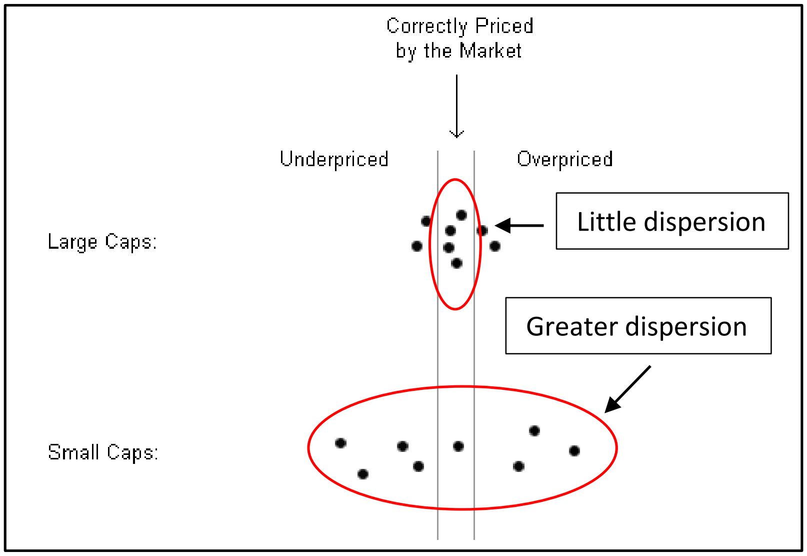
Rebooting Your Thinking on Long/Short Equity:
Yes, Size Does Matter

Long/short equity is a strategy that has long played a central role in diversified hedge fund portfolios. Recently, some firms have been emphasizing long/short equity as the strategy that has failed to provide diversification of the broader equity markets. Given the recent performance of many managers in the space, this is not an unreasonable stance. That said, we feel that the focus of most long/short equity funds is misplaced and not directed to areas of the market where they can add the most value. This primarily comes down to market-cap spectrum where most funds focus on large-cap equities to allow for greater fund capacity. The tradeoff, of course, is that these are amongst the most efficently priced securities in the market.

The appeal of a long/short equity fund is the prospect of outperforming the market over an economic cycle, with lower volatility and drawdown. Long/short equity funds should also provide a complementary and differentiated return stream to the broad market. Managers stand the best chance of being able to accomplish this by focusing on less efficent areas of the market, specifically smaller capitalization companies. The vast majority of long/short equity managers do not focus on small-caps for a variety of reasons but most notably, the asset class does not allow them to grow their fund to a "sufficent" scale. Alpha isn't easy to generate and it makes sense that it should be harder to come by with significant assets under management. There is no investment strategy that we are aware of that scales indefinitely. More recently many allocators have grown frustrated with the performance of their long/short equity allocation as it has failed to meet their expecations. The two chief culprits for this are market cap focus and crowding in commonly held names by other hedge funds. Both of these issues can be remedied by focusing on less efficent areas of the market.

Focusing on less efficent areas of the market within long/short equity can play another important role in portfolio construction, namely providing exposure to underrepresented asset classes. Most portfolios already have a large weighting to the S&P 500 Index, and therefore most investors do not need additional exposure to this area of the market. Allow us to emphasize the constituents of the S&P 500 – it primarily consists of 500 of the largest companies in America and makes up *80%* of the overall market's value. It is widely regarded as the single best gauge of large capitalization U.S. equities (with large cap being defined as a company with a market capitalization value greater than $5 billion). If investors are looking for differentated returns they would be much better served focusing on areas of the market where they do not already have material exposure. There are several research studies that confirm that large caps are more accurately priced than small caps. We recall a graphic based on David Swensen's, CIO of Yale University's endowment, simplistic explanation of the market efficiency between large and small caps at a recent lecture that sums it up quite nicely:



Source: http://www.moneychimp.com/articles/index_funds/why_sv.htm

Considering these factors, it seems illogical that an investor would want to pay for an active manager that focuses on the most efficently priced securities in the market. **Simply put, size matters.**

There are certain sub-strategies in our view that are conducive and particularly ideal for long/short equity investing, where there are both big winners and losers which creates an ideal backdrop for long/short portfolios. In our view, small caps are a better alpha driver than large caps. U.S. small caps, defined as companies with capitalizations less than $2 billion, are a highly inefficient space because a majority of the dedicated research is focused on the larger cap part of the spectrum. Small-cap inefficiencies can be even greater in other developed equity markets, such as Europe and Japan. In the stock market, the number of eyeballs decline proportionately with the size of the company (there are for example, 45 sell side analysts covering $630 billion market cap Apple (AAPL) while many small cap companies are hard-pressed to find even *one*). The fact of the matter is that there are fewer sell-side firms focused on small caps, resulting in greater market inefficiencies. As alpha becomes increasingly more difficult to generate, investors need to be looking at less efficient areas in order to find it. We believe that it is worthwhile to select long/short equity managers that primarily focus their efforts looking under the smallest rocks, as chances are, very few will be looking there.

Remember, size does matter, and that bigger isn't always better.

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Long/short equity is an investment strategy that involves buying long equities that are expected to increase in value and selling short equities that are expected to decrease in value.

Volatility is the statistical measure of the dispersion of returns for a given security or market index. Volatility can either be measured by using the standard deviation or variance between returns from that same security or market index. The higher the volatility, the riskier the security.

A **drawdown** is the peak-to-trough decline during a specific recorded period of an investment, fund or commodity. A drawdown is commonly quoted as the percentage between the peak and the subsequent trough.

Alpha is a measure of performance on a risk-adjusted basis. The excess returns of a fund relative to the return of a benchmark index is the fund's alpha.