Long-Short Equity

A Practical Alternative for a Changed Market

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After decades in a stable relationship, stocks and bonds are having a fight worthy of a *People* magazine cover. Equities perch at record highs, with proponents touting robust earnings, whereas bond prices highlight the likelihood of snail-like growth and the risks of disinflation — or even deflation.

Explaining this historic dichotomy is tough, but for an individual investor, the question of how to react to it is even tougher, especially when focusing on just those two asset classes. Let's briefly look at what's behind the discordant messages and then focus on what do to about it — for there are a raft of new, practical alternatives that many investors know too little about, and which can be useful in coping with these particularly uncertain times.

A DECOUPLING OF THE ECONOMY AND CORPORATE PROFITS

If you had to pick one explanation for the state of the financial markets, it would be that corporate profits have disconnected from what most people consider "the economy." In the past, we've spoken about these two interchangeably; they moved in lock step. That hasn't been the case recently, as can be readily seen by looking at jobs participation rates, real wage (non) growth; first-time home-buyer statistics, income distribution patterns or any other measures of how well profits reflect the wellbeing of the middle class. The fact is, corporate profits can now surge even if "the economy" isn't performing well.

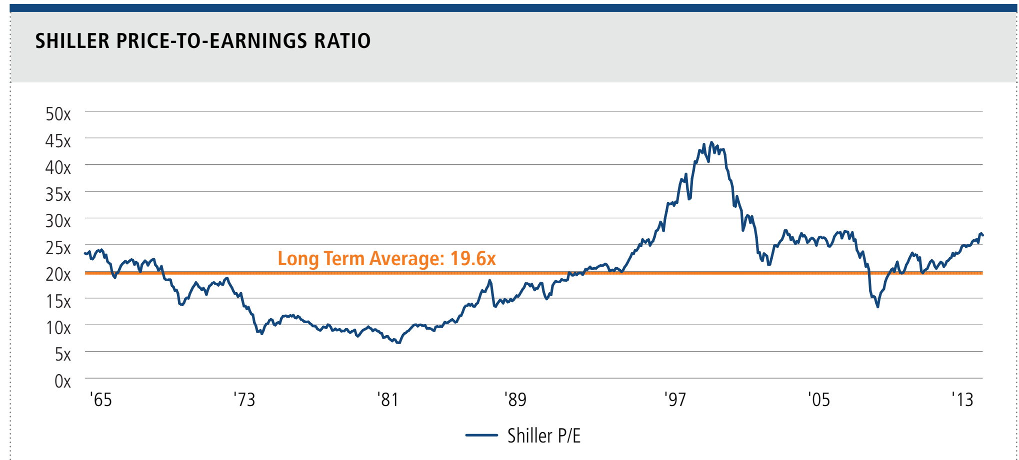
Two megatrends appear primarily responsible. The first, technology, is overwhelmingly important yet rarely discussed in investing circles. Technology is relentlessly driving profits higher while reducing available jobs and costs. The second is more familiar to investors: the breathtakingly large central bank experiments since the great financial crisis, which have reduced borrowing costs and enabled corporations to increase profits without the need to improve top lines. But these factors are conspiring with many others, related and unrelated: the total globalization of economies, markets and competition; the advent of the (highly disinflationary) sharing economy; the sudden emergence of the United States as a major energy producer; the collapse of demographics in Japan, and their rapid deterioration in the eurozone and even China; automation and artificial intelligence sapping away a growing percentage of middle-class jobs; and the rise of a digital economy that fundamentally changes the rules of industrial-era competition, with less need for capital, a penchant for tiny workforces and a habit of producing "winner take all" outcomes (think Google, Facebook, and now Air BnB and Uber).

COMING TO TERMS WITH THE NEW REALITY

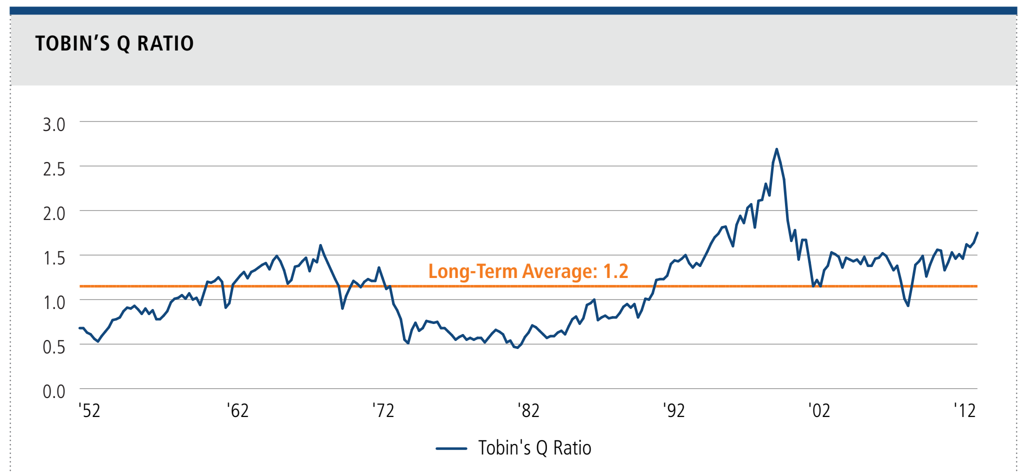
How this litany of unprecedented factors drives financial markets from here is, quite literally, anyone's guess. What is not a guess is that stocks are expensive in historical terms. The Tobin's Q (measuring the replacement value of the S&P 500) and the Schiller

PE (price-to-earnings ratio, adjusted for the cyclicality of profits) are significantly above their long-term averages. Meanwhile, the ratio of market capitalization to GDP, the so-called "Buffet Index," which is commonly used to measure stock valuations, stands at more than twice its normal levels, an extremely significant two standard deviations north of its long-term average (see display).

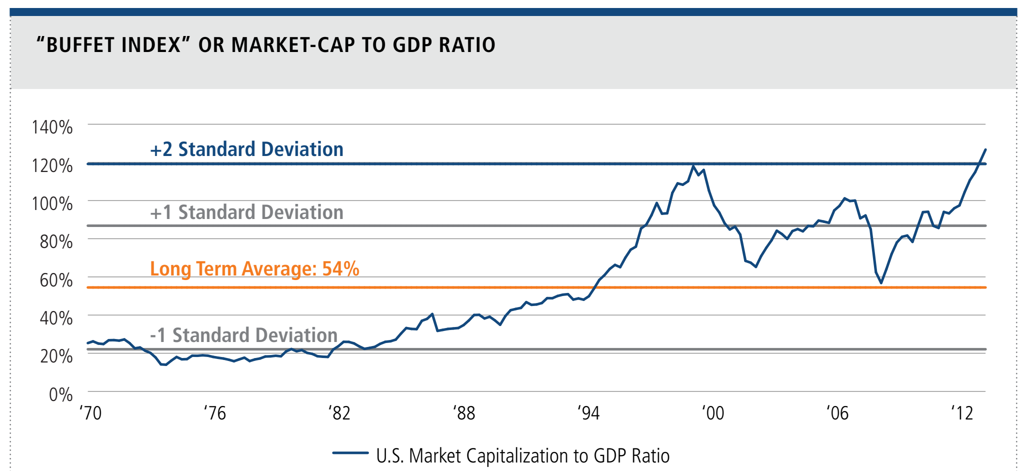
U.S. STOCK VALUATIONS ARE HISTORICALLY HIGH, BY SEVERAL MEASURES



Source: Yale University Department of Economics.



Source: Federal Reserve.



Source: Federal Reserve Bank of St. Louis.

For many investors, the concern is not just that stocks could suffer a sudden downdraft, although all three measurements last hit similar levels before the crashes of 2000 and 2007. It's that future returns from here could be muted. Obviously, the more you pay for something, the less the profit potential; and you're paying a lot to buy stocks right now.

Current equity valuations highlight the appeal of mitigating against a potential market downturn while the low-interest-rate environment means fixed income investors need other sources of return, assuming that the modest returns the market can provide from here may not be adequate for an investor's future needs.

WHY BONDS ARE NOT CURRENTLY APPEALING

In the old days, an investor might turn to bonds for both yield and principal preservation. At current interest-rate levels for investment-grade bonds, however, that's just not feasible. Yields are at historic lows, which is proving to be a challenge for investors seeking income. Meanwhile the price appreciation that many fixed income instruments have experienced in the last decade is unlikely to continue.

Worse, interest rate risk and duration risk are at extreme levels. If you did buy a new 10-year Treasury today, and rates were to rise just 1% tomorrow, the value of the bond would instantly fall almost 10%. That loss is quite real even if you hold the bond until maturity because, by definition, the nominal dollars you get back will have lost significant purchasing power (from the inflation driving interest rates north) during the holding period.

Given this environment, bonds cannot be expected to continue in their traditional role as the antivolatility ballast for a 60/40 portfolio or as the "safer" part of a 30/70 retirement arrangement. Accordingly, many investors are considering moving away from traditionally "safe" fixed income securities and going further out on the risk-return spectrum in the search for yield.

FINDING A PRACTICAL ALTERNATIVE

Fortunately, investors today have access to a range of tools designed to address the challenges of the current environment. Alternative strategies have been used by institutions for decades, and recent changes in law, regulation and financial industry dynamics have opened the way for investors of all stripes to participate in hedge fund strategies through mutual funds.

Let's focus on the most famous one, long-short equity strategies. Benjamin Graham, the father of value investing, invented the basic idea when confronted with the frothy markets of the 1920s. He went "long" certain stocks, and simultaneously "short" others, with the goal of being able to profit regardless of the overall market direction: So long as the favorite stocks do *relatively* better than the least favored ones, the strategy produces profits whether equities overall rise or fall. Of course this strategy is not without risk, as an investor's least favorite stocks could appreciate, resulting in a loss from the short position.

This long-short approach is designed to cushion exposure to downside market volatility compared to a portfolio that is exclusively invested long in stocks. But reducing your long exposure comes with a trade-off: In up markets, the strategy will likely underperform the broader market. When risks of the market appear high, however,

reducing your directional exposure to the equity markets while also staying invested is often the right call.

Long-short is a popular way to limit equity risk while staying "in the game" and trying to produce gains. Many others exist as well: global macro strategies, various arbitrage approaches, even "low beta" stock funds. While these strategies are quite different, they are all designed to pursue returns without being exposed to the full volatility of the equity markets.

Like many nontraditional strategies, long-short equity strategies are available through single-manager funds, which express the particular viewpoint of a single portfolio manager, and through "multimanager, multistrategy" funds. Here, the fund manager hires outside hedge fund managers, experts in specific strategies, to act as submanagers of the fund.

Allocating to nontraditional strategies certainly requires homework and thought. But with all today's uncertainty, and the extremely lofty valuation levels of traditional stock investments, a more sophisticated and robust risk-managed approach is clearly appealing.

ABOUT BOB RICE

Bob Rice, Managing Partner of Tangent Capital, is a financial expert, speaker and bestselling author who is a frequent guest on several national business news programs. Bob uses his 25 years of experience in non-traditional investments as an advisor, lawyer and principal to work with advisory firms engaged with Neuberger Berman. He is the author of *The Wall Street Journal* bestseller, *The Alternative Answer*. Bob has served as a financial products partner at Milbank Tweed; the CEO of a publicly traded technology company (the successor to his own startup); and a trial lawyer for the U.S. Department of Justice.

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