EQUITY LONG/SHORT POST-CRISIS:

A STRUCTURAL ANALYSIS OF THE DECLINE IN ALPHA

The old adage was that equity long/short managers would capture 80% of the upside in the S&P 500 but only half the downside. Frustratingly, in the post-crisis period, the typical equity long/short manager has returned roughly half the upside and half the downside – not a very compelling proposition given the fee structure, illiquidity and headline risk.

Why, in recent years, has this proven strategy failed to outperform some traditional equity markets on a risk-adjusted basis? We conclude that there are two interrelated factors. First, a broad migration of capital out of the equity markets has undermined a key element of traditional value investing. Second, a change in the structure and oversight of many funds has intensified pressure on near term performance and position-level liquidity. Both these factors have narrowed the typical opportunity set and, we believe, hindered returns.

The typical equity long/short fund was approximately flat over the five years to June 2012. The driving factor, of course, is that equity returns have been poor – most indices are flat to down over the period. The chart below tells the first part of the story. Over the five years to June 2012, global equities, emerging markets and commodities all returned between zero and negative 20%. Clearly, this is bad for equity long/short managers who, as a group, run consistently positive betas (generally 0.3-0.5).

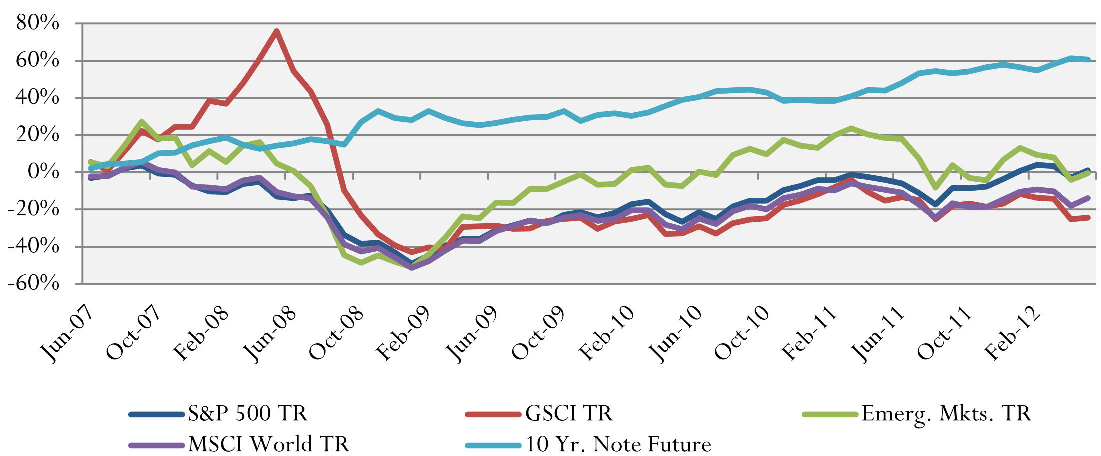

Figure 1 - Compounded performance by investment over the past 5 years

Given that equity long/short managers delivered around 400 bps per annum of alpha in the decade leading up to the crisis, one might have expected several hundred basis points of positive net returns even during a flat period in the markets. What changed? Most observers blame a combination of macroeconomic volatility, political uncertainty, high correlations, and too much capital in the industry. I contend that a more subtle structural change in the equity markets has created an additional impediment to returns.

In the chart above, what's striking is that fixed income returns were staggeringly high during this period of low to no returns in risk assets. The 10 Year Treasury future – an asset with a fraction of the risk of the other asset classes – appreciated around 60% with de minimus volatility. The divergence between bonds and other assets is important since empirical evidence clearly demonstrates that capital chases returns. This period is no exception: the following chart (from ICI data) shows how almost $1.1 trillion of capital flowed into fixed income mutual funds over five years while $600 billion was withdrawn from equity mutual funds. The scale of the withdrawal from equity mutual funds is notable given that all US equity mutual funds had perhaps $4.0-4.5 trillion in AUMs at the beginning of this period.

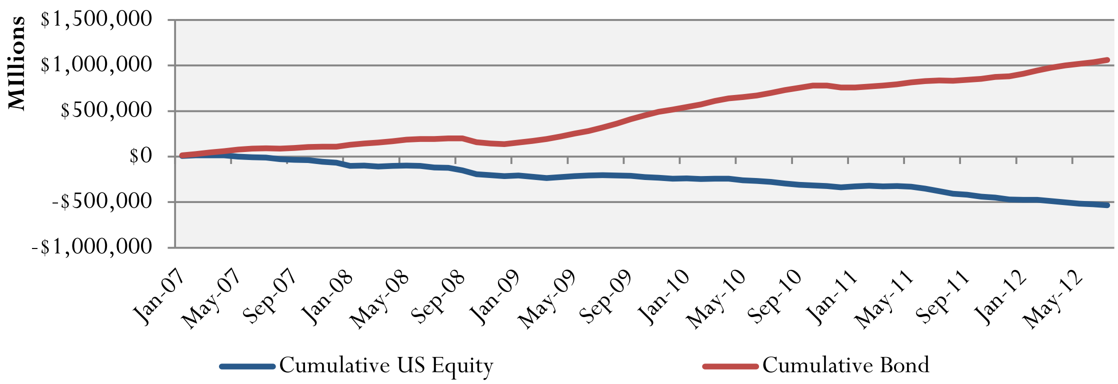

Figure 2 – Cumulative capital flows in mutual funds by underlying asset class

Interestingly, ETF fund flows were not nearly as significant a factor. Despite rapid growth, ETFs still account for less than 10% of the domestic mutual fund industry; inflows to both bond and equity ETFs were less than $150 billion each over the same period. Aggregate information on direct investment by institutional investors shows the same trend: allocations to equities have come down by around one-third over the past decade.

The narrow question is why this has been so problematic for equity long/short managers. Equity long/short managers are predominantly fundamental value buyers. Buy good/cheap stocks, short expensive/bad ones. Consequently, most value investors rely on two assumptions: first, the market will occasionally underprice the fair market value of a business and, second, other market participants over time will recognize the discount, bid up the price and close the valuation gap. At Baupost, I'd sponsor investor dinners: invite ten mutual fund managers and pitch one of our positions – and hope that Fidelity or Wellington would load up on it. What we could find at 60 cents on the dollar, they might buy at 65, 70 or 80 cents. This latter part of the process seems to have broken down. Anecdotally, we repeatedly hear stories of managers who've bought "cheap" stocks only to see them drift downward on no material news. We get the strong sense that this pattern has been repeated over hundreds of individual stocks over the past few years, and you can hear the fatigue in managers' voices. Overall, the data strongly suggests that the natural pool of buyers for off the run value stocks has been dwindling.

Historically, there have been two other potential buyers of undervalued stocks: corporations themselves and private equity buyers. In the chart below, we see that, while the number of announced buybacks has recovered to pre-crisis levels, the dollar amount is still 30% lower. This is despite the fact that, as shown in the chart on the right, corporations are sitting on record levels of cash and can borrow at low rates (and, yes, there is still a huge tax benefit to leverage). Another "buyer at a cheap price" appears to have pulled back from the market.

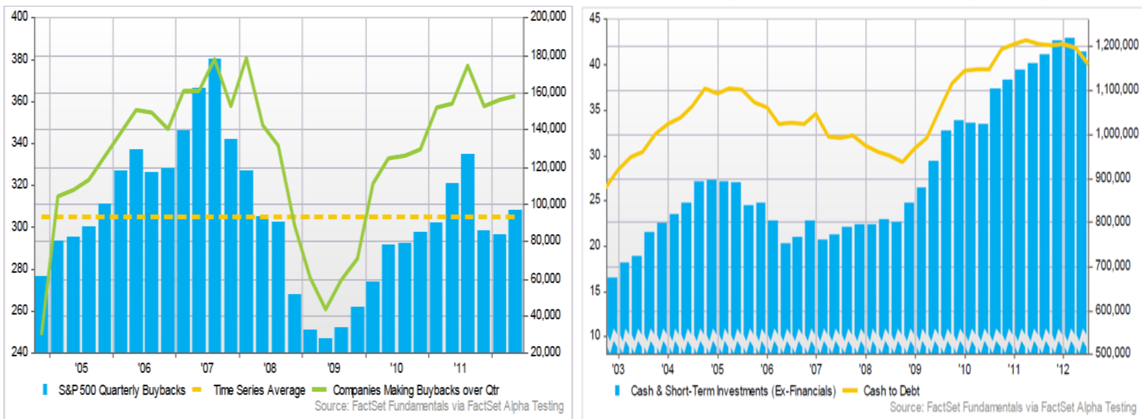

Figure 3 & 4- Quarterly share repurchase (left) and cash to debt (right) for S&P 500 companies

The third pool of potential buyers consists of private equity funds. Pre-crisis, if a company's stock was sufficiently cheap, a leveraged buyout firm or other private buyer might try to buy it. Today, however, despite historically low interest rates and moderate equity valuations, public investments in US public companies remain at a small fraction of pre-crisis levels. The following is a chart gives a sense of the magnitude of the decline:

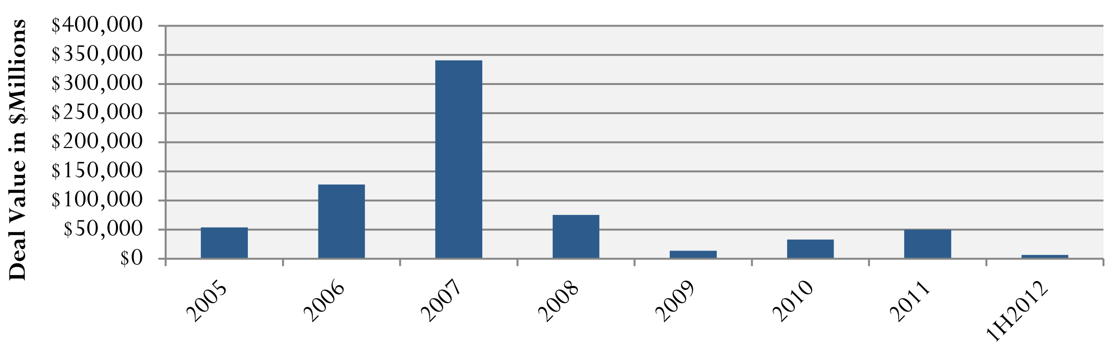

Figure 5 - Private equity investments in US publicly-traded companies

Put together, the data suggests that equity long/short managers have been caught on the wrong side of a major structural shift in the investment landscape. Two generations of value investors have been trained that "other" buyers will recognize a mispricing, and correct it. Over the past few years, the "other" buyers simply haven't been there. The change hasn't been as sudden and dramatic as the seizing up of credit markets in 2007-08, but it's arguably been just as important.

What will cause capital to return to the equity markets? Several factors are at work here. First, investors simply cannot afford to keep chasing fixed income returns when central banks have made it clear that that they want to see more inflation in the system. The scale of the distortion between the fixed income and equity markets over the past few years is shown below: for fifteen years, the earnings yield of the Russell 2000 Value index was approximately equal to yield on the Two Year Treasury note. This 1:1 relationship was remarkably stable until early 2010. Now, the forward earnings yield on the index is above 7% while the Two Year yield is hovering close to zero. Something is seriously askew here and it will correct itself over time.

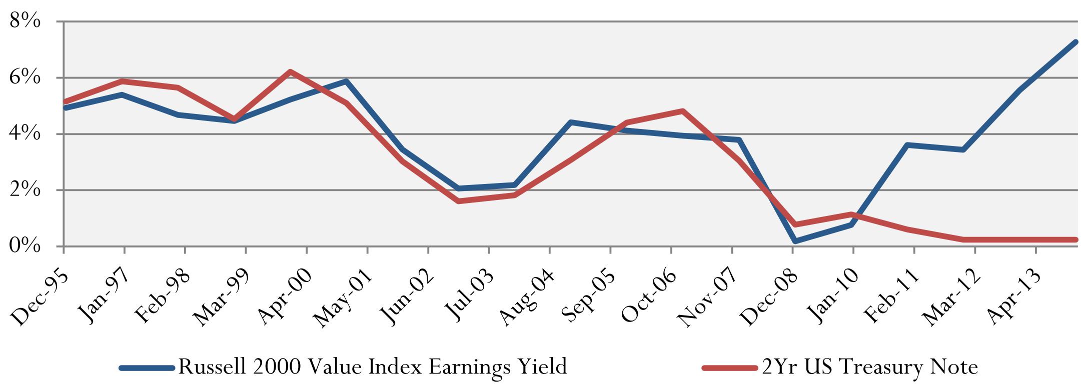

Figure 6 - Yield comparison between Russell 2000 Value Index companies and 2Yr Notes

As the global deleveraging process continues, excess cash on corporate balance sheets will be used for acquisitions and stock buybacks; corporations worldwide have $3.4 trillion in cash today. Private equity firms, sitting on $1 trillion of commitments that are due to expire in several years if undrawn, will resume investing in US public equities. In the mutual fund world, capital chases returns, so this year's performance will help. Retiring Baby Boomers and institutions simply cannot afford to remain over-allocated to fixed income investments with negative real yields. As shown below, the dividend yield on the S&P 500 now exceeds the yields on both the Two Year Treasury Note and Ten Year Treasury Bond. For Baby Boomers, given that most dividends (still) qualify for special tax treatment, the after-tax current income of investing in equities is now materially greater than holding Treasurys.

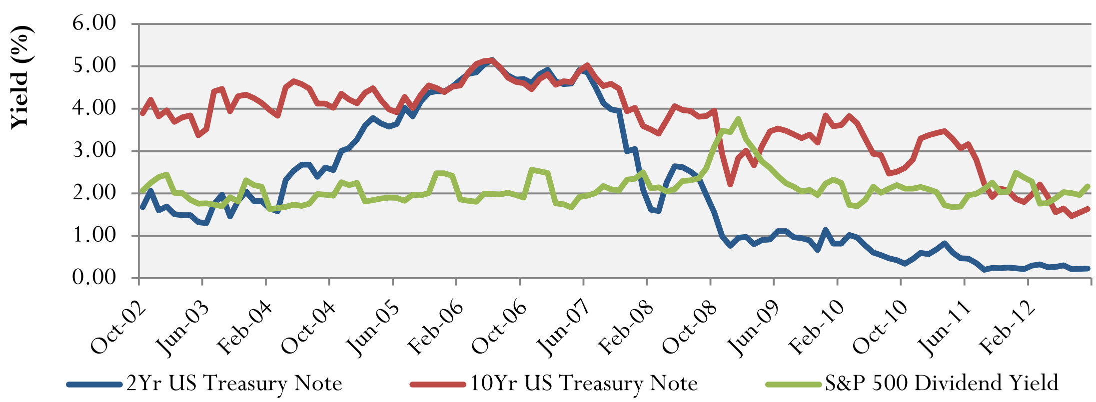

Figure 7 - 2Yr and 10Yr US Treasury Notes yields vs. S&P dividend yield

For the reasons above, beta looks better today than at any time in the past ten years. Just how good is a matter of debate. Earlier this year, Goldman calculated an ex ante risk premium as high as 8-9%, and a well-known valuation expert came up with 6% -- both well above the long-term average of 3-4%. (Note that both the calculations do rely on current negative real interest rate benchmarks.) Either way, equities are a lot more attractive than fixed income today. Ironically, our research shows that hedge fund managers correctly recognized this early in 2011, but remained underinvested due to macroeconomic uncertainties.

So, how has this affected the typical equity long/short manager? The waning confidence in traditional value investing has led to a greater focus on positions with catalysts and, consequently, competition across a narrower opportunity set:

- With less patience and tolerance for simply buying cheap stocks, we see more focus on stocks with defined catalysts. 2008 showed that the "valuation floor" simply wasn't there for many stocks, especially illiquid ones. Instead of "I can lose $10 but make $30," managers have trouble quantifying the downside. 2008 also taught managers that to stubbornly hold a losing position can be fatal to the fund. The subsequent years have reinforced the idea that cheap stocks can get cheaper – much cheaper – without much news. However, by avoiding cheap stocks without catalysts, managers narrow the opportunity set and may limit returns.
- Managers have gravitated to large cap stocks, where liquidity is seen as a potential buffer against severe drawdowns. Among investors, the fear of gating remains irrationally high; a highly liquid portfolio is a precondition for retaining and raising assets these days. Managers seek to demonstrate that they can liquidate positions in a matter of days; the decline in overall trading volume, as shown to the right, limits many funds to large cap stocks. This raises a legitimate question as to whether managers can maintain an information advantage relative to the rest of the market.

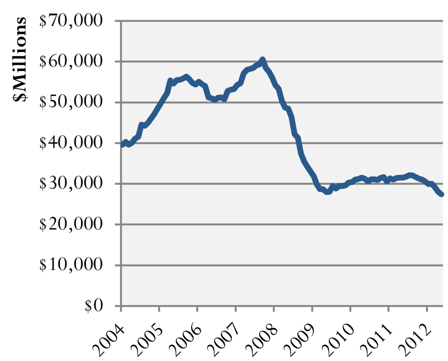

Figure 8 - NYSE 12 month average daily value traded

Both shifts have the effect of narrowing the opportunity set; consequently, competition has increased and position crowding is prevalent. The Tiger and Lone Pine progeny employ similar analytical techniques, information, etc. A talented pool of managers has been fighting for alpha in a narrower opportunity set. A secondary constraint has created an additional impediment to returns: managers have faced intense pressure to post near term results. More lenient redemption terms plus greater institutional oversight has shortened the typical evaluation cycle from six months to one or two. Patience is rarely rewarded and managers are often driven to cut risk quickly in down markets and chase returns in up markets. Our research clearly shows that hedge funds are very good at gradually adjusting exposures across asset classes over months and quarters, but that near-term market timing is difficult, if not impossible, to get right consistently. This represents another clear constraint that may impact long-term returns.

The past five years have demonstrated quite clearly that even highly talented managers will struggle in the face of wrenching structural shifts in the markets and creeping changes in the fund management investment model. Going forward, we conclude that the principal underlying issue – the flight of capital out of equities – will reverse itself. Stronger returns will draw capital flows, institutions and individuals will rebalance overweight fixed income allocations accordingly, and external buyers like corporations and private equity firms will resume historical levels of investment. This process will create ample opportunities for talented managers, broaden the opportunity set, and enable many equity long/short funds to deliver higher risk-adjusted returns going forward.

However, not all managers will benefit equally. When evaluating an individual fund or strategy, it has become increasingly important to understand the precise constraints that can hinder returns – for instance, a cyclically underwhelming opportunity set, a mismatch between manager and investor expectations, reactive deleveraging and re-leveraging, an overemphasis on near term results, a focus on crowded large cap stocks, the competitive landscape among investors, insufficient resources to identify off the run opportunities, and many other factors.

I look forward to discussing these topics with you in the future. Please do not hesitate to call with any questions or comments.

ADB