130/30 Funds: 130% Gimmick/30% Good Idea

Don't get swept up by these funds

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Attempting to ride the "alternative investment" wave of the past few years, a plethora of 130/30 mutual funds have emerged, marketed to individuals or institutions unwilling or unable to take the hedge fund plunge. Also known as short-extension funds, these 130/30 mutual funds invest around a standard equity (or bond) benchmark, such as the S&P 500, and take on leveraged positions. For example, using a $100 portfolio of stocks, stocks worth $30 are borrowed and sold short, and borrowed money is used to purchase an additional $30 in stocks, for a total of $130 in long stocks and $30 in short positions. Other versions include 120/20 funds, as most funds try to stay under the SEC's regulatory limit of 150/50, which amounts to 2:1 gross leverage.

Here's how most 130/30 fund managers describe their funds: 130/30 funds allow managers to more efficiently exploit their stock-picking skills and generate alpha by not only owning the winners but also shorting the losers. Unlike typical mutual funds, where the manager can only underweight or avoid underperforming stocks in an index, a 130/30 fund manager can short these stocks to earn a profit. Meanwhile, the investor takes the same risk as a traditional 100% long mutual fund, because the risk of shorting 30% of the portfolio is offset by taking an extra 30% long stock position. So the manager can make more profit, without taking more risk.

If that sounds too good to be true, it's because in many cases it is. The table below shows 10 different 130/30 or 120/20 funds with long-only equivalents in the same Morningstar category. In half the cases, the 130/30 fund underperformed the long-only fund, sometimes by a wide margin, such as Mainstay's 130/30 International and International Equity Fund. Only one 130/30 fund significantly outperformed the long-only fund: Mainstay's 130/30 High Yield topped High Yield Corporate Bond. Why did so few of these funds live up to expectations?

130/30 and Long-only comparison	Ticker	Morningstar Category	Inception Date	Annual Report Net Expense Ratio	Turnover Ratio %	Return Since 130/30 Inception
Calamos 130/30 Equity A	CELSX	US OE Large Growth	6/20/2008	1.98	72.00	-47.24
Calamos Growth A	CVGRX	US OE Large Growth	9/4/1990	1.21	73.90	-47.47
Dreyfus 130/30 Growth A	DTTAX	US OE Large Growth	10/18/2007	2.76	0.00	-50.16
Dreyfus Equity Growth A	FRMAX	US OE Large Growth	12/31/1999	1.23	112.00	-46.74
Fidelity Advisor 130/30 Large Cap A	FOATX	US OE Large Blend	3/31/2008	1.55	288.00	-44.75
Fidelity Advisor Mega Cap Stock A	FGTAX	US OE Large Blend	2/5/2008	1.01	97.00	-40.18
BNY Mellon U.S. Core Equity 130/30 Inv	MUCIX	US OE Large Blend	8/1/2007	2.71	164.00	-43.36
BNY Mellon Large Cap Stock Inv	MILCX	US OE Large Blend	7/11/2001	1.05	56.00	-44.36
MainStay 130/30 Growth A	MYGAX	US OE Large Growth	6/29/2007	1.50	311.00	-40.80
MainStay Large Cap Growth A	MLAAX	US OE Large Growth	6/30/1995	1.23	115.00	-32.98
MainStay 130/30 High Yield A	MYHAX	US OE High Yield Bond	12/14/2007	1.29	26.00	-11.72
MainStay High Yield Corporate Bond A	MHCAX	US OE High Yield Bond	1/3/1995	1.07	29.00	-20.13
MainStay 130/30 International A	MYITX	US OE Foreign Large Bl	9/28/2007	1.60	204.00	-56.32
MainStay International Equity A	MSEAX	US OE Foreign Large Bl	1/3/1995	1.46	82.00	-37.32
Nicholas-Applegate Global Eq 130/30 I	NGTTX	US OE World Stock	4/1/2008			-44.93
Nicholas-Applegate Global Select I	NACHX	US OE World Stock	9/30/1997	1.03	80.00	-43.86
RiverSource 120/20 Contrarian Equity A	RCEAX	US OE Large Blend	10/18/2007	1.50	23.00	-49.44
RiverSource Large Cap Equity A	ALEAX	US OE Large Blend	3/28/2002	0.97	68.00	-52.65
RidgeWorth US Equity 130/30 I	SUEIX	US OE Large Blend	12/27/2007	1.30	87.00	-42.78
RidgeWorth Large Cap Core Equity A	CFVIX	US OE Large Blend	5/7/1993	1.11	78.00	-43.50

No Free Lunch

130/30 funds, unlike traditional mutual funds, have an additional hurdle called negative carry, which refers to the cost of shorting and leverage. If the fund manager produces gains through shorting (and this is a big if), he or she must earn extra returns, above and beyond the cost of the carry.

Negative carry is the difference between the financing costs (the prime broker's lending rate) and the interest received on the short-sale proceeds held as collateral. The short-sale proceeds of a 130/30 fund in most cases are not used to purchase more stocks. Rather, they are required to be held as collateral at the prime broker, earning interest. Prime brokers charge a "haircut," which is netted against the interest paid on short-sale collateral, to compensate for locating and controlling the stock they lend to customers. And the haircut grows for "hard to borrow" or illiquid stocks. Finally, after shorting 30% of the portfolio, funds must buy stocks on margin to arrive at the 130% long position, and these margin rates typically exceed the net interest earned on the short collateral.

In addition to negative carry, shorting stock incurs significant trading costs that buying does not. First, managers pay, rather than receive, any dividends on the stocks they short. This cost increase investors' expense ratios. For example, BNY Mellon U.S. Core Equity 130/30 sports a 2.71% net expense ratio. Per its Aug. 31, 2008, annual report, 38% of its total expenses came from interest, and 15% came from paying dividends on shorts. Second, managers must post additional collateral, or margin, when shorted stocks increase or leveraged long stocks decline in value. Finally, because short-stock positions can lead to unlimited losses (a stock price has no upper bound), these positions are typically held short-term, leading to higher commission expenses from portfolio turnover and short-term capital gains (or losses). Fidelity Advisor 130/30 Large Cap has a 288% turnover ratio, almost three times that of Fidelity Advisor Mega Cap Stock, a similar large-cap long-only fund.

As you can see, the 130/30 strategy is far from free. Let's now talk about risks.

Measuring Risks

Some 130/30 fund literature says the risk of a 130/30 fund is equivalent to the benchmark index's or an equivalent long-only fund's. This can be true, but only with much risk management. Many long-only managers do not closely monitor the market risk of their portfolio or underlying stocks, as their mandates allow only relatively small departures from the benchmark in the first place. 130/30 managers, however, must carefully measure this risk to stick to their investment objective.

Market risk and exposure can be estimated by beta (the sensitivity of a stock to a particular benchmark), and the beta of a fund is the weighted average of the betas of its stocks. The beta of the benchmark index is 1.0. In order for market exposure of a 130/30 fund to match that of its index, the collective beta of the 130% long stocks should be 1.3, and the collective beta of short stocks should be 0.3. The problem with beta is that it is largely a historical measure, and we all know past stock returns never perfectly predict future returns. So it's highly possible for a 130/30 fund to have more or less risk than its 100% long counterpart. From a practical standpoint, this risk exposure must be actively monitored and traded, which of course has costs. So 130/30 managers must weigh the cost of hedging against the benefit.

As you can see in the table below, several 130/30 funds do not keep their betas close to 1.0, so investors are not getting 100% market exposure in these funds--sometimes it's more, and sometimes it's less.

S&P 500 Beta comparison	Ticker	Morningstar Category	Weekly Beta 2008-03-23 to 2009-03-21 USD
BNY Mellon U.S. Core Equity 130/30 Inv	MUCIX	US OE Large Blend	1.01
CRM 130/30 Value Inst	CRITX	US OE Large Value	0.87
Dreyfus 130/30 Growth A	DTTAX	US OE Large Growth	0.96
ING 130/30 Fundamental Research A	IOTAX	US OE Large Blend	0.95
Legg Mason Ptnrs 130/30 US Lg Cap Eq A	LMUAX	US OE Large Blend	0.88
MainStay 130/30 Core A	MYCTX	US OE Large Blend	0.99
MainStay 130/30 Growth A	MYGAX	US OE Large Growth	0.90
RidgeWorth US Equity 130/30 I	SUEIX	US OE Large Blend	0.95
RiverSource 120/20 Contrarian Equity A	RCEAX	US OE Large Blend	1.13
Robeco WPG 130/30 Large Cap Core Intl	WPGLX	US OE Large Blend	1.01
Wilshire Large Cap Core 130/30 Invt	WLCTX	US OE Large Blend	0.90

Shorting: Not the Opposite of Going Long

Many 130/30 funds were launched by long-only fund companies and managers with no shorting experience. To compensate for lack of skills in shorting, these fund companies require managers to stick to a specific long/short structure (even though the SEC allows any exposure, static or dynamic, up to 150/50) and to use purely quantitative stock-picking models, simply ranking a universe of stocks from best to worst according to factors designed to find good buys, or good long stocks. Then, the bottom-ranked stocks are selected as shorts. However, just because a stock isn't a good buy, doesn't mean it's a good short. Unlike buying, shorting a stock requires a detailed assessment of risk, availability, and timing.

Losing short positions (when the stock goes up) become greater allocations in the portfolio while winning shorts (stock goes down) become smaller allocations. On the long side, the winners become larger and the losers become smaller--a natural hedge. So the manager has to have many more winners on the short side than on the long side, and the portfolio has to be constantly rebalanced. Small positions, stop losses or a strict sell discipline (covering a short if a position declines a certain percent), can help mitigate downside risk.

Another thing to consider is liquidity. Small-cap stocks are less available and more expensive to short. And there are trading issues. Shorting is often driven by short-term sentiment and momentum or price factors rather than long term-fundamental issues, and it takes an experienced trader to appropriately time the trade.

There's Still Hope

While we believe that 130/30 or 120/20 funds are largely marketing gimmicks, the idea of a long portfolio, combined with a short extension to emphasize a manager's best and worst picks, is a good one. But the key to success is a dynamic short-extension, rather than sticking to a static 130/30 or 120/20 model, which has no economic rationale.

Take JP Morgan U.S. Large Cap Core Plus, which is virtually identical to its U.S. Equity Fund, differing only in the short-extension, which tactically varies, and currently hovers around 118/18. Notice a gimmicky descriptor is absent from the fund's name, and it is also absent from the fund's investment mandate. The fund's manager, Tom Luddy, can position the portfolio as he wants based on current market opportunities, as long as the portfolio keeps a 100% net long market exposure.

This fund differs from many 130/30 funds in that its stock-selection process is fundamental and bottom-up, rather than quantitative. This allows Luddy and his analyst team to take advantage of strong convictions on which stocks to long and short, the purpose of a 130/30 fund. Luddy is heavy on risk management, and it shows. The 52-week beta (to the S&P 500 index) of the short extension fund almost exactly matches its long-only equivalent, which ranges between .97 and 1.04 on a rolling six-month basis. The fund's maximum drawdown, the largest loss experienced by the fund, occurred between October 2007 and February 2008, and differs from that of its long-only brother by only 30 basis points. Meanwhile, its performance since inception (from Nov. 1, 2005 through April 16, 2009) is significantly better, by 8 percentage points. Same risk with better returns--what typical 130/30 funds promise, but can't deliver.

The lesson is that short extension funds make sense when run with the correct expertise, but gimmicky mandates don't.