

Why Active Extension Strategies (e.g., 130/30)?

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In recent years, active extension strategies have grown in usage among the institutional investment community. In this note, we first provide a precise definition of what we mean by an extension strategy. We then explore some of the sources of their growing popularity, as well as their costs and benefits relative to both long-only alternatives as well as more traditional long-short strategies. Finally, we present some concluding comments.

What is an “active extension strategy”?

Active extension strategies represent a hybrid between long-only and long-short strategies. Specifically, the portfolio is oriented around a long-only benchmark, but employs a moderate amount of shorting and leverage. Shorting in this case is used to 1) better exploit negative views on stocks that are expected to underperform and 2) fund additional long positions that are expected to outperform. For example, in the case of a 130/30 strategy this would result in a levered portfolio of approximately 1.6X capital, which is intended to display a risk profile comparable to a long-only portfolio with 100% market exposure and/or a beta of approximately equal to 1.0.

Why the growing interest?

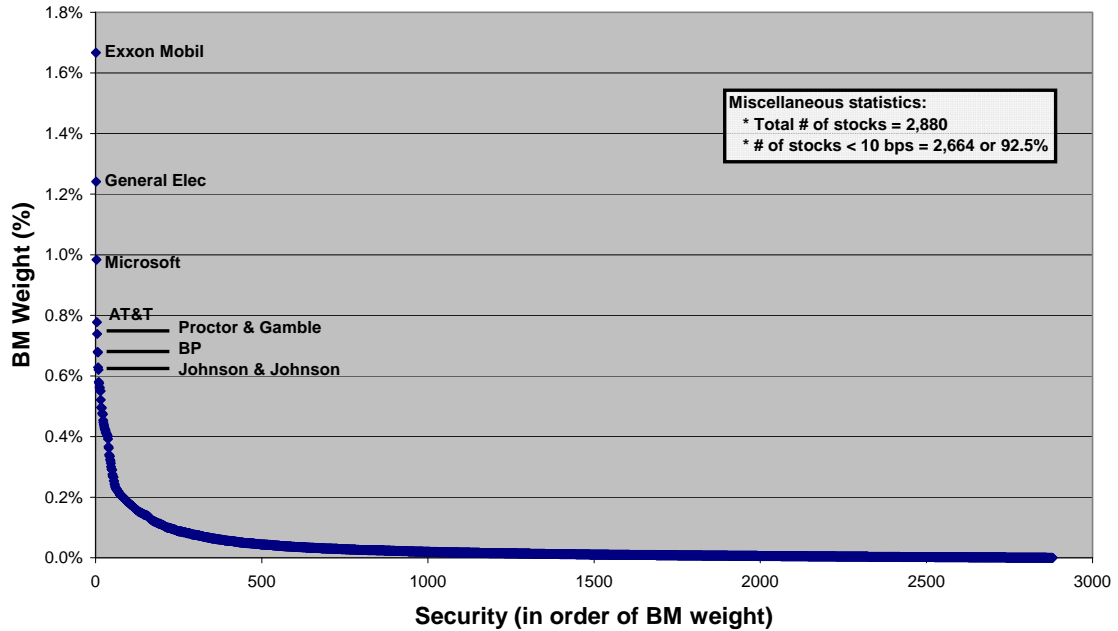
While there probably is no one single driving force behind the growth in these strategies, we believe that a combination of the following considerations offer an explanation:

1. Investor’s desire to improve alpha over traditional long-only strategies: Assuming a manager has skill, the removal of short sales constraints allows the investor to better capture the insights available from that manager. While the client’s desire to improve alpha is a never ending one, the unusually low active risk environment over the past several years has led to reduced alpha realizations from many active managers. As a result, clients have increasingly sought out creative alternatives. A fuller description of this point is provided below.
2. Increasing comfort with short and levered investing on the part of investors and investment managers: Both groups have evolved to be increasingly comfortable with the concepts of leverage and shorting, and with the risk considerations attached to shorting. Moreover, the use of more sophisticated risk control measures and portfolio construction techniques has allowed investors to exploit leverage and shorting in a more moderate fashion.
3. Greater transparency and understanding of performance results: Because of the approximate net 100% equity exposure inherent in these strategies, they may allow for a more obvious disentangling of alpha and beta effects in portfolio performance when compared to more traditional long-short strategies. As such, active extension is more acceptable to certain segments of the marketplace that previously viewed the performance results of more traditional long-short strategies as a murky blend of the pure alpha and exposure to the overall market.
4. Increasing product availability: As additional active extension strategies have come to market, plan sponsors have a greater breadth of solutions to choose from.

In particular, the greater breadth of opportunity described in 1. above is worth exploring in more detail. The most direct way to illustrate the binding limitations of long-only investing is to consider the weights associated with a particular benchmark such as the MSCI All-Country World Index. The graph below is a descending rank order list of stocks according to their benchmark weights. For a long-only mandate, these benchmark weights ultimately serve as the binding limit to which a manager is able to express a negative view or outlook. Specifically, the most bearish position a manager can take is avoiding the stock all together. The ability to express an underweight is therefore equal to the benchmark weight itself. The larger the stock’s benchmark weight, the greater one is able to express a negative view, while the smaller the stock’s benchmark weight, the less one is able to express a negative view. In light of these characteristics, note how many stocks in the

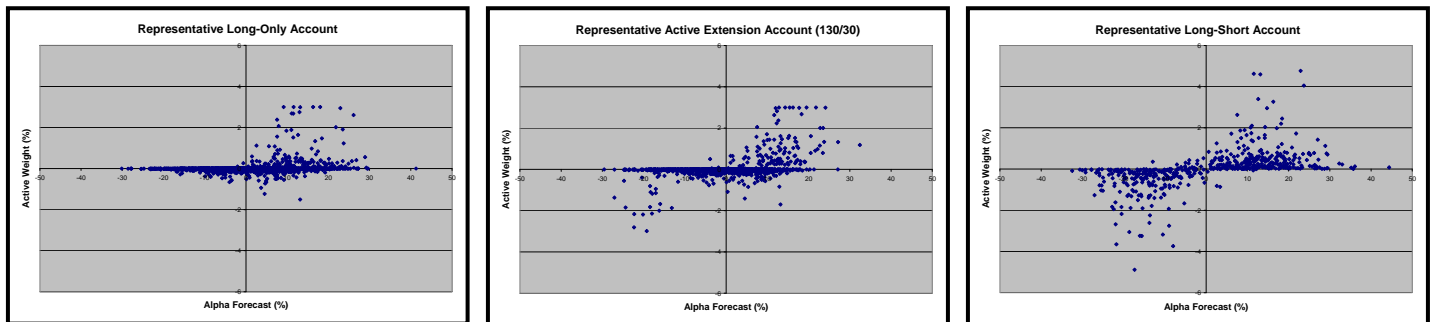
benchmark have weights less than 10 basis points (2,664, or roughly 92.5%) and how quickly after the largest 100 names the graph begins asymptoting to zero.

MSCI ACWI Benchmark Weights
(as of January 21, 2008)



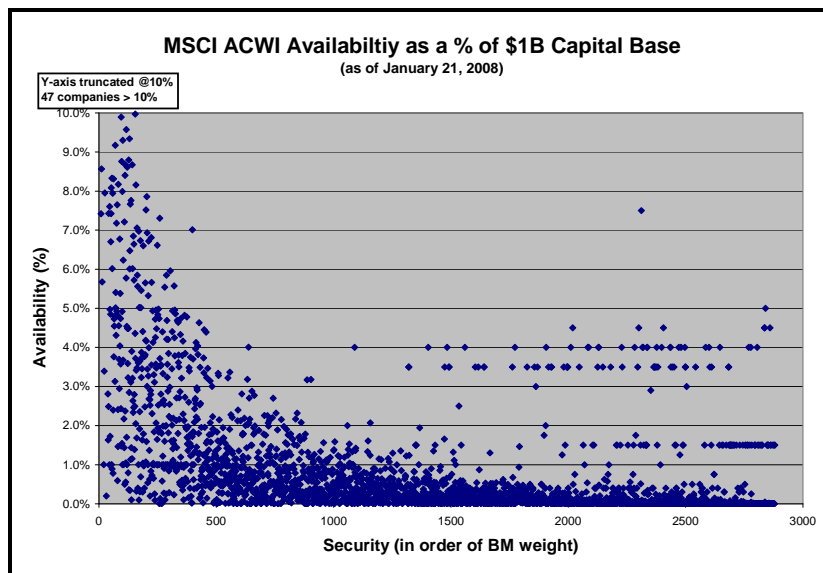
It is this “short-sales constraint” that makes it is exceptionally difficult, in a long-only strategy, to express ones negative views, or forecasts, through underweights in the smaller constituents of the benchmark. The ability to express forecasts in active portfolio positions is sometimes referred to as the strategy’s “transfer coefficient.” This is often measured as the correlation between a manager’s forecasts and the active weights in the portfolio. The higher the transfer coefficient, the more effective a manager is at expressing his views in the portfolio. The lower the transfer coefficient, the less effective a manager is at expressing his outlook.

To illustrate how such a concept plays out across a spectrum of different strategies, the following graphs represent the relationship between forecast alpha and active weight for three different Arrowstreet Capital strategies: 1) long-only, 2) active extension (130/30) and 3) long-short. While immaterial to the conclusions drawn from these graphs, please note that the active extension portfolio is a paper portfolio.

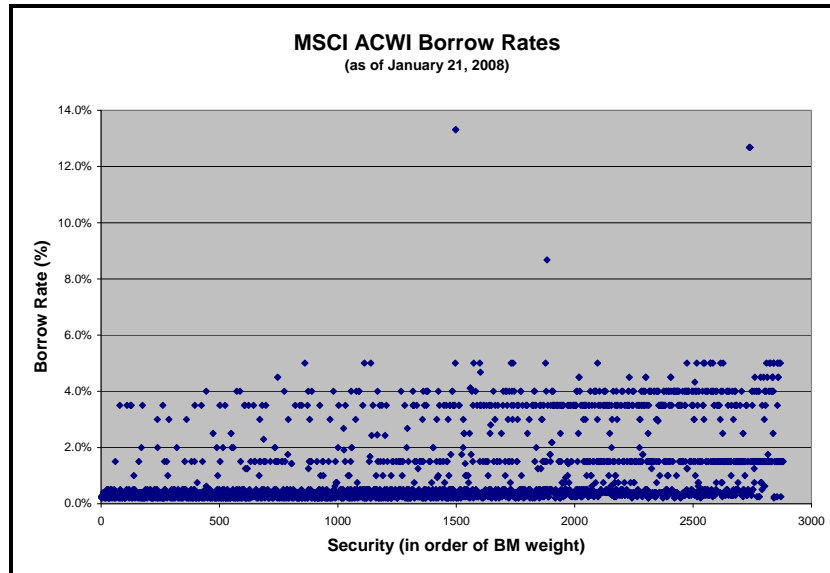


As one progressively moves from long-only (far left) to long-short (far right), in each case further loosening the short sales constraint and utilizing increasing amounts of leverage, the transfer coefficient improves. Unsurprisingly, the most visible improvement is observed among securities with negative forecasts. Note how in a long-only context, very few of the negative forecasts are able to be expressed in the form of meaningful active underweights relative to the benchmark. In a long-short context, however, the removal of the short sales constraint and use of leverage allows these same views to be expressed in a much more pronounced way. The active extension portfolio represents a hybrid between the long-only and long-short portfolio. The portfolio itself is oriented around a capitalization weighted benchmark, as is the case with the long-only portfolio. The use of limited shorting and leverage, however, allows for some increased ability to express negative forecasts through active underweights.

Recognizing that both stock loan availability and borrow costs are important determinants that influence the degree to which one is able to translate this theoretical concept into reality, consider the following graphs. The first graph uses the same set of securities in the original benchmark weight graph, but instead shows each stock's availability according to a prominent global prime broker, as a percentage of a \$1 billion USD capital base. Note the y-axis has been truncated at 10% so as to better illustrate the range of availability among smaller capitalization names. While there is a clear inverse relationship between size and stock loan availability, availability is still typically several multiples of the stock's benchmark weight expressed in the original graph. As such, through the utilization of short positioning a manager is able to express his actual outlook in the portfolio to a much greater degree.



The next graph uses the same sorted list of securities, but instead relates it to the stock's borrowing cost, sourced again from the same prominent global prime broker. With the exception of some the extreme high borrow rate outliers in the data, there generally is a relatively cheap supply of stocks across the capitalization spectrum, albeit at a gradually increasing rate. As a result, stock loan fees appear to be a relatively minor hindrance for manager's trying to maximize their transfer coefficients.



Of course, all of these observations are predicated on the idea that the manager has forecasting skill to begin with. Otherwise, the use of these practices simply would result in the performance amplification of a flawed investment process

Compared to long-only strategies

As noted above, the biggest difference between a long-only strategy and an active extension strategy is the mitigation of the short sales constraint. Other considerations to bear in mind include:

The additional fees associated with short positions, and specifically stock loan fees.

The increased management fees typically charged for active extension strategies.

The requirement to identify managers with skill in producing forecasts not only for stocks that they like, but also for stocks that are unattractive. This skill will often be better represented in quantitative strategies, whose process typically involves producing a full set of forecasts.

Compared to long-short strategies

The biggest issue in comparing long-short strategies and active extension strategies is the introduction of market exposure, or beta, in the latter group. Of course, some long-short strategies do introduce a long bias, but this is rarely what their clients are paying them to do.

Is the introduction of beta a good thing? Most investors do want some level of beta in their portfolios. It is, moreover, the case that active extension managers typically incur little if any marginal cost in producing beta and this may make them obvious candidates for helping their clients produce beta for their portfolio.

Conclusions

Active extension strategies represent an innovative area of growth within the institutional investment industry. These strategies offer an effective tool for clients seeking to improve their overall plan's alpha without with the sometimes murky beta exposure implications of more traditional long-short investing. To date, active extension fundings have paled in comparison to the amount of assets deployed via long-short and long-only mandates. Nonetheless, given that their funding has disproportionately come from existing long-only pools of capital, the prospects for growth are significant should this trend continue.