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Listed Property Investing: A long/short approach

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Over the last two decades, assets under management by long/short equity hedge funds have grown by roughly 10% annually. This growth was the most rapid of any hedge fund strategy and according to data from BarclayHedge, long/short managers have succeeded global macro funds to claim the largest share of industry assets. Although a portion of this growth in long/short assets was attributable to market appreciation, the demonstrated ability of the managers themselves was also a key factor stimulating inflows.

Long/short equity managers are those who hold a long equity portfolio offset by a portfolio of short equity holdings. The short portfolio serves as a hedge against market declines but also provides an opportunity for managers to add value by selecting stocks more likely to underperform the market. Analysis by Alliance Bernstein concluded that global long/short managers generally carry a net long bias - i.e., the exposure of the long portfolio exceeds that of the short portfolio. The reason for carrying net long exposure is that stock prices generally rise over time and well selected short positions should, in theory, underperform in the long run. By varying net exposure (the difference between a portfolio's long and short positions) as market conditions change, managers are acting as tactical asset allocators by changing the net exposure as they deem appropriate.

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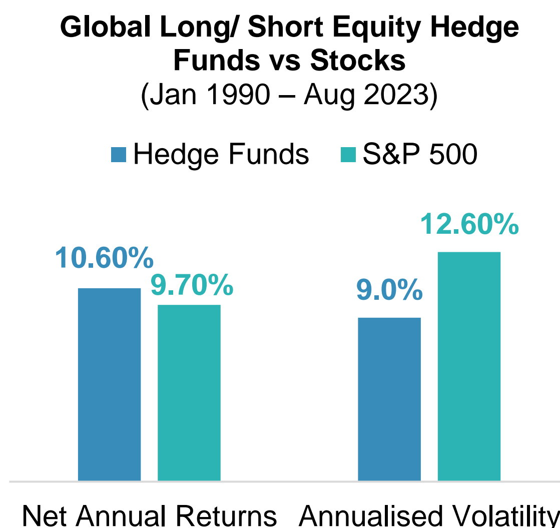
Long/short equity hedge funds have historically outperformed traditional long equity exposure with lower risk, maximizing the Sharpe ratio. This is a result of a demonstrated capability by long/short managers to generate alpha via stock selection, rotation in and out of cash and timely shifts in market exposures (e.g., large vs. small capitalization, sector, geography, etc).



Source: HFRI Equity Hedge; S&P 500 Stock Index

The above chart highlights the ability of long/short managers to outperform the broader market both in terms of annualised returns as well as volatility. It is important to note that this outperformance is net of fees (it is a common misconception of hedge funds that they charge unjustifiably high fees). While the hedge fund space in South Africa is still nascent (albeit growing), there are several long /short equity managers building impressive track records across a variety of sectors.

As a hedge fund manager in the real estate sector, there are a number of strategies at your disposal to try to maximise risk-adjusted returns while also protecting capital in down markets:

1) Managing net exposure

One of the tools at a hedge fund's disposal is its ability to move in and out of cash depending on market conditions and how much value is seen in the sector at any given moment. Being able to reduce market exposure (i.e., moving to cash) in bear markets and increasing exposure in bull markets, should result in outperformance versus the underlying index while doing so at a lower volatility.

In addition, global real estate and local real estate are lowly correlated, which means that blending them together in a portfolio can deliver similar returns at lower volatility. Particularly in the last few years, this ability to diversify between local and global listed real estate has been critical to delivering an absolute return mandate.

2) Take short positions to increase gross exposure

Global listed real estate has evolved significantly over the last 2 decades. The traditional sectors of real estate, including offices, industrial and retail have shrunk in size as new and unique sub sectors have

gained institutional acceptance. The advantage of having new real estate sub sectors is that the fund has more options to invest long and short depending on where the opportunity lies.

When looking to take short positions, a hedge fund can either put on a pair trade (offsetting a long position on a stock with a short position on another stock) or, if the manager believes the price of a stock will decline, put a straight short on (straight shorting comes with higher risk due to the possibility of unlimited losses if the price of the stock being sold rises significantly). Pair trades can take on many forms and allow hedge funds to take advantage of intra-sector mispricing, hedge themselves against macro factors and exploit opportunities arising from corporate events such as M&A, initial public offerings, corporate announcements etc.

a) Fixed Income / Real Estate Pair

Real estate is often viewed through a similar lens to bonds due to the income component of the total return – REITs have to pay out materially all their distributable income to qualify for the tax benefits associated with "REIT" status. Using a fixed income / real estate pair can be an effective method for removing country risk (when matching the bond country to the stock country). Additionally, this pair was an effective source of funding in the 2010's when coupons were low on bonds and the spread was compelling.

b) Sub Sector Specific Pair

Sub-sector pairs are a great way to take advantage of intra-sector mispricing, underlying demand fundamentals (gateway cities vs sunbelt markets) or macro head and tailwinds. A good example of this can be found in the office sector. Offices are experiencing a structural headwind as work from home grips the globe. Many longer-term leases that were struck pre-COVID still need to roll off and reprice, and as a result the full effect of the lower demand for offices hasn't been felt yet. A-grade offices are mopping up what's left of the demand, as employees demand more amenities from their workspaces, while B grade offices are becoming all but obsolete.

In addition, one of the themes for this year so far has been the bifurcation of returns between companies with lower leverage vs companies with higher leverage. In a rapidly rising interest rate environment, having higher leverage and a shorter debt maturity profile poses a real risk to company earnings. Hedge funds can look to have short exposure to these stocks and can pair it with a long position in a stock in the same sub-sector (neutralizing market risk) but with a better balance sheet.

However, there is a risk of being short a company with a stretched balance sheet and with poor management. These stocks often have depleted share prices and make for compelling take-out targets by more well capitalized companies.

c) Sector Long short

The real estate sector can quite often see notable variations in sector performance; the fundamentals for the data center sector differ largely from that of the self-storage space, meaning that sector allocation within any given portfolio is of vital importance. Sectors benefiting from long-term thematic or demographic-driven

supply/demand tailwinds should outperform. A hedge fund can choose to pair sectors against each other within a specific market (i.e., long industrial/short malls based on the exponential growth of e-commerce vs. in-store shopping through the Covid pandemic) to limit market risk but benefit from shifting consumer trends.

3) Use Synthetic Instruments (Derivatives)

Hedge fund managers can use derivatives and other synthetic instruments in their efforts to generate outsized returns at a lower standard deviation. From a risk perspective, currency futures can be used to try to mitigate against country/currency risk. Synthetics can also be used to gain exposure otherwise not possible. An example of this is in Hong Kong where it is impossible to physically short a stock. To "get around" this, a hedge fund can short on swap – effectively giving the fund the same exposure as shorting the physical security.

4) Use Leverage to Increase Return Profile

Hedge funds can use borrowed capital as a funding source to buy assets and generate returns. While hedge funds have a notoriously bad reputation when it comes to levels of leverage taken, when used responsibly, leverage can be a very effective tool in enhancing returns. Since the Global Financial Crisis, the industry has become a lot more regulated and the use of leverage, which is typically controlled and monitored by a hedge fund's prime broker, is minimized to protect the broader portfolio. The Catalyst Hedge funds have a historic leverage level of 1.3x (versus a global average of 2.1x according to a study by the University of Albany).

<u>Conclusion</u>

Locally, recent changes to pension fund regulation 28 which allows the allocation to alternative asset classes of private equity and hedge funds to increase to 15% has increased the interest in the hedge fund sector as an investable fund type for retail and pension fund investors.

Hedge funds have, for years, had a misconception of being highly risky, expensive and volatile vehicles only appropriate for a select few. While certain hedge funds certainly have had these characteristics, a more measured use of the wide tools available to an active hedge fund manager should actually decrease risk and leave an investor far better protected should the tide go out.

The effective use of these strategies means that nimble hedge funds can protect capital during market drawdowns as well as earn positive absolute returns in market upturns. This is invaluable in an environment of higher marker volatility and higher equity-bond correlations.

Glacier Research would like to thank John Hawinkels for his contribution to this week's *Funds on Friday*

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