management. Many great traditional money managers see that they can add value and reduce some downside risk by employing non-traditional strategies. These strategies may include short selling, leverage, or arbitrage strategies. I think that non-traditional investing is so important that I will dedicate quite a few pages to the process of why money managers migrate to the alternative side and how they can add value.

The term *hedge fund* is often associated with alternative asset or non-traditional asset investing. It's funny because when one says hedge fund, the general public tends to think that this is a very risky vehicle. In most cases, this is not true at all. Most traditional money managers who decide to run hedge funds do so to enhance the returns, to have more tools at their disposal, and to reduce volatility.

Market Risk Versus Non-Market Risk

Broadly, there are two types of risk inherent with money management. One risk is called market risk, or the variability of returns that one may achieve that is based on the market. In other words, if the market drops 10 percent, an index fund will drop 10 percent. This is because the index fund returns are entirely dependent on the market. The index fund is exposed to 100 percent of the market risk. As you can see, it is impossible for the index fund to add value over the index. Because of this, investors are unwilling to pay high fees for the service of simply achieving index returns.

Non-market risk in money management usually refers to factors that affect securities that are not dependent on the overall market. For example, what if a broad-based group of gold stocks does well but your gold stock does poorly? This may be because the individual company that you own accidentally

dumped a chemical into a river during the mining process, causing environmental damage, or because the company missed its quarterly earnings numbers. This risk was not caused by the market, but by a specific event that happened to a particular company.

Alternative investment managers generally consider themselves to have an edge that allows them to use their individual skill to do better than other managers. Because of performance-based compensation, they generally want their returns to be more dependent on their individual skill than on the market. They can therefore try to take away market risk, over which they have no control, and shift their portfolio more towards non-market risk, where they feel they may have more control. This means that the portfolios may look very different than the underlying index where they invest. For instance, here in Canada, financial service stocks consisting of banks and insurance companies make up a large percentage of the index. Most alternative managers or mutual fund managers who have done a fabulous job over time will not own bank stocks just because they make up a large piece of the index. They will only own them if they feel the prospects or valuations of the companies are compelling. This is the case with all the managers in this book, and this "thinking outside the box" mentality is not coincidental. It is one of the fundamental reasons they have done so well.

Alternative asset managers generally have 80 percent of their returns attributable to their skill and only 20 percent attributable to the market. The opposite is true with traditional money managers, whose returns are 80 percent attributable to the market. This is one of the reasons why many traditional managers have trouble beating the market. I classify the stock pickers profiled in this book as non-traditional even if they don't hedge, as they follow their own reasoning rather than the market index and their portfolio returns are generally more affected by their decisions than by the index. This is the only way you can outperform.

An Introduction to Long/Short Equities

What Is Long/Short Equity Investing?

Long/short equity funds are the most popular type of hedge product available in Canada, with approximately 80 percent of the funds falling into this category. In the U.S., approximately 35 percent of hedge funds are long/short and they also represent the largest category of hedge fund. Long/short equity funds are the easiest of all hedge fund styles to understand because they use equities

as part of their investment strategy. Other hedge styles use complex arbitrage strategies, derivatives, fixed income, or a myriad of other vehicles to achieve their objectives. While absolute returns (positive returns) are a common goal of most hedge strategies, the different styles will generate varying risk/return profiles.

Long/short equity fund managers buy stocks they like and sell short the ones they don't like. In many cases, the reason for selling a stock short is to reduce the overall risk in the portfolio, not to make a bet that the stock will go down. The long/short model is based on the premise that using a modest amount of leverage combined with short selling could generate market-beating returns, with less risk than the market.

The returns of long/short equity funds should be primarily dependent on the stock-picking abilities of the manager, and less on the overall return of the market.

Although long/short investing has evolved, the original model, developed by Alfred Jones around 1949, used a modest amount of leverage, short selling for risk control, and some profit generation. The terms listed below are defined in the glossary at the end of this chapter.

Example:

Long exposure:	125%
Short exposure:	75%
Net exposure to market:	50%

In the above example, if the manager can simply generate index returns with the long exposure to the market, he will be generating 125 percent of the market returns. Without the short position, the volatility would also be 125 percent of the market. Hence, the manager initiates a 75 percent short exposure. The short can be used for risk control, in case the market falls, and the fund can generate positive returns on these positions. As can be seen, the net exposure to the market is only 50 percent. If the manager can simply use the shorts over time as a risk-reducing measure, he actually does not even have to generate positive returns on the short. If the shorts break even over time, we can see that the fund can generate 125 percent of the market returns, with 50 percent of the risk, on any given day (125 percent long – 75 percent short).

This is easier said than done, and I have oversimplified this example, as managers have other parameters and risk controls they look at, but you get the point.

Long/Short Equity Style Differentiation

To consistently accomplish their goals, a long/short manager must be a good stock picker, have a defined investment philosophy, and have a method that is sustainable. A manager can achieve these goals through various measures. Below are several methods employed by long/short equity managers:

Pairs Trading

This style is commonly used to reduce the market risk of a particular trade. An effective pairs trade is very dependent on the manager's stock-picking abilities. Given the two main types of risk—market risk and non-market risk—a manager may be a great stock picker, but if the overall market declines rapidly, the stock may still fall simply because of overriding market factors. Also, the stock may fall because an entire industry is falling. For example, if the aerospace sector falls out of favour, this will likely cause a precipitous fall in airline stocks.

On the other hand, stock-specific risk can be attributable to situations where individual stocks are falling even though the market is rising. This can occur for a variety of reasons, including poor earnings, bankruptcy, lawsuits, fraud, etc.

A manager will employ pairs trading to reduce the effect of market risk on the portfolio. The return of the portfolio will be entirely dependent on the stock-picking ability of the manager rather than the specific industry represented by the equities.

Example:

After events such as September 11, 2001, certain sectors fall out of favour, as happened then with the hotel industry. A long/short manager may see value in the sector but is worried about the prospects for the entire industry in case people stop travelling. In this case, by buying a stock, or "going long," the manager is still exposed to the hotel industry. The risk is that a great stock can still turn out to be a lousy performer.

To offset this risk, the manager will short a stock deemed to be of lesser quality or which has low chances of appreciation. If the long and short posi-

tions are of equal value, the industry risk is reduced and the return is solely dependent on the performance of the stocks relative to each other.

Long:	ABC Hotel
Short:	XYZ Hotel
Net Exposure	0%

Possible Outcomes:

I.	ABC rises	+30% (for illustrative purposes)
	XYZ falls	+20% (share price fall = capital gain)
	Total return	+50%
II.	ABC rises	+30%
	XYZ rises	-20% (share price rise = capital loss)
	Total return	+10%
III.	ABC falls	-30%
	XYZ rises	-20%
	Total return	-50%
IV.	ABC falls	-20%
	XYZ falls	+30%
	Total return	+10%

Clearly, the third scenario is the alarming one. A manager can reduce the risk of this example by several methods. First, the manager diversifies with many different pairs trades. Second, an active stop-loss program can be used that will eliminate the position if it goes offside by a predetermined amount.

Industry or Sector Rotation

Some long/short equity managers tend to take a "top down" macro view of the economy. Based upon their analyses, they will make sector bets. Sectors that are perceived to benefit from the macroeconomic outlook will have long exposure in the portfolio, whereas sectors that are perceived to have a negative outlook will be shorted. Individual stocks are then picked in each sector according to the manager's stock-picking parameters. Equities may be selected

on the basis of their growth or value attributes. This type of fund may have a higher volatility than a fund that strictly does pairs trading, but the returns can be very high if the manager is correct.

Example:

Specific or general economic events may cause some sectors to come into favour, while others will fall out of favour. With this set of certain circumstances, it can be highly profitable if a manager can short one sector and go long in another sector. The following would have worked well during the 2001-2002 bear market.

Short: Technology
Long: Gold

There are two ways to execute the trades. A manager can use index products as a proxy on the sector or, of course, execute trades in the underlying stocks of the particular index. As with the previous example of pairs trading, managers can use various means to manage the risks arising out of several outcomes.

Special Situation or Opportunistic

Some long/short managers use an approach that is opportunistic in nature. They may take advantage of short-term mispricing of securities or extreme value situations based on market perceptions. This is usually very stock specific in nature and may not be hedged with other investments. The manager may also use a combination of this method and other long/short strategies. This type of trading may be more non-market dependent in nature than some other management styles because returns are more event driven in nature.

The strategy is highly dependent on the manager's ability to identify opportunities, and may involve the need to be very active.

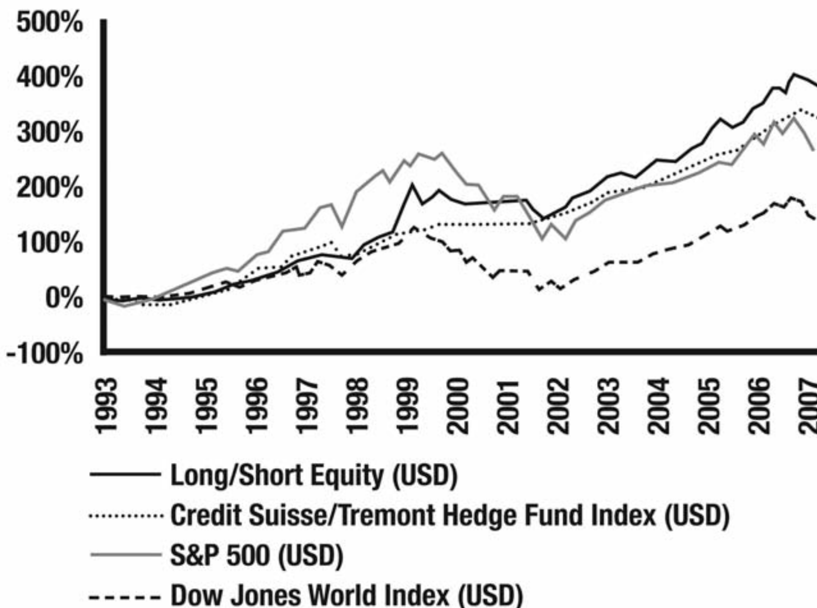
In other words, the manager may be in and out of positions quickly, maybe on a week-to-week or month-to-month basis. For this reason, liquidity is paramount. The manager may want to limit the size of the fund and pay attention to how many shares of a particular equity are owned in comparison to the average trading volume of that stock.

Example:

A stock picker buys a security such as a closed-end fund that trades on the market, knowing that the security is redeemable at a point in the future for its net asset value (NAV). The security may be purchased when it is trading at a 10 percent discount to its NAV based on the premise that it can be redeemed or "cashed in" in three months at its NAV. In this case, the only risk that would be involved is that the NAV of the security would go down. However, in any scenario, there would still be a "cushion" of 10 percent for the hedge manager. This style of long/short can overlap with some other hedge styles, such as event driven or arbitrage.

In the above case, if the NAV is stable, a manager could achieve a low-risk 10-percent return over the period of three months if they execute it properly.

The goal of most long/short equity funds is to achieve equity-like returns with less risk and volatility than the market. As measured by the Credit Suisse/Tremont Long/Short Equity Hedge Index from January 1994 until March 31, 2008, the index has been able to achieve annualized returns of 11.6 percent per year. On the other hand, the S&P 500 over that time frame has generated returns of 9.5 percent per year. Further, the Long/Short Index has achieved the better returns with only about 70 percent the volatility of the S&P 500. To achieve their objectives, long/short managers can use a variety of tools including selective use of leverage, short selling, and option-based hedging strategies.



An investor should understand the statistical measures associated with the long/short fund in order to properly analyze it in the context of the portfolio. Alternatively, and more practically, a prospective investor should rely upon an individual who understands the long/short strategy and can give proper advice within the context of a portfolio approach.

In the course of these interviews, several managers were long/short equity managers, including Eric Sprott, John Theissen, Frank Mersch, Randall Abramson, Peter Pucetti, and Rohit Sehgal. Given the choice of putting their own money in their long/short equity product or a long-only product, most of the above managers choose the long/short because of the added flexibility.

Long/Short Equity Glossary

Long/short investing is relatively simple to understand. Most managers use variations of the basic principle of buying stocks they like and shorting stocks they dislike, or at least dislike relative to their long holdings.

Short selling – We won't get into all of the dynamics of a short trade; however, the basics are important. Shorting a stock consists of borrowing a stock that you don't actually own, and then selling it with the hope that it can be bought back at a lower price. The difference between the stock's selling price and the lower buyback price is your profit. On the other hand, buying the stock back at a higher price than what you sold it for will generate a loss.

Leverage – Many long/short equity funds use some leverage in the investment process. Leverage is simply borrowing against existing holdings to try to enhance returns over what would normally be possible. In other words, an investor borrowing $0.50 for every $1.00 invested would have $1.50 invested. Thus any gains would be on the $1.50, and the only cost would be the borrowing cost of the $0.50. Of course, leverage can work against you, resulting in a larger loss than would be normal if things go awry.

Gross exposure – The combination of adding the stocks that are owned by the fund (long positions) to the stocks that are shorted by the fund (short positions). For example:

Long positions	125%
Short positions	75%
Gross exposure	200%

Net exposure – The difference between the long exposure and the short exposure of the long/short equity fund. For example:

Long positions	125%
Short positions	75%
Net exposure	50%

Market risk (systematic risk) – The risk associated with owning securities in a particular market. It is that part of a security's risk that is common to all securities of the same general class and thus cannot be eliminated by diversification. The measure of systematic risk in stocks is the beta coefficient.

Sharpe Ratio – A number measuring the reward-to-risk efficiency of an investment, used to create risk-efficient portfolios. In other words, the Sharpe ratio measures the return of an investment per unit of risk. The mathematical formula is listed below; however, the number is readily available for different investments and it is not required for the individual investor to calculate it.

The definition of the Sharpe ratio is:
$S = (r_X - R) / StdDev(x)$

Where:
S is the investment;
r_x is the average annual rate of return of *x*;
R is the best available rate of return of a risk-free security (e.g. cash);
StdDev(x) is the standard deviation of r_x.

Practically speaking, the higher the Sharpe ratio, the better the investment, based on a return-to-risk measure.