FUNDS NEWS

Long list of winners in short story

Investors can make money when fund managers 'short' stocks, **James Dunn** reports

ON the last day of July, retail giant Coles Myer gave a strategic presentation to investors, which detailed its restructuring from eight business units with 12 brands to three business units with 10 brands.

The sharemarket didn't like it, and the stock fell almost 14 per cent.

That caused plenty of grimacing among the stock's investors, both retail and institutional.

But not at Melbourne-based K2 Asset Management, which had "shorted" Coles Myer.

K2 did not own Coles Myer, but it had sold the stock anyway, betting that the share price would fall and it could buy it back cheaper. It borrowed the shares from its prime broker, sold them in the market, and waited for the price to fall.

> **"Returns come very quickly, because stocks tend to go up slowly but come down quickly"**
> Karl Siegling, Cadence Capital

It did, so K2 bought the shares back and delivered them back to the broker, for delivery to the buyer, 6 per cent ahead on the deal.

"Our exposure only lasted three weeks, so that's quite a nice return," says Mark Newman, chief investment officer of K2 Asset Management.

"Clearly there's the risk that the stock goes the other way, but if we can make 5 to 10 per cent on a short position, we're generally pretty happy."

Karl Siegling, portfolio manager at Cadence Capital, short-sold agribusiness heavyweight Great Southern Plantations at $3.80 in May, on the basis of the stock's deteriorating free cashflow, his doubts over its ability to increase the scale of its operations and concerns over the uncertain regulatory environment for agribusiness managed investment schemes.

The stock is now trading at $2.30 and Siegling has made nearly 40 per cent in just over two months.

"That's the beauty of shorting, your returns come very quickly, because stocks tend to go up slowly but come down quickly," he says.

But Gordon Fell, managing director and chief investment officer of absolute-return funds manager Rubicon Asset Management, has a short-selling story to top all of them.

In 2002, Rubicon short-sold manufacturing investment company ION, which had become a favourite of investors, on the back of its star status as sole supplier of cast alloy wheels to legendary motorbike maker Harley-Davidson (and components to Ford, Holden, Ssangyong, Peugeot and Proton).

ION had risen from 28c in June 2000 to $3.15 by May 2002. But Rubicon's "short" worked almost too well: ION slid into administration in December 2004, at 93c.

"That was a problem, because it's actually hard to close out the transaction if the stock completely disappears, because when you short-sell you close the transaction by buying and delivering," said Fell.

The manager then needed a declaration from the liquidator that the shares were now worthless but closed the transaction, at a 100 per cent profit.

This is the world of the long-short funds, absolute-return funds (that is, seeking the highest return possible) that go long (buy) under-valued stocks and short (sell) over-valued stocks.

In this way, funds profit from falling stock prices as well as rising.

Over the last three years, Newman says it has been "very difficult to make money shorting" in the Australian market so the funds have not performed well. "It's not just that we've had three consecutive years of 20 per cent gains. In 2003 and 2004, only 15 per cent of the S&P/ASX 300 fell in value in the year.

"In a normal year about half the market will fall and half will rise. It's been a very broadly based upward momentum on the market."

But now, he says, volatility has sharply increased, and short-sellers are loving the changed environment.

"Recently we've seen the impact of higher oil prices, a tight labour market, inflation creeping into the system in terms of wages and project costs, margin squeeze and lack of ability to pass on cost increases, all flowing into a spate of companies making earnings downgrades. We like all that."

Happy returns: K2's Mark Newman is pleased at returns made in a short period

Picture: David Crosling

Australian long/short funds

- Colonial First State FirstChoice-Acadian Australian Equity Long-Short Fund
- Portfolio Partners High Growth Shares Trust
- Portfolio Partners Long/Short Sustainability Trust
- HFA Equities Fund A Class
- Merrill Lynch Asset Allocation Alpha Fund
- Naos Absolute Return Fund
- Naos Small Companies Fund
- Tricom Trust — AGS Select Long/Short Strategy
- Rubicon M&A Fund
- Blue Mountain Absolute Return Fund (Aust/NZ)
- K2 Australian Fund

Source: Morningstar

David Smythe, co-principal at Zenith Investment Partners, agrees that the period from 2003 onward has not been the right environment for a long-short fund to shine.

"In an upward-trending market as we've had, having a 'short' component has been a drag on overall performance," he says.

"But the short component offers greater capital protection and greater ability to outperform in falling markets, so we certainly see some investment merit in having it in the portfolio.

"It's still a pretty small sample size in this market: it will be interesting to see whether, if conditions turn in the market turn around, more funds employing this philosophy open up."

Darren Howlin, head of research at dealer group Professional Investment Services, says long/short funds have a role as a "satellite" position in clients' portfolios.

"It's definitely not for the core portion of the portfolio.

"They certainly haven't been shooting the lights out with their performance, but one would hope now that we've had more volatility come into the market over the last couple of months, we should see their returns coming to the fore."

Most Australian long/short funds are firmly biased to the long side, with shorting used more as a risk management tool, says Amanda Gillespie, head of investment consulting at Lonsec.

"Most of the funds are still looking to deliver most of their performance through their long positions, while having the flexibility to go short as well, opportunistically," she says.

"There are only a few funds that will seek always to have a short component."

The point of a long/short strategy, says Fell, is that long-only active fund managers are "punching with one hand tied behind their backs", even though they use the same skills to arrive at the same conclusions.

"Long-only managers do form negative judgements on a stock, but they express that by not owning it at all, or holding an underweight position.

"We simply differ in the extent to which we express that insight, because we take it further, and sell the stock.

"At any time, we would have 30 to 50 positions on the long side, and 20 to 30 on the short side."