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NORTHERN EXPOSURE

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Short-Sighted

Brad Steiman exposes the faulty logic in expecting short selling strategies to add value in a so-called "sideways market."

Not long ago, fatigued investors were feeling the cumulative weight of two severe financial crises, periods of heightened stock market volatility, and an endless supply of bad economic news. Investors who extrapolated recent market experience were losing faith in equities and looking for alternatives.

Equity strategies that can short became more popular for investors who embraced the idea that making money in a "sideways market" required stock picking unconstrained by a long-only approach. As usual, the investment industry was quick to capitalize on and foster this popular theme by rolling out new products to meet the demand of retail clients looking for market-neutral investments.

Traditional equity managers also started moving in this direction. One prominent Canadian mutual fund company allowed most of its managers to short sell in their portfolios following an industry-wide amendment that permitted mutual funds to short up to 20% of a fund's net asset value. The company noted: "Our portfolio managers are constantly researching securities of all types. Often, they find overvalued securities that they believe are set to decline in value, but previously there wasn't a direct way for our investors to benefit from this research."

This approach illustrates that removing the constraint on shorting amplifies stock picking and, in a sense, puts traditional active management on steroids. Removing constraints can be desirable, but only if the underlying process adds value. To the contrary, a large body of literature documents that traditional active management—or, in this case, stock picking—fails to add value after fees and expenses. This conclusion challenges the assertion that magnifying the impact of stock picking by removing the short selling constraint can provide a tangible benefit to investors.

Studies of traditional active management mostly have been limited to long-only mutual funds because the data set is larger and far more reliable than data for alternative investments.[1] However, the long-only constraint should not diminish the relevance of these findings to managers who also go short.

One of the main reasons for removing the short selling constraint is to capitalize on identifying over-valued securities. But if this ability were reliable and systematic, you would expect to see it in the multitude of tests on the long-only universe of mutual funds. Although managers in this universe cannot short the stocks "they believe are set to decline in value," they can choose not to own them, which would result in persistent outperformance relative to their long-only benchmarks.

In very simple terms, being able to short stocks may double the stock picking opportunity set, but this offers no benefit if traditional stock picking doesn't work to begin with. Zero multiplied by two is still zero!

As there is no value from simply increasing the range of stock picking opportunities by allowing managers to short, a market-neutral strategy will have an expected return of T-bills minus fees and expenses, where the standard is "two and 20," unless the portfolio is long another dimension of expected return that is persistent and pervasive—such as size, relative price, or direct profitability. In the event that a market-neutral strategy with systematic exposure to one or more of these dimensions is included in a portfolio that already has market beta, the client would be better off reducing the "two and 20" and eliminating the cost of shorting by combining market beta with the desired exposure to other dimensions of expected return in one long-only strategy.

We have already addressed the flaw of assuming good stock picks are the answer, but there is a bigger problem with adopting a market-neutral approach as a solution for the sideways market, or one where the expected return is zero. The whole notion is a fallacy because there is always a positive expected return on capital.

That doesn't mean your return is guaranteed to be positive, but it is always *expected* to be. No return is guaranteed because the market can only know what is knowable—and unknowable information is, by definition, *new* information. If the information were considered bad news, or if risk or risk aversion were to increase and investors were to require higher expected returns, prices would drop.

The market mechanism works to bring prices to equilibrium where, based on the *new* information, the expected return on capital remains positive and commensurate with the level of risk or risk aversion in the market. The opposite would be true if the new information were considered good news, or if risk or risk aversion were to decline. This is how well-functioning capital markets result in expected returns always being positive. In other words, investors shouldn't *expect* a sideways market ex-ante.

Good and bad news also have to be defined relative to expectations rather than in absolute terms. The *new* information could be considered bad news in an *absolute* sense—for example, unemployment increased to 9%. But this information could be received as good news in a *relative* sense if market prices reflected expectations of an increase to 10% unemployment.

The table below is a simple illustration of how new information relative to expectations can influence security prices and returns.

New Information	Relative to Expectations	Result
Good news	Better than expected	↑ Above normal return
Good news	As expected	– Normal return
Good news	Worse than expected	↓ Below normal return
Bad news	Better than expected	↑ Above normal return
Bad news	As expected	– Normal return
Bad news	Worse than expected	↓ Below normal return

Investors betting on a sideways market are obviously expecting a below-normal return on equities. They aren't betting on the future being good or bad, but *worse than expected.*

Nobel laureate Friedrich Hayek described the market as a communication mechanism that "garners, comprehends, and disseminates widely dispersed information better and faster than any system man has deliberately designed."

When you consider that expectations are already embedded in prices, betting against them is, well, short-sighted!

1. Data for hedge funds and other alternative investments can lack integrity because of voluntary reporting that results in survivorship bias, self-selection bias, and backfill bias.