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A third of fund management companies find barriers to offering 130:30 funds

130:30 funds are an attractive proposition for both clients and fund management companies. For clients they potentially offer greater returns for the same net active risk; for fund management companies they bring many of the benefits of running hedge funds without the associated organisational impacts. However, many fund managers are discovering they do not have the capability to support 130:30 funds. A prime broker recently told Investit that over a third of those investment management companies they met in Europe, who want to offer 130:30 funds, cannot do so due to operational, technological or cultural issues.

In this article we look at the reasons many investment management companies are eager to launch 130:30 funds. And we look at the reasons why many of them will struggle to offer this product.

130:30 - a more efficient approach to active investment?

130:30 is not a new investment strategy; it packages a long/short investment approach in an attractive investment vehicle. In these funds, 30% of the fund's equity exposure is shorted (ie selling a holding, rather than just underweighting it). The resulting cash is then used to enhance the overweight positions in the fund – effectively leveraging them. It is worth noting that 130:30 is not a set ratio, some managers prefer anything from 120:20 to 140:40. In a 130:30 fund the net active risk (overweights and underweights) is the same as a traditional long only fund, although the exposure to an investment manager's investment process will be 160%.

Long/short strategies have a convincing argument. If an investment manager has more skill than other market participants they should bet more often. 130:30 funds allow just that.

The demand for 130:30 funds

Why are 130:30 funds so popular with clients and investment management companies alike? There is significant client demand from the institutional market. Pension fund clients are exhibiting an increasing need for alpha-based returns to improve solvency levels (gap-closing funds). And as equity markets have been rising, a product that can enhance market returns is particularly appealing.

130:30 funds also offer an alternative to institutional investors who do not feel comfortable with alternative assets with total return performance targets. A recent JP Morgan Fleming Alternative Investment Strategies survey suggested pension fund assets moving into both hedge funds and private equity funds is only 1% for each asset class. This is very low compared to the assets many investment consultants predicted would move into alternative assets four years ago. 130:30 funds provide an opportunity for trustees to improve the returns of a long only fund, with the same fund manager, the same investment process and so on - all very nice and safe....

Retail investors are also showing a keen interest in 130:30 funds. UCITS III will allow investment managers to package these funds for retail investors. While UCITS III do not borrow stocks to sell, they do use derivatives to gain the same economic effect.

Investment management companies also want to offer 130:30 funds. This can allow managers to tap into new demand and increase assets under management, and therefore revenue. More complex products obviously require a higher fee structure – or, less cynically, higher returns can command higher fees. Both long only and hedge fund managers are in the market to offer these funds. Following this train of thought, investment management companies who operate both long only and hedge fund businesses have the

experience to run these long/short funds; it would not be a surprise to see companies like Threadneedle Investments launching a 130:30 fund.

130:30 funds also help investment managers retain good portfolio managers. Many investment management firms have seen defections by high quality portfolio managers to hedge fund businesses, where they can short stocks and command the pay that goes with the returns. Many investment management firms see offering 130:30 funds as a way of retaining their more mobile managers.

The organisational impacts on investment management firms of offering these funds are also small (distinct from the operational issues). Investment managers do not have to launch a hedge fund business, just apply a different portfolio construction process to the existing investment approach. Managers can use the existing investment process to throw up buy and sell-signals and short the losers, rather than underweight them.

Barriers to entry

130:30 funds are attractive to investment management companies and investors alike. So, why is not every manager offering them? A prime broker who spoke to Investit said over a third of managers who want to launch these funds find out they do not have the operational processes, technology and culture to support them - not all investment approaches (and portfolio managers) are good at shorting stocks.

We have outlined some of the issues below:

- **Prime brokers may seem expensive, but do offer a lot of help. Investment managers may not have much experience dealing with prime brokers.** If investment managers decide to short stocks by borrowing them to sell them, they may need a prime broker – a broker and custodian combined – as custodians cannot hold short positions. Cynics point out many reports on the benefits of 130:30 funds have been written by prime brokers and the support they provide for 130:30 funds will come at a price. Investment management companies will also have to negotiate new relationships and contracts.
- **Using over the counter derivatives can create more problems than they solve.** Investment management companies do not have to physically short stocks to run 130:30 funds. And if they want to offer 130:30 funds to retail clients, UCITS III do not use conventional shorting. So, many managers are creating synthetic short positions by using over the counter (OTC) derivatives such as contracts for difference (CFDs). However, many managers just do not have the skill sets, systems or operational processes to invest in these products.

When investing in OTC derivatives, investment managers have to calculate the daily exposure to the fund the OTC derivative brings and move assets as collateral between themselves and the counterparty to meet this exposure. This is a complex process, and one that many investment managers have little experience of. It also brings greater credit risks – the collateral is an exposure to a broker that has an impact on a 130:30 fund's overall risk exposure.

- **Investment management companies do not always have the appropriate technology to support 130:30 funds.** Current technology at conventional investment management companies focuses on long only investment and new technology that can cope with shorting and OTC derivatives does not integrate well with traditional systems. In the front office, portfolio modelling systems often cannot group long and short positions together and have limited support for OTC derivatives.

Current compliance systems only focus on long-only checks and do not understand the difference between gross and net exposure and do not neutralise long positions against short positions. Compliance systems may not be able to produce sufficient reporting to allow compliance departments to check shorts are not front running underweights in other client portfolios. Also, these systems needed to check 130:30 funds do not hold short positions that are being overweighted in

other funds run by the investment management firm, otherwise there will be some very difficult questions from investment consultants.... Order management systems also have limited support for shorting.

In the back office, systems do not have the capability to record short positions and check that they are covered. NAV calculations of short positions (whether managed by selling stocks or using OTC derivatives) are also very difficult to calculate – and check. Processing corporate actions on short positions is rarely done properly.

- **Investment approaches do not always suit shorting stocks.** Shorting is not investing. And not all investment managers have an investment approach and culture best suited to shorting stocks. Many portfolio managers who have run money in long-only portfolios are used to identifying stocks which will rise relative to the market. There has always been less focus on identifying losers and building a strong discipline around the underweights. Pension funds are looking for those portfolio managers who have experience in shorting stocks and investment approaches that give clear indications of those stocks to be shorted. Firms that explicitly derive values or rankings for whole universes or have some way of identify the overpriced as well as the underpriced will start on this road with an advantage. This is why quantitative fund management companies, whether running long only or hedge funds, are particularly qualified to offer 130:30 funds.

Should they or shouldn't they?

130:30 funds are a way of packaging a long-short investment approach in a fund that appeals to both retail and institutional investors – it has less headline risk than many other hedge fund products. For investment management companies, 130:30 funds offer many of the benefits of hedge fund investing – staff retention, higher fees, improved returns – without the complexities and organisational impacts of starting a hedge fund business. Not all investment managers are capable of running 130:30 funds with their current investment approach *and* their current technology and operational processes. For these managers, building a robust operational framework will require serious investment. Managers need to decide whether the benefits of entering the 130:30 market will be worth it. From the client perspective, with many firms launching 130:30 funds, or planning to launch them, it is up to clients to identify those managers with the experience and investment approaches to offer a robust - and successful - investment vehicle.

About the author

Richard leads the Investment Process practice. He works with clients on the beliefs that drive their investment processes (and the consequent construction of portfolios) and how the whole is translated into a coherent marketing message.

He began manager assessment in 1989, selecting funds for manager of manager's programmes for Schroder and FPAM. Richard ran funds for Friends Ivory & Sime before going on to develop products and marketing messages with Flemings and as UK Marketing Director at AXA.

Since joining Investit he has successfully completed projects analysing and developing investment processes and delivering evidence-based marketing messages for Fixed Income, Equity, Property and Multi Asset products.

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