

130/30 Funds

What is a 130/30 Fund?

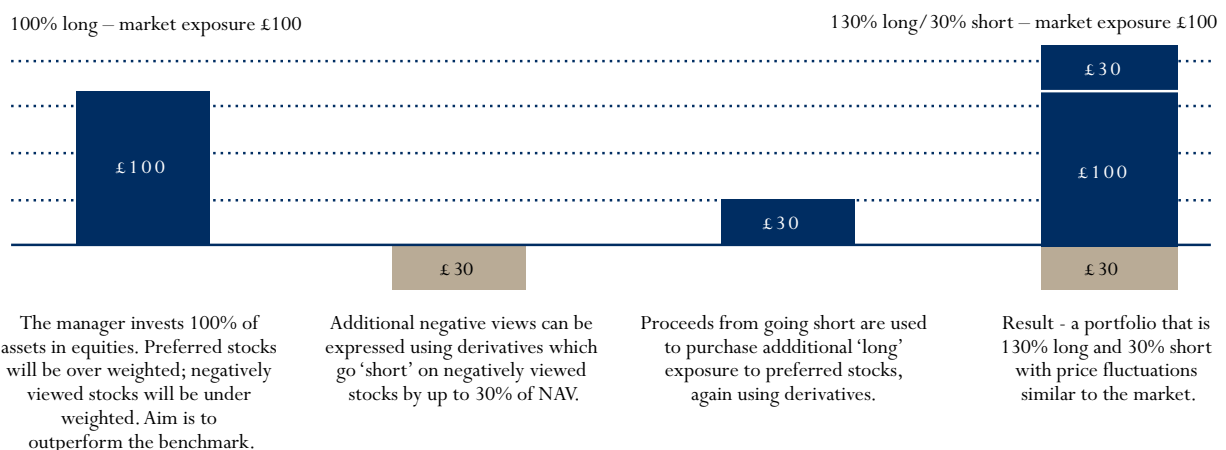
The so-called '130/30 Fund', or short extension fund, is a relatively new type of product that is aimed at boosting investor returns from equity markets. The fund is a long-short equity fund meaning that the manager can benefit both from owning stocks they like (long), but also from selling stocks they believe are likely to fall in value (shorting). It is important to appreciate that 'going short' means that the manager is selling a stock he doesn't own, expecting to be able to buy it back at a lower price in the future and hence make a profit.

How does a 130/30 Fund work?

The mechanics underlying such funds explain the name. The fund's assets are split into two parts: a long portfolio and a short portfolio on a typical 130%/30% basis respectively (although this ratio could be 125/25 or 140/40 etc).

The process runs as follows:

- Assuming £1m of assets the manager buys a £1m long portfolio of shares they have identified as stocks likely to rise in value.
- The manager then effectively borrows £300,000 of stocks they believe will fall in value and sells them with a view to buying them back at a later date at a cheaper price*.
- With the cash received from this transaction the manager adds a further £300,000 to the long portfolio of favoured shares thereby creating the 130% long/30% short structure.



*Under current rules managers of retail funds are unable to physically sell shares they don't own so this transaction is effected through the use of contracts with brokers. No stock is actually sold (although the effect is the same) but the description above explains the principles involved.

Why invest in a 130/30 Fund?

The major attraction of these type of funds is that the fund manager is able to extend his bets by increasing exposure to stocks he likes while also being able to profit from stocks he thinks will do badly.

With a traditional long only portfolio, the manager's ability to profit from a negative view on a stock is limited because the largest underexposure he can have is simply not to hold the stock at all. With a short extension fund, the manager can effectively hold less than zero in a stock, allowing the fund to benefit if the price of the stock falls. This enables the manager to take high conviction positions in both favoured and out of favour shares.

In theory this should allow high quality managers to provide higher returns on their best investment ideas, but there are a number of issues.

Points to consider?

Whilst a 130/30 Fund provides the manager with more flexibility, it also increases the pressure to choose the right stocks for both the long and short portfolios and there is a degree of scepticism about whether many traditional managers have the skill set to short stocks. And unlike a traditional long only portfolio where the maximum loss is capped if the shares held fall to zero, the short element of the portfolio can, in theory, suffer unlimited losses if share prices continue to rise. This can happen because you have sold a stock you don't own, expecting to buy it back for a lower price. If instead, the stock goes up, you are exposed to a loss since you are obliged to buy back the stock at some time in order to close out your sale. As you can see, there is no limit on your loss – the higher the stock price the more you could have to pay to close out the position. Depending on how the portfolio is structured the short element of the portfolio could actually compound losses rather than protect the fund in volatile markets.

At a more technical level there is also the need to be able to handle the complexity of processing investment transactions efficiently which place much greater demands on risk controls and back office administration. Increased costs and the difficulties obtaining an exact match to the desired stocks to be shorted can also introduce added complexity.

Who would invest?

It is early days for the development of long/short funds for the private client market and the concept is still untested in volatile markets. They fit between traditional funds and unconstrained long/short funds, providing a potential stepping stone for investors looking to take (limited) advantage of short selling, but investors should be wary. There is little experience yet of managers operating in this area hence it is probably too soon to tell whether the benefits outweigh the risks associated with implementing the new techniques.