Long-Only: *The Natural Benchmark Choice for 130/30*

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Short-extension investment strategies, in general, and 130/30 strategies, in particular, are garnering increased investor interest, but little agreement exists about how to measure manager skill in these strategies. Because these strategies are compared to hedge funds and have significant implementation differences from those of a long-only strategy, some suggest the use of peer groups or even a 130/30 index as a benchmark. Regardless, a short-extension investment strategy is not a separate asset class and competes for the same investment assets as a long-only strategy, and thus requires the same long-only benchmark to measure manager skill.

INTENT OF 130/30

Whereas, in a long-only strategy, equity exposure can range from 0% to 100%, in general the term "130/30" refers to an investment strategy that maintains 100% net long stock exposure by combining a short position (30%) with an equally extended or leveraged long position (130%); hence, the use of the more general term—short-extension strategy.

The strategy's intent is to relax the long-only investment constraint so that active managers can capture additional alpha from their negative stock evaluations. The investor's usual goal is to increase alpha while controlling beta.

BENCHMARK CONFUSION

130/30 strategies are called the market's compromise between long-only managers and hedge funds. Benchmarks and performance attribution issues for long-only managers are addressed with an array of indices designed to replicate the neutral position of like-styled long managers. There is, however, ongoing debate about the appropriate benchmarking of hedge funds. The debate revolves around which of the following approaches should be used: 1) absolute returns, 2) stock index plus some fixed value, or 3) peer groups. Because 130/30 strategies are viewed as a compromise between the two strategies (hedge funds and long-only), some investors argue that 130/30 should be viewed as a separate subasset class. To take this path implies a need for separate asset class benchmarks. 130/30 indices offered by traditional index providers such as Standard and Poor's (S&P), money managers such as Credit Suisse, and others, including Lo and Patel [2008], make it easy to assume that these strategies require new, separate benchmarks.

NOT A SEPARATE ASSET CLASS

For recognition as an asset class within the asset allocation process, an investment category must offer an expected return premium to cash and diversification benefits, and be open for investment (Foresti [2005]). Based on this definition, a 130/30 investment strategy is not a separate asset class or a subasset class. Relaxing the long-only constraint may change the financial risk and expected return dispersion, but not the expected return premium or diversification from the long-only strategy. In fact, a central feature of a 130/30 strategy is to maintain systematic or market risk equal to that of a long-only portfolio of similar style.

IT'S ALL ABOUT ALPHA

A constant refrain of the proponents of 130/30 strategies is not only the existence of, but the requirement for, positive alpha. The S&P 130/30 index uses S&P market analyses that are not conceptually different from the market analyses of other active money managers, except that the evaluations are published using the S&P Stock Appreciation Ranking System (STARS). This index does not attempt to represent the collection of 130/30 products. Rather, it is designed to demonstrate the quality of the STARS recommendations as well as shepherd the creation of investment products with expected returns equal to the S&P 500 plus the alpha of the strategy.

Even 130/30 indices designed to be benchmarks do not attempt to represent the collection of 130/30 products. Being passive or "plain vanilla" (Lo and Patel [2008]) does not make them representative of the asset class or even of a "normal" 130/30 portfolio. Christopherson [1998] defined the normal portfolio as "a set of securities that contains all of the securities from which a manager normally chooses, weighted as the manager would weight them in a portfolio" (p. 128). A 130/30 manager begins with the long-only portfolio and adjusts stock-specific risk away from the long-only portfolio. According to Lo and Patel [2008],

> it is a well-known fact that a long-only portfolio with no alpha will not benefit from the flexibility of leverage and short-sales. Consider the trivial example of leveraging all the positions of the S&P 500 by an additional 30%, and then shorting every stock by 30%. The outcome of this 130/30 portfolio is simply the S&P 500. For a 130/30 portfolio to yield positive excess return above and beyond its long-only counterpart, the factors used to construct expected-return forecasts must add value (pp. 12–38).

This passage by Lo and Patel confirms that the long-only portfolio is the best representation of the 130/30 strategy. When the expected alpha is zero, what remains is the beta of the long-only portfolio.

APPROPRIATENESS OF BENCHMARKS

The current definition of a stock index (Business Dictionary.com [2007]) is "a statistical indicator of changes in the value of a group of stocks." The main difference between this and previous definitions is the loss of the word "representative." It has been common for articles evaluating indices to use the qualities of a good benchmark, as articulated by CFA Institute [1998], as a measure of the quality of the index. Webster [1985] defines a benchmark as "something that serves as a standard by which others may be measured." Unlike the CFA Institute definition, the Webster definition also excludes the words "appropriate" and "representative." Users of indices and benchmarks cannot assume that they are appropriate or representative of an asset class. The abilities of an Olympic miler can be benchmarked to those of other elite runners, high school milers, or jet planes. A 130/30 plan may be benchmarked to a 130/30 index or any other investment, but this does not mean that it is representative or appropriate.

Representative benchmarks are important tools to aid in asset allocation, risk budgeting, and performance attribution of investment policy. 130/30 strategies are not a separate asset class, which excludes them from use in asset allocation. 130/30 strategies imply the search for alpha, and thus are allocated funds from a corresponding part of the active-management risk budget. 130/30 equity managers are funded from the active-equity risk budget just as 130/30 bond managers are funded from the active-bond risk budget. Both active and passive managers are evaluated using the passive long-only benchmark. Each manager adjusts his or her security-specific risk from the long-only benchmark. Thus, attribution—including the negative attribution of short investments—is measured against the long-only benchmark.

ONE BENCHMARK PER ASSET CLASS

The investment community has already decided that same-asset-class investment strategies with implementation differences use the same benchmark. Unlike long-only passive managers, long-only active managers incur additional operational and transaction costs, yet both use the same passive index as their benchmark. Differences in the investment or fee structure do not necessitate different benchmarks to reflect these additional costs.

CONCLUSION: LONG-ONLY BENCHMARK IS THE NATURAL CHOICE

130/30 managers are competing in the same asset class against active and passive long-only managers; consequently, each manager should use the same benchmark. A 130/30 manager could argue that because of his investment structure, he incurs additional costs (borrowing, transaction, administration, and opportunity) versus those of a long-only active manager, and thus should have a benchmark that reflects these additional costs. The best response is summarized by paraphrasing from Kuberek [2005]: 130/30 managers should be judged against the appropriate passive benchmark, not one that is selected simply because it takes long and short positions or has similar operational costs. If the 130/30 manager cannot beat the naïve benchmark, then in what sense is the manager adding value? This leaves the long-only benchmark as the natural choice for benchmarking 130/30 investment performance.

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