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When Long Means Loss

By Chidem Kurdas, New York Bureau Chief
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NEW YORK (HedgeWorld.com)—Long-only or heavy long-biased stock funds were all the rage in 2005. Those launched by well-known managers and large hedge fund firms received much attention and money. For instance the Renaissance Technologies Corp. equity strategy, started last August, took in close to $7 billion.

But funds with relatively high market exposure are not much in the news nowadays. Not surprisingly, managers try to avoid the limelight when they've racked up losses. On the whole it has not been a good time for unhedged buy trades in equity markets, whether developed or emerging.

Last year it was tough not to be very long-biased and not to own emerging markets securities, said Ken Phillips, a hedge fund investor and manager of RCG Capital Advisors LLC, New York and Boulder, Colo. He resisted the temptation and hewed to a low market exposure approach, which demonstrated its advantage in recent months.

In balancing long and short positions, Mr. Phillips considers not only the commonly used net exposure measure but also the coverage ratio of long to short exposure. He argues that net exposure alone can be misleading. "You want to come at the data from both directions," he said.

Take two long/short equity portfolios, one $60 long and $10 short and the other $100 long and $50 short. Both have $50 net long exposure. But the first has a coverage ratio of six while the second has a ratio of two.

The lower the ratio, the more defensive is the portfolio with respect to market volatility. An aggressively long-biased fund might have a ratio of 10. Mr. Phillips has kept the ratio at a very conservative 1.6 for his hedge fund investments.

The exposure question is not confined to long/short equity strategies. Consider Mangan & McColl Partners, a merger and special situations hedge fund that was liquidated this month after suffering heavy losses. In 2004 the fund had around $1 billion in assets but by the end it was down to less than $390 million, in large part because of heavy redemptions in 2005.

Michael Markov of Markov Processes International LLC, of Summit, N.J., did an analytical inquest to find out what went wrong with Mangan & McColl Partners. Using a proprietary technique he constructed a portfolio of market indexes that mimic the returns of the fund.

This exercise shows that the strategy diverged from what it was supposed to be. In particular, the portfolio was not hedged as promised. In 2005 the strategy was 100% net long and had very specific uncovered bets, Mr. Markov found. It also had increased exposure to international equities.

Projecting the hypothetical portfolio into 2006, he estimates that it would make heavy losses due to the substantial market exposure. Shutting down the fund was clearly the right choice.

In the past three years international equity was such an alluring asset class—the MSCI EAFE Index gained 39% in 2003, 21% in 2004 and 14% in 2005. With those numbers, long-heavy investing in international markets took off. Hedging, always expensive and difficult, is particularly unattractive in soaring markets.

Using returns-based style analysis, Mr. Markov identified a trend of increasing long exposure during 2005. He found that equity hedge fund returns in 2005 behaved like a long-only portfolio with a large component of cash **Previous HedgeWorld Story**.

Come this May, unhedged long positions took on, in dramatic terms, a tragic role. Hedge fund management is a Shakespearean business, said Mr. Phillips.

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