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PORTFOLIO STRATEGIES

New approach gets hedge fund returns with traditional risk

More 120/20, 130/30 strategies offered to pension funds

By Barry B. Burr

FLORHAM PARK, N.J. — A new active equity management approach is being touted by advocates as offering a better chance to outperform benchmark indexes and achieve hedge fund-like alpha without transparency or fee issues while keeping the risk level of a traditional portfolio.

A growing number of investment firms have begun offering the approach — mostly called a 120/20 or 130/30 strategy — to pension funds in the last year.

Jacobs Levy Equity Management Inc., Florham Park, N.J., already has received $3.7 billion in investments and commitments from pension funds this year since it began offering its 120/20 strategy, said Bruce I. Jacobs, principal.

UBS Global Asset Management, Chicago, has $300 million in its version, a 130/30 strategy, since it began in September, said Scott Bondurant, executive director-head of long/short products.

In the past year, Barclays Global Investors, Goldman Sachs Asset Management, INVESCO, JPMorgan Asset Management and State Street Global Advisors also began offering 120/20, 130/30 or similar strategies (*Pensions & Investments*, Sept. 5, 2005).

The strategy overcomes a disadvantage that traditional active equity managers have in trying to outperform benchmarks like the Standard & Poor's 500 or the Russell 3000 because they cannot underweight securities they expect to underperform enough to achieve significant results.

Because only about 15 stocks in the Standard & Poor's 500, the Russell 1000 or the Russell 3000 have an index weight greater than 1%, traditional long-only active equity managers can underweight only these 15 or so stocks by one percentage point or more, Mr. Jacobs and Kenneth N. Levy, also a principal of the firm, write in a forthcoming article in the Journal of Portfolio Management.

"Fully half the stocks in the S&P 500 have an index weight below 0.1%; half the stocks in the Russell 1000 have an index weight below 0.03%; and half the stocks in the Russell 3000 have an index weight below 0.01%," they noted. "The investor's ability to benefit from a negative view about a stock is very limited if the stock can be underweighted by only 0.10 or 0.01."

Long, short positions

Under the 120/20 portfolio, 120% is invested long and 20% short, allowing the net position to be 100% invested. The 130/30 strategy invests 130% long and 30% short.

Bruce Jacobs said Jacobs Levy has received $3.7 billion to invest in its 120/20 strategy.

Short selling "can enhance performance by permitting meaningful underweight positions that are simply not achievable in long-only portfolios," the Jacobs Levy paper notes.

The 120/20 approach is not a long-short or market-neutral strategy, Mr. Jacobs said in an interview.

The 120/20 strategy is more optimal than long-short, Mr. Jacobs said. The 120/20 "bundles beta and alpha together by providing beta exposure and enhancing returns with underweighting," which also allows the portfolio to do more overweighting than a long-only manager could do of equities expected to outperform.

Although short selling reduces a portfolio's equity market exposure below 100%, the exposure is "restored by matching the amount of stock sold short with additional purchases of stock held long," Messrs. Jacobs and Levy wrote.

Mr. Bondurant agrees. "A critical feature is all short proceeds are reinvested back into long stocks so you end up with … a portfolio that has the same level of absolute risk compared to the equity market and traditional long-only strategy," he said.

"We don't view ourselves as a hedge fund but an equity substitute," Mr. Bondurant added.

A key to the strategy is enhanced prime brokerage structures, through which qualified investors, such as pension funds, can set up stock loan accounts. The accounts allow investors to use the proceeds from short sales to purchase long positions, keeping the portfolio 100% invested without borrowing on margin and without triggering consequences of unrelated business taxable income for pension funds and other tax-exempt fund sponsors.

Using enhanced prime brokerage, "the investor is not a customer of the prime broker, as would be the case with a regular margin account, but is instead a counterparty in the stock loan transaction," they wrote.

"The shares the investor holds long serve as collateral for the shares borrowed," they wrote. "This differs from the situation in a margin account. … With a stock loan account, the shares borrowed are collateralized by securities the investor holds long, rather than by the short sale proceeds. This eliminates the need for a cash buffer. All the proceeds of short sales and any other available cash can thus be redirected toward long purchases."

Prime broker charges

The prime broker charges a fee of about 0.50% of the market value of the shares shorted. That would mean a fee of about 0.1%, as a percentage of capital, for a 120-20 portfolio, they wrote.

The pension funds investing in the new Jacobs Levy strategy are all conversions from existing long-only active equity portfolios, said Mr. Jacobs, whose firm manages $22.5 billion in total. He declined to name clients.

"I've never seen such a dramatic interest in something new before," Mr. Jacobs said.

Mr. Jacobs called the 120/20 strategy "sensible. It's a better way to run money. Any manager, given their insights into equities, should be able to do better than they do with long only. Institutional investors are ready for it because they've heard about hedge funds and their benefits. But there is a transparency that is lacking with hedge funds," a problem the firm's enhanced equity strategy doesn't have.

The 120/20 strategy provides "transparency to the manager's investment process, transparency to the manager's holdings and transparency to security valuation. And the fee is much more benign than a hedge fund manager fee," Mr. Jacobs added.

Variations often depend on client comfort with the risk level at each investment management firm.

"We have done quite a bit of work figuring out what the right level is," Mr. Bondurant. "We believe the sweet spot is the range of 120/20 to 140/40," resulting in 130/30 "as the optimal balance without taking high levels of tracking error."

For Jacobs Levy and UBS, the 120/20 or 130/30 is an extension of the investment process each firm has used in long-only strategies,

"Because it has the same level of absolute risk as a long-only strategy, it is every much of an equity substitute just with higher expected returns," Mr. Bondurant said.

The Jacobs Levy paper notes another advantage of the strategy: The "enhanced active equity portfolio can also benefit from greater diversification."

The strategy "can significantly underweight many unattractive (stocks), even when those names are not meaningful weights in the index. Greater diversification across underweighted and overweighted opportunities should result in greater consistency of performance relative to the benchmark."

Also, the authors note: "The advantage of being able to sell stocks short may be magnified by certain non-linearities between overvalued and undervalued securities. Suppose, for example, that earnings disappointments have a stronger impact on prices than positive earnings surprises. With the ability to augment security underweights with short positions, investors skilled at anticipating earnings disappointments can better exploit their information." ■