

Fundamental Approach to Managing a 130/30 Portfolio

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Introduction

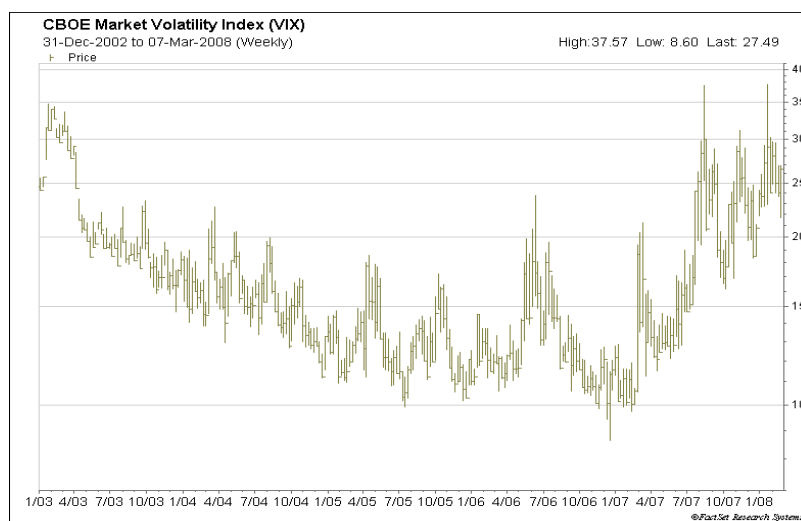
As the complexity of investment products has evolved, one relatively new product that has received considerable recent attention is a 130/30 portfolio. A 130/30 portfolio allows a manager to short 30% of the portfolio and invest the proceeds from the short positions along with the initial investment, resulting in a 130% gross long exposure. This ability to short enables a manager to reflect and incorporate negative opinions it may have regarding a stock selection within the portfolio.

Though the styles have many inherent differences, 130/30 portfolios may be offered by either a fundamental manager or a quantitative manager. A reasonable question arises as to whether a 130/30 portfolio is better suited towards one type of manager over the other. In this paper, we examine the key differences between quantitative and fundamental approaches, highlighting applicable determinants of success.

Depth versus breadth

Quantitative managers generally seek to add alpha incrementally by capturing the spread of best and worst performing stock in the index. As such, the ability to effectively rank stocks from top to bottom and breadth are key determinants for alpha generation. For these reasons, quantitative managers maintain large portfolios which typically include 100 to 200 or more long and short positions.

Fundamental managers, however, do not have to rely on ranking the index or breadth. Stock selection and understanding the risks from a bottom up approach is at the core of fundamental 130/30 investing. Fundamental 130/30 portfolios are more concentrated both on the long and short side, as generating alpha from conviction rather than ranking is their value proposition. We believe this focus on depth as opposed to breadth will enable fundamental managers to better take advantage of short-term behavioral biases in the market, particularly as volatility has returned to pre-2004 levels.



Although much of the theoretical research on active extension highlights the importance of ranking and breadth as a means of increasing the information ratio, in times of heightened volatility, managing losses in a leveraged portfolio becomes even more vital. Fundamental managers who maintain more manageable portfolios and have a good understanding of the security specific risk of their holdings may be better

positioned to anticipate the magnitude of their losses, providing the ability to more fluidly trim and add to positions. A 130/30 portfolio is leveraged so having the ability to anticipate losses may mean quicker recovery and better protection of capital.

Dynamic hedging

Another difference between quantitative and fundamental managers is the use of hedging in the short portfolio. Most quantitative managers utilize shorting as an additional source of alpha generation whereas fundamental managers can allocate a portion of their short portfolio as hedges against specific exposures in their long portfolios. Hedging serves as a particularly important risk management tool in a 130/30 portfolio as the additional 30% of exposure may increase the risk profile of the long portfolio. Fundamental managers can use different techniques to hedge this additional exposure. For example, a fundamental manager will invest in an individual stock position within which it has a high degree of confidence and conviction. The fundamental manager may consider the sector in which that stock resides (e.g., consumer discretionary) and then in order to reduce net exposure in that specific stock, simultaneously hedge out some of the volatility in the stock by shorting a basket of other stocks in that sector. This basket would include sector stocks, which the fundamental manager believes are not as well positioned as its individual stock position in the long-term, but are highly correlated with that stock selection and accordingly should help dampen the volatility of the manager's overall exposure in the near-term.

There are various hedging alternatives available to 130/30 managers, including the use of derivative products such as index futures and swaps. The use of derivatives may alter the risk profile of a 130/30 strategy, particularly if the manager lacks the experience and controls to manage these investments in a leveraged portfolio. As investors evaluate 130/30 managers, careful thought should be given to the types of hedging techniques being used and how they impact the overall risk of the portfolio. Hedging is intended to help reduce exposures and mitigate some of the risk, but derivative hedging techniques may add to risk if they are not used appropriately.

Back-testing

Quantitative managers generally rely on models that are simulated on back-tested data and the predictability of these models depends on various inputs. Although back-tested data may be useful for deciphering clusters and trends of the past, it can serve to focus disproportionately on the analyzable and ignore unanticipated possibilities. For example, event risk, as we witnessed during the summer of 2007, can be devastating to a portfolio and more importantly it can destroy a manager. Quantitative managers, which rely on the same models across multiple strategies and employ heavy leverage across the firm, may be more impacted by event risk as the magnitude and frequency of this type of risk is almost always unpredictable.

Quantitative managers may argue that there is often a lag in the time it takes for fundamental managers to recognize a change in expectations while data is analyzed and forecasts are updated. However, building reliable information networks and triangulating the data released across these networks on a regular basis is a competitive advantage of fundamental managers. The ability to anticipate events like a setback in product development, delays in a cost restructuring plan and margin degradation through explicit observations provides precision and adds considerable value in the long-term. Moreover, most major catalysts for change such as restructurings, new corporate management and regulatory reformations that result in the greatest creation of value occur over time. Information regarding these types of events is often not quantifiable, particularly in the early stages, and fundamental managers can build the conviction to invest before the rewards of change are realized.

The use of back-testing to show how a 130/30 approach would have performed over a longer track period also presents issues. The use of such testing typically requires a manager's input of a number of critical assumptions to test a model. Assumptions such as transaction costs, handling of missing data, rebalancing and turnover can be adjusted, which may affect accuracy and reliability. Investors evaluating back-tested results should carefully consider how much input from a manager is required in testing their models and

what, if any, assumptions were made when comparing funds that use different back-testing methodologies.

Conclusion

There are many differences among quantitative and fundamental managers and we have attempted to summarize some of the primary distinctions between the two approaches. There is no doubt that as 130/30 products continue to be brought to the market, the types of investment styles utilized will complete the spectrum between quantitative and fundamental styles of investing. The sustainability of any approach whether it is quantitative or fundamental is determined by how well it performs over various market cycles. The current market conditions have been a good test for many 130/30 managers and will be beneficial for investors in determining which approaches make sense for their portfolios in the long-term. We believe fundamental managers are important participants in the 130/30 marketplace, helping investors diversify the way they can attain greater alpha potential and realize the benefits of relaxed constraint investing.

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