Morgan Stanley

INVESTMENT MANAGEMENT

Long-Short Equity Strategies

"Hedging" Your Bets

SOLUTIONS & MULTI-ASSET | AIP HEDGE FUND SOLUTIONS TEAM | INVESTMENT INSIGHT | NOVEMBER 2019

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With U.S. equities near record highs, investors may be seeking ways to position their portfolios for what lies ahead. It could be an opportune time to consider the inherently risk-mitigating characteristics of long-short equity strategies.

As the name suggests, long-short equity strategies invest both long and short in publicly traded equities and equity-related instruments. Compared to their long-only counterparts, long-short strategies are designed to have lower sensitivity to equity market movements, as measured by beta, volatility and drawdowns. When included as part of a broadly diversified portfolio, such strategies have the potential to: (1) generate profits from their long and short positions and (2) provide an element of protection, or hedge, when markets decline because gains on short positions will dampen losses on long positions.

> *What is shorting? Short selling involves borrowing shares and selling them at a certain price on the assumption that the price will decline, allowing the seller to buy shares back at a lower price and return them to the owner. Short selling is only profitable when share prices decline and may be exposed to steep losses if share prices rise.*

A Broad Category With A Strategy For Every Risk Appetite

A range of strategies fall under the general category of long-short equity *(Display 1)*. In our view, the most compelling strategy in today's market environment would be a low-net or zero-net strategy, otherwise known as "market neutral." Compared to other long-short equity strategies, market neutral strategies tend to exhibit low or zero beta, lower market risk, lower market volatility and seek to generate returns through stock selection. These strategies are not designed to shoot the lights out, but they have the potential to provide steady gains even in down markets.

Long-Short Strategies Are Also Actively Managed

In addition to the potentially risk-mitigating benefits of including short positions, long-short strategies typically have flexibility to adjust their risk profiles in response to changing market conditions. They are not required to maintain static exposures, nor are they tethered to a benchmark. Managers of market-neutral strategies can take a variety of steps to reduce risk and protect capital, specifically:

- Reduce overall portfolio gross exposure by selling longs and covering shorts at the same time, so that the portfolio has less capital at risk
- Reduce position sizes to reduce volatility
- Incorporate portfolio protection in the form of index hedges, futures or options

Long-Short Strategies Have Held Their Own In Prior Market Downturns

During the bear markets of 2000-2002 and 2007-2008, and the down markets of mid-2011 and late-2018, long-short equity strategies broadly, as measured by the HFRI Equity Hedge (Total) Index, and market-neutral strategies more specifically, as measured by the HFRI Equity Market Neutral Index, achieved their goal of mitigating downside risk relative to the broad markets across a variety of metrics *(Display 2)*.

DISPLAY 1

Characteristics of Long-Short Equity Strategies

	BETA	RISK/RETURN	VOLATILITY	PREDICTABILITY
Market Neutral	Low	Low	Low	High
Moderate Net	Medium	Medium	Medium	
High Net	High	High	High	
Variable Net	Varies	Varies	Varies	Low

DISPLAY 2

Long-Short Equity Performance During Downturns

PERFORMANCE	HFRI EH: EQUITY MARKET NEUTRAL INDEX	HFRI EQUITY HEDGE (TOTAL) INDEX	MSCI WORLD NET (USD)
2000-2002	23%	4%	-42%
2007-2008	-1%	-19%	-35%
Q2/3 2011	-6%	-12%	-16%
Q4 2018	-2%	-9%	-13%

Source: Total return data from Bloomberg as of November 20, 2019

MAX DRAWDOWN	HFRI EH: EQUITY MARKET NEUTRAL INDEX	HFRI EQUITY HEDGE (TOTAL) INDEX	MSCI WORLD NET (USD)
2000-2002	-2%	-10%	-47%
2007-2008	-8%	-29%	-46%
Q2/3 2011	-6%	-13%	-20%
Q4 2018	-2%	-9%	-13%

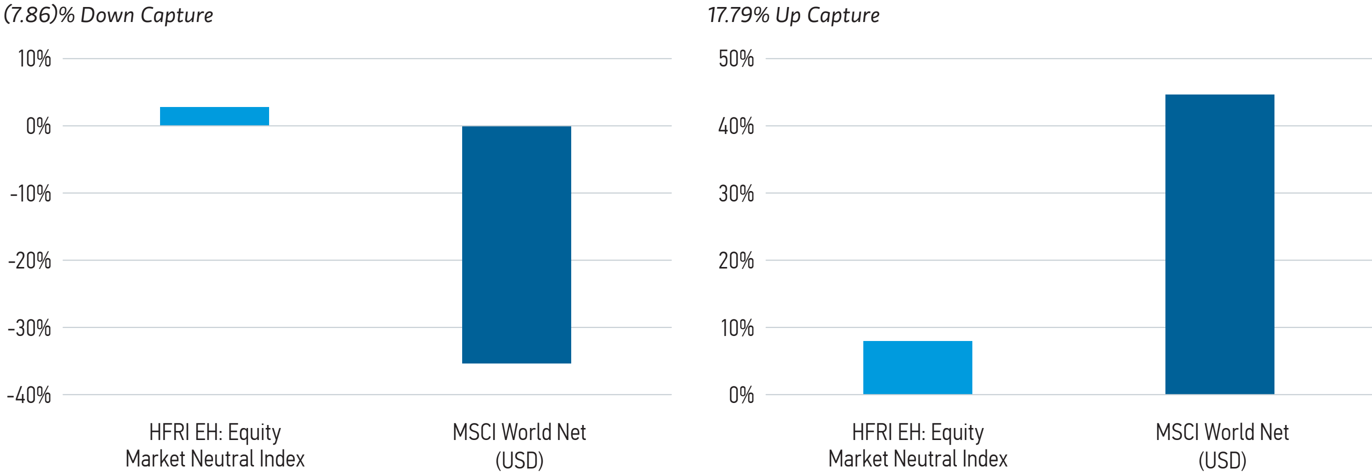
Source: Total return data from Bloomberg as of November 20, 2019

ROLLING VOL	HFRI EH: EQUITY MARKET NEUTRAL INDEX	HFRI EQUITY HEDGE (TOTAL) INDEX	MSCI WORLD NET (USD)
9/30/19	2.51%	9.96%	17.53%

Source: Bloomberg as of November 1, 2019

DISPLAY 3

Down and Up Capture Ratios for HFRI EH: Market Neutral Index vs. MSCI World Net (USD) Index



Source: Bloomberg as of November 20, 2019. Annualized return data during negative (down capture) / positive (up capture) months over the period January 1990-September 2019.

Among long-short equity strategies, market-neutral strategies have proven particularly adept at managing downside risk over time, while allowing investors to participate in up markets as well *(Displays 3* and *4)*.

Of course, past performance is no guarantee of future results. Four main risks will always face long-short equity investors:

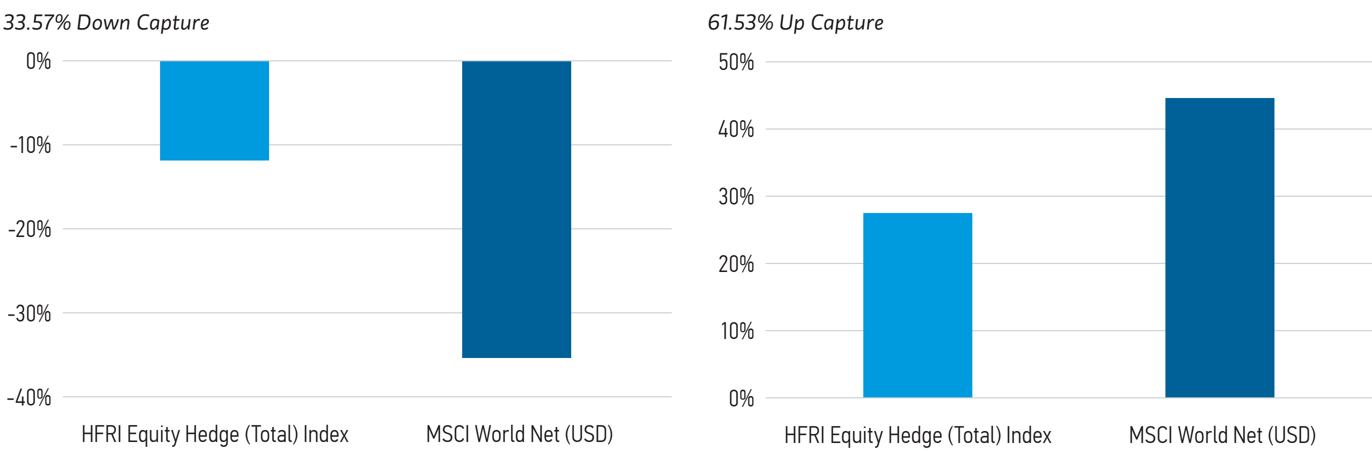
1. **MARKET RISK:** the risk of loss due to the impact of general market movements.
2. **IDIOSYNCRATIC RISK:** the risk of loss due to company-specific factors that are generally not correlated with the broad market movement.
3. **SHORT-SALE RISK:** the risk than an investment sold short generates significant losses because the stock price appreciates.
4. **LEVERAGE RISK:** the risk of loss due to unexpected interaction between longs and shorts or an improperly hedged portfolio.

Conclusion

Against a backdrop of the longest-running bull market in history, investors may well be concerned about the potential for weaker markets. In our view, including an allocation to market-neutral strategies in a well-balanced portfolio could provide valuable downside risk-mitigating benefits.

DISPLAY 4

Down and Up Capture Ratios for HFRI Equity Hedge (Total) Index vs. MSCI World Net (USD) Index



Source: Bloomberg as of November 20, 2019. Annualized return data during negative (down capture) / positive (up capture) months over the period January 1990-September 2019.

GLOSSARY AND INDEX DESCRIPTIONS

Net market exposure: Takes into account the benefits of offsetting long and short positions; is calculated by subtracting the percentage of the fund's equity capital invested in short sales from the percentage of equity capital used for long positions.

Short interest ratio: A formula that represents the average number of days it takes short sellers to cover their positions, or repurchase the shares they have borrowed. This ratio indicates whether a stock is heavily shorted or not shorted versus its average daily trading volume.

MSCI World Index Net (USD): A market cap weighted stock market index that represents large and mid-cap equity performance across 23 developed markets countries with net dividends reinvested in US dollars.

HFRI EH: Equity Market Neutral Index: Equity Market Neutral strategies employ sophisticated quantitative techniques of analyzing price data to ascertain information about future price movement and relationships between securities, select securities for purchase and sale. These can include both Factor-based and Statistical Arbitrage/Trading strategies. Factor-based investment strategies include strategies in which the investment thesis is predicated on the systematic analysis of common relationships between securities. In many but not all cases, portfolios are constructed to be neutral to one or multiple variables, such as broader equity markets in dollar or beta terms, and leverage is frequently employed to enhance the return profile of the positions identified. Statistical Arbitrage/Trading strategies consist of strategies in which the investment thesis is predicated on exploiting pricing anomalies which may occur as a function of expected mean reversion inherent in security prices; high frequency techniques may be employed and trading strategies may also be employed on the basis on technical analysis or opportunistically to exploit new information the investment manager believes has not been fully, completely or accurately discounted into current security prices. Equity Market Neutral Strategies typically maintain characteristic net equity market exposure no greater than 10% long or short.

HFRI Equity Hedge (Total) Index: Investment Managers who maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. EH managers would typically maintain at least 50% exposure to, and may in some cases be entirely invested in, equities, both long and short.

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