TS&W Thompson, Siegel & Walmsley LLC
INVESTMENT MANAGEMENT

Short Positions in an Equity Portfolio: Strategic and Operational Considerations

The single biggest difference between active long/short strategies, including extension strategies such as 120/20 and 130/30 investment products and traditional long-only investing, is the introduction of short positions into a portfolio. By blending short positions, in moderation, into a long portfolio and thus providing opportunities to capitalize on underperforming as well as outperforming stocks, investment managers can potentially boost "alpha," or excess return, for their clients. It is a sound and increasingly popular strategy, but one that requires deft management to carry out well, as it requires a solid understanding of both long and short investing. And because it is a more complex strategy, it requires better communication with investors. Distinctions between long and short investing in particular need to be thoroughly explained.

The fact is that short positions are fundamentally different from long positions in their risk and payoff characteristics and in the way they respond to company-specific news and stock market developments. They are typically not held as long because market or firm-specific reasons for shorting a stock frequently change quickly. Additionally, short positions are more complex administratively, as they require arrangements to be made for borrowing stock and paying lending fees. Stocks that are difficult or costly to borrow can be particularly nettlesome for portfolio managers and administrative staff.

In this commentary, we focus our attention on the key strategic and operational issues that arise in managing short positions in an equity portfolio and identify ways around the complexities that often arise.[1] Our insights are gathered from the experiences of managing several long/short products and active extension portfolios at Thompson, Siegel, and Walmsley LLC in recent years.

Payoff Profiles and Risk

Perhaps the most fundamental difference between a short and a long position is that the payoff profile of a short position is inherently inferior to that of a long position. As a result, a portfolio manager must be more diligent with risk controls when shorting stocks.

When a manager takes a long position in a stock, the potential appreciation in the price of that stock is unlimited. In contrast, with a short position the potential loss associated with the holding is unlimited. What is more, long-only portfolios have what may be perceived as a natural risk control

[1] Readers interested in a discussion of the efficiency gains associated with active extension strategies are directed to "130/30 Expands into Mid Cap Space," a white paper released by Thompson, Siegel, and Walmsley LLC in March 2007 (www.tswinvest.com).

that short portfolios lack: winning positions become larger allocations over time in long-only portfolios, while losing positions become smaller allocations. The opposite is true with short positions: if left unchecked, losing short positions become greater allocations while winning short positions become smaller allocations.

Since portfolio managers holding short positions start out with an inferior payoff profile, investment success lies with effective risk controls. A manager can readily improve the payoff profile of a short position by implementing a strict stop-loss discipline, which limits potential losses. Some managers choose to employ stop-losses for long positions as well, but stop-losses are critical for short positions because the downside risk associated with a short position is much larger.

The unfavorable allocation dynamic that arises with shorting can also be managed. Portfolio managers can use a partial cover of a losing short position to reduce the allocation to that position. Likewise, additional shares can be shorted when there is a winning position in order to maintain or increase that allocation within the portfolio. Once again, the risk associated with shorting can be controlled, but the portfolio manager must be vigilant.

Different Investment Horizons and Higher Turnover

Portfolio managers with an active extension strategy learn to be nimble in moving in and out of short positions because the circumstances that create good short positions can change on a dime. The best short candidates are those that appear overvalued by various financial measures; stocks, for example, whose prices don't fully reflect poor quality of earnings, low returns on capital, or a particularly negative outlook for their business prospects. Most of the time, however, the circumstances that created the overvaluation situation will not last long. In situations where stock prices are falling, the company's management is likely doing everything it can to rectify the situation and increase the value of the company so that its share price begins to rise again.[2] In addition, failing companies often attract buyout bids from either competitors or private equity firms, which can prevent prices from continuing to fall or, even worse for investors shorting the stock, propel share prices higher. The likelihood of a buyout bid was especially high in 2006 and the first half of 2007 when credit was abundant and both buyout funds and corporate balance sheets swelled with cash.

Due to these circumstances, portfolio managers trim their investment horizon when considering short positions and may hold these positions for only months rather than years. Most short candidates are companies that are victims of temporary problems that can be corrected. If the existing management doesn't solve these problems, the board of directors will replace management. If the board does not take action, activist shareholders may try to gain control of the board. Even if these actions are ultimately unsuccessful, the perception of change is often enough to quickly

[2]While generally uncommon, we can think of one instance where company managers may not have been working to raise the value of their company. In this case, the aging founders of a small publicly traded company owned the majority of the company's outstanding shares and still ran the business. The family actually had it in their best interest to minimize the value of the company until after the younger generation inherited it, so as to minimize estate taxes.

reverse a declining share price. There are certainly some companies in irreversible secular decline, and these make great shorting opportunities, but they are few and far between. In reality, most good shorts cease being good shorts once the headwinds subside. A savvy portfolio manager reduces his investment horizon and accepts higher turnover in the short book to address this reality.

Selection of a prime broker

In addition to the strategic issues discussed above, there are operational issues that arise with short positions that simply do not arise with long positions. To execute a short sale, shares of a stock must be located and borrowed, and the lender of the shares must be compensated for extending the loan. It is not particularly efficient for an investment manager to maintain the necessary network to carry out this process, so an intermediary—a prime broker—is generally required. The prime broker acts as a custodian for the account and facilitates the reinvestment of proceeds from short sales into additional long positions. While the various prime brokers in the market offer similar services, there are some differences in brokers' ability to quickly locate and lend shares. In practice, it is the ability to secure hard-to-find shares that separates the top prime brokers from others in the market.

If investors place their allocation into a commingled fund, the governing body of the fund will be responsible for the selection of the prime broker. Alternatively, investors might choose to have their allocation managed in a separate account. In that case, investors will be responsible for due diligence and selection of the prime broker. This may require the development of a new set of skills or at least the ability to obtain a checklist of operational considerations. Many investors may prefer the simplicity of investing in a commingled fund, where prime broker due diligence and selection have already been established.

Complications of Borrowing Shares and Covering Positions

Before selling a stock short, you have to borrow shares, which in itself can present unique challenges. What if, for instance, a large number of investors want to short the same stock? In that case, the supply of shares available for shorting may be severely limited by a shortage of shares in accounts that allow lending and by an inability of the prime broker to access these shares.

If shares are particularly highly sought, two problems can arise. First, the manager may have to pay more to borrow the shares, which reduces the return from shorting the stock. Second, the shares become at risk of being called away. When this occurs, managers almost always end up covering the short position at a disadvantageous price, which also reduces the return.

The good news is that the additional risk associated with shorting hard-to-borrow stocks can be managed. Portfolio managers can receive daily updates from prime brokers on the borrow rates for securities they short. An increase in the borrow rate will be recognized and existing high-rate borrowing can be identified prior to any short position being taken. Managers can then set appropriate limits on their exposure to high-rate shorts. Generally, only one to two percent of Russell 1000® Index stocks are difficult to borrow at any given time, but, unfortunately, those stocks are often the most obvious short candidates because of some well-publicized weaknesses.[3] Five to ten percent of the Russell 2000® Index may be hard to borrow at any given time.

In some cases, attractive short candidates may have an adequate supply of shares to lend, so they are not difficult to borrow and do not carry high borrow rates. Therefore, they may not be identified by a portfolio manager reviewing lists of stocks that carry high borrow rates. Moreover, the shares may not be at risk of being called away. However, these high short interest shares are at risk for sudden large upward movements in share price following a favorable earnings report or other positive news release. While it is common for any share prices to rise after positive news emerges, the share price increase is disproportionate in high short interest stocks because of the large number of buy-to-cover orders from managers who no longer wish to be short the stock.

This potential risk, however, can be handled as well. Short interest is reported twice a month and managers can track short interest as a percentage of the float and set appropriate limits for portfolio exposure. Data limitations may make changes in short interest difficult to track at times during the month, but prime brokers often provide at least some information on changes in short interest between reporting periods.

Concluding Remarks

With sound theoretical underpinnings and some encouraging early performance results, active extension products have become among the most popular new investments on the market in recent years. We expect these products to continue to gain market share and believe they will eventually become attractive alternatives to most long-only equity products. As investors become more familiar with the mechanics of the active extension strategy, the concept of shorting stocks will move farther away from the realm of alternative investments and into the mainstream.

As with any active investment strategy, however, product success will ultimately depend on portfolio performance, and performance in turn will depend on the skills of the portfolio manager. Those managers with a comprehensive approach to addressing the many issues that arise when short positions are taken, such as the strategic and operational issues outlined here, will be best positioned to create greater alpha with the new active extension products on the market.

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[3]We consider a security to be difficult to borrow if the rate to borrow the shares exceeds the base rate to borrow.

Author's Biography

Mark S. Tyler, CFA is a portfolio manager with Thompson, Siegel & Walmsley LLC in Richmond, VA, which he joined in 2003. Mr. Tyler currently manages the TS&W Large Cap 130/30 Fund LLC and the TS&W Leveraged Market Neutral Fund LLC. Prior to joining TS&W, he spent two years as a senior analyst at Priority Capital Management, the investment adviser to two long/short funds. Mr. Tyler previously spent four years as a sell-side analyst with Wachovia Securities, two years as a portfolio manager and analyst with D.B. Root & Company and began his career as a research associate for Capital Asset Management. Mr. Tyler is a graduate of The College of William and Mary and holds the Chartered Financial Analyst designation.

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