Extension Strategies: Making A Long Story Short

By: Martin Gerber

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The secular trend towards lower interest rates over the past 25 years, together with contribution holidays prevalent in the 1990s, have created significant funding issues for many pension plans. Faced with the prospects of increased contributions and/or reduced benefits, many plan sponsors are considering innovative solutions to improve the efficiency of their portfolios – in other words, higher returns for a given level of risk.

One solution widely being contemplated for equity portfolios is often referred to as extension strategies or 120/20 portfolios. Equity extension strategies remove the 'long- only' constraint, extending the capability of traditional long-only management to include a short-selling component within the portfolio. The name 120/20 refers to the percentage of capital committed to long and short positions. For example, 120 per cent is invested in long positions with 20 per cent of the allocated capital invested short.

Extension strategies are designed to make traditional equity allocations work 'smarter' and 'harder,' providing potentially higher risk-adjusted returns to plan sponsors willing to relax the long-only constraint. In the United States, these strategies have been available for more than three years.

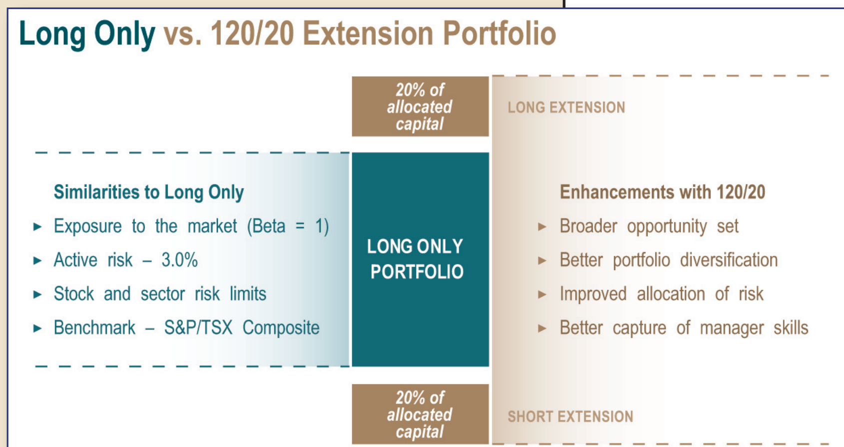
Investing Smarter

Equity market indices used to benchmark equity managers are typically 'top heavy' because they are capitalization weighted (stocks with larger capitalizations have more emphasis while smaller capitalization stocks have very little). The S&P/TSX Composite Index is a good example. As of June 30, 2007, the top 10 stocks in the index made up approximately 30 per cent of the total index, roughly the same combined weight as the bottom 229 stocks. Benchmarks constructed along these lines can have significant implications for traditional long-only portfolios.

Investment managers seek to add value by overweighting stocks expected to perform well while avoiding stocks expected to perform poorly. Since long-only managers are limited in their ability to underweight stocks to a maximum of their weighting in the index, it can be difficult for them to generate meaningful amounts of added value from such small positions. As a result, managers frequently concentrate their long bets on fewer, larger securities. Unfortunately, this typically reduces diversification and may increase volatility.

Allowing some degree of short selling within a portfolio alleviates this situation by enabling managers to more fully express their views (positive or negative) over a larger universe of companies. By spreading portfolio risk across both the 'good' and 'bad' stocks where the manager has the strongest insights (conviction), the portfolio has the potential to generate much higher levels of return for each unit of risk taken. This is investing smarter.

For this to be effective, an investment manager must have a process that systematically ranks both 'good' and 'bad' companies. Most quantitative investment processes operate this way, so it is not surprising that quantitative managers have seen the biggest growth in this area.



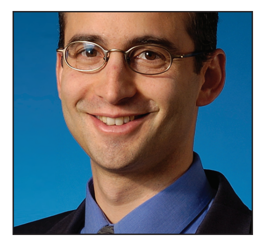
Shorting also allows plan assets to work harder. When short selling is permitted, the proceeds can be used to further increase exposure to companies thought to be attractive. Using our 120/20 example, if the proceeds from the 20 per cent of the portfolio sold short are invested in long positions (120 per cent long), the result is that 140 per cent of the original allocated capital is working to make money, further leveraging investment manager skill and thus making plan assets work harder.

It is important to note that overall exposure to movement in the market (beta) is typically targeted to be the same for an extension portfolio as for a long-only portfolio. While the manager's skill is being leveraged, market risk is not. Thus shifting allocations to extension strategies from long-only portfolios need not impact a plan's existing risk budget.

Even Great Solutions Are Not A Cure-all

Shorting is not a panacea. Allowing for shorting within a portfolio will not make a bad manager good, nor will it make a good manager better, unless the investment process used effectively identifies companies expected to perform poorly. Managers also need to have experience navigating the incremental complexities of long/short mandates.

Despite their added complexity, the superior risk/reward profile offered by extension strategies provides a compelling reason for plan sponsors to consider including them within their portfolios. ■



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Martin Gerber is head of the quantitative equity team at Connor, Clark & Lunn Investment Management (mgerber@cclgroup.com).