European long/short equity strategies

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Both in assets and number, European hedge funds have seen an astronomical rise in recent years. In this article, we take a closer look at how the European long/short equity space has fared in this growth. A number of variations exist between how each fund operates; we explain how these can be examined and why they are important.

Europe differentiates itself from other regions in a number of ways; we explain how some of these differences make it a unique playing field for equity long/short managers. We will also discuss the dynamics of the European long/short industry and the factors influencing its future development.

How has the European long/short equity strategy evolved? Over the last several years, European long/short equity funds have grown significantly, both in terms of number as well as in assets. Although the overall growth has been substantial, data from EuroHedge shows that the long/short share of all strategies in the Europe has been steadily declining, and currently amounts to less than 25%. (See figure 1). Recent developments illustrate this as well: of the 128 new funds launched in Europe in the first half of 2004, 38 were in the long/short equity space.

On the one hand, this rapid growth has been demand-driven, given that institutions look to enter hedge funds as an asset class on a meaningful scale. On the other hand, low barriers to entry for long/short hedge funds have allowed for a steady flow of supply.

Pension funds and insurance companies have become more sophisticated and familiar with hedge funds. In increasing numbers, they continue to rethink their approach to Asset Liability Management (ALM). Long/short equity hedge funds are generally thought of as a subset of the hedge fund universe and therefore receive a subset of the 0% to 15% (typically 4%) institutional allocation to hedge funds.

Figure 1 | Progression of assets under management for European hedge funds

Assets Under Management in USDb	Jul 04	Jan 04	Jul 03	Jan 03	Jan 02	Jan 01	Jan 00
Total assets managed by European hedge funds	216	168	125	84	64	46	28
Total assets managed by European equity long/short	53	43	37	34	28	23	13
Market share of European equity long/shorts	24%	26%	30%	40%	44%	50%	46%
YoY growth of European total assets	73%	100%	66%	32%	39%	65%	79%
YoY growth of European equity long/short assets	42%	28%	71%	21%	21%	78%	117%

Source: EuroHedge

However, some look at this strategy as a natural extension of active equity fund management. As such, some institutions begin to consider equity long/short managers as a subset of their equity allocation, which, on average, can range from 20% to 40% in Europe. This second paradigm could significantly accelerate the growth in assets as well as market share for European long/short equity managers. Barriers to entry may also fall further as the institutionalisation of hedge funds proliferates. This is particularly promoted by the intensifying competition amongst prime brokers fighting for market share by seeking to provide an ever expanding range of services to hedge funds.

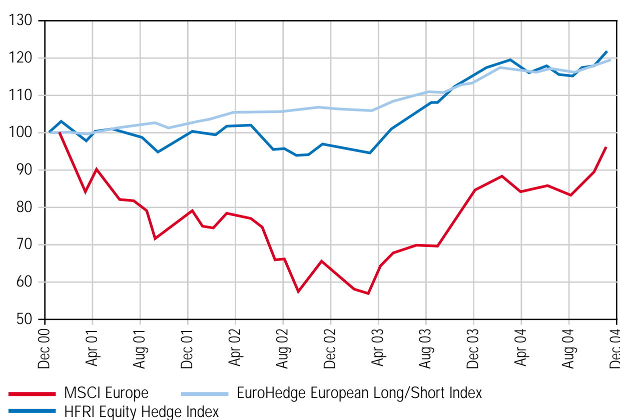
European long/short equity has returned close to 20% in the last 4 years. This period has seen a bear as well as a bull market and figure 2 clearly depicts the benefits of absolute returns whilst protecting downside risk. The performance of the strategy over the course of this cycle has proved it can generate significant alpha and should continue to become a more attractive portion of a portfolio than benchmark based active managers. Equity long/short in Europe relative to the rest of the world has posted similar returns over this period; *albeit (and characteristically) with much lower volatility.*

In terms of manager location, figure 3 shows that, while the UK remains the dominant location for hedge funds, its share of the total has eroded from 76% to 63% from 2001 to 2004. There is a clear trend that the growth in new hedge funds is spreading across Europe, with France and the Nordic region leading the charge.

What do European long/short equity mangers do?

When looking at European long/short managers, there are several aspects of the value proposition one must consider. The attractiveness of a fund is not only a function of the portfolio manager's calibre and the infrastructure supporting him, but also the different attributes that make up the strategy pursued. Europe benefits from the same geographic dispersion as the Asian arena whilst displaying equivalent sophistication to the US markets. When tackling equity markets in Europe, a manager's approach to the various exposures can heavily influence the return and volatility profile of a fund. A key tenet in selecting an attractive manager is interpolating how appropriate these attributes are to the manager's edge and expected market conditions. It is also important to consider these attributes

Figure 2 | Relative performance of European long/short strategies



Source: MSCI, EuroHedge, HFRI

Figure 3 | Location of European hedge funds

Country	2004	2001
UK	567	220
France	87	12
Switzerland	62	20
Other	47	2
Sweden	27	8
Ireland	27	3
USA	23	11
Finland	15	2
Norway	13	1
Spain	12	1
Germany	12	6
Russia	7	N/A
Netherlands	6	4
Total	**905**	**290**

Source: EuroHedge

when building a portfolio of long/short managers, as this can be a substantial source of diversification.

The net exposure taken by a manager is probably one of the key influences on performance and volatility. Some managers incorporate their market views in the portfolio and adjust their exposures accordingly. Others argue that this is a futile exercise and choose to keep a constant net exposure that they feel comfortable with. In Europe, anecdotal evidence suggests that managers often have a top-down view and adjust their exposures to market conditions accordingly. However, overall exposures seem to remain lower when compared with their US counterparts who tend to keep a longer, and more constant, net long bias. European managers, therefore tend to outperform their US-peers as a group in declining markets.

Obviously, managers that run a neutral portfolio will not get any benefits of market rises (nor are they subject to declines) but are relying solely on their stock picking skills to produce returns. But even a portfolio that has no market exposure may have taken directional bets on another level, for example on a sector[1].

Previous publications of swissHEDGE have explored how long/short hedge fund managers differ from traditional long-only managers and detailed the practice of shorting. Still, it is worthwhile to delve again into how different managers use shorting as part of their strategy.

There are two main motivations for shorting: one is to capitalise on the view that a stock will decline in value, the other is to use it as a hedge. When using shorts as a hedge, the manager will typically look to neutralise certain risks to which he does not want to be exposed. If the manager is worried about his overall exposure, an index future may be appropriate. Often, managers will want to be exposed to a stock specific risk and will hedge their position by going short a stock from the same sector (but that is expected to be less attractive for a variety of reasons), thereby aiming to neutralise all other factors. Similarly, many different instruments can be used to eliminate a variety of unwanted risks such as interest rates, commodity prices, foreign currency movements, to name just a few.

When using shorts to generate returns, the manager simply seeks to profit from a situation where the security is expected to decline because it is overvalued or the company is expected to suffer deteriorating fundamentals. In these cases, the manager will short the stock irrespective of what is held on the long book. This leads to greater mismatches and a higher risk/return profile for the fund as the long and short books are not correlated.

Other attributes to consider are portfolio concentration and portfolio turnover. A concentrated portfolio will generally produce lumpier returns and will have stock specific risks. On the other hand, a diversified portfolio will usually be closer to the market and may exhibit sector and market risk, while its stock specific risk may be diluted. In terms of trading velocity, buy & hold strategies can produce extremely different returns than a more active trading style. In low volatility environments, the latter will face a smaller opportunity set and would probably underperform managers with longer holding periods.

As with the long-only world, managers can have a bias for differing styles such as value or growth, large cap and small cap, momentum or contrarian. Within the context of a long/-short portfolio, these biases can either be hedged out or mismatches can amplify the volatility of returns. Along with the appropriate use of leverage, this allows long/short managers far greater flexibilities in their investment approach.

All of the above factors may change the risk/return profile of managers quite dramatically. This is good news as it enables portfolio diversification by investing in managers within the same region. In a context where markets across the globe have become more correlated and hence the benefits of geographical diversification have declined, these are useful considerations.

The (changing) European equity landscape and what it takes for managers to succeed

For a good long/short fund to succeed, there are several attributes the markets must provide to help managers capitalise on a superior analytical skill-sets. Asymmetry of information will provide opportunities for astute managers to capitalise on company insights not yet reflected in the price of underlying securities. Having a broad and deep market is also essential to allow these asymmetries to be widespread and efficiently capitalised on.

The market capitalisation of the European market is USD 5.2t over 17 countries and 91 indices. Structurally, Europe holds differing interest rate policies, currencies and international growth drivers as can be seen in the «Investor's View» section of this issue. Despite closer integration, there is still a lot of scope for information asymmetries and niche investment areas. Compared to the US and Japan, Equity managers in Europe have richer diversities to contend with.

[1] If a portfolio is net long an economically sensitive sector (industrials) and net short (by the same percentage) a defensive sector (pharmaceuticals), the overall portfolio may appear to be market neutral, whilst in fact it will be extremely sensitive to the market cycle.

Europe benefits from more developed markets, allowing managers greater use of more sophisticated hedging strategies. Some managers use derivatives to hedge out unwanted risks; these are more readily available and cheaper in Europe than in Asia. Most managers make greater use of shorting stocks to hedge out this unwanted risk. Availability of borrow in Asia is more restrictive and costs for some names can be astronomical (occasionally as high as 700 bp).

European markets have become more integrated and this trend is set to continue. The introduction of the Euro has helped shift the focus of investment managers from country specific issues to cross border trends. Capital allocations became sector based as comparability increased across different countries. Ten accession countries joined the European fold in May 2004, with four of them likely to adopt the Euro by 2007. This convergence within the continent will also provide various opportunities for hedge funds as different companies and countries will benefit in different ways. We can see evidence of this closer integration within Europe by looking at cross border M&A as a proportion of total European M&A. This has seen a marked increase as investors continue to feel comfortable looking outside their own borders for interesting investment opportunities (see figure 4).

Figure 5 shows where deal flow in Europe is likely to originate from in the months and years ahead. There is a clear trend towards consolidations in Eastern Europe and Germany especially in the Industrial and Utilities sectors.

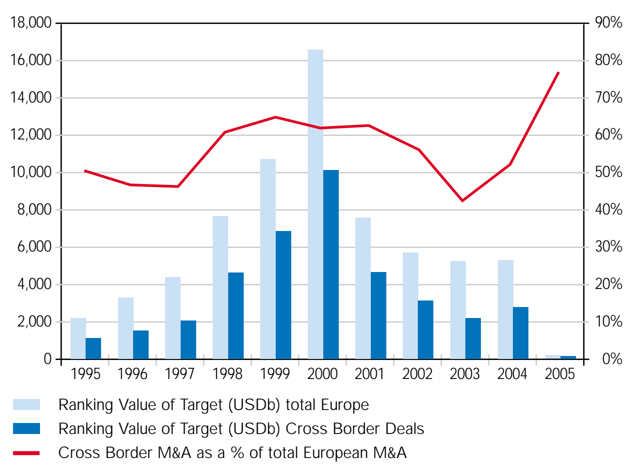
When looking at investment opportunities and choosing their niche areas of focus, long/short managers will have to take into account this enlarging universe and ever deepening and broadening markets.

New accounting standards to create opportunities?

The trends we have seen spawning out of European integration are set to continue with the advent of the new International Financial Reporting Standards (IFRS)[2]. European companies are set to implement IFRS as of the beginning of 2005. This will not only make European companies more comparable to each other, but align many

[2] The Morgan Stanley Global Valuation and Accounting team has done some interesting work on the impacts this may have.

Figure 4 | Cross border M&A relative to total European M&A



Source: Thomson Financial

Figure 5 | European heat chart

Country	CEE/CIS	Germany	Italy	UK	Nordic	France	Benelux	Iberia	SEE	TOTAL
Indutrials	135	115	60	36	74	37	48	10	11	626
Consumer Foods	59	55	49	29	23	34	16	5	3	273
Financials	44	77	37	30	28	15	18	11	12	272
Energy/Utilities	82	26	13	23	23	3	12	6	5	193
Business Services	24	2	19	19	20	24	24	2	1	185
Leisure	20	24	24	48	6	14	7	15	4	162
Retail	14	28	19	24	22	3	13	1	0	124
Pharmamedical	14	4	5	17	14	12	5	3	0	113
Transport	27	2	11	8	16	1	8	5	7	108
Media	14	8	12	21	9	28	9	4	0	105
Telecomcarriers	39	12	7	10	16	5	4	3	5	101
Technology	13	20	13	9	18	8	8	0	3	92
Construction	19	17	13	2	7	3	6	1	8	76
Defence	5	1	3	3	2	1	0	1	0	16
TOTAL	509	503	285	279	278	188	178	67	59	

Hot	Warm	Cold
100	50	20
80	40	10
60	30	0

Based on MM inteligence classified as «company for sale» or between 1. Jan and Sept 2004.
Based on the dominat sector and geography of the potential target.

Source: Mergermarket

accounting rules with US GAAP. Overall, accounting rules will be changing to promote the reflection of fair value.

Significant changes to net income include the abolition of goodwill amortisation, changes to pension accounting, and stock based compensation. Shareholder's Equity is set to be influenced by changes including pensions, purchase accounting, accounting for convertibles and proposed dividends. With more line items and a greater focus on the accounts reflecting the fair value of the underlying business, earnings volatility is likely to increase. This in turn could create greater stock price volatility.

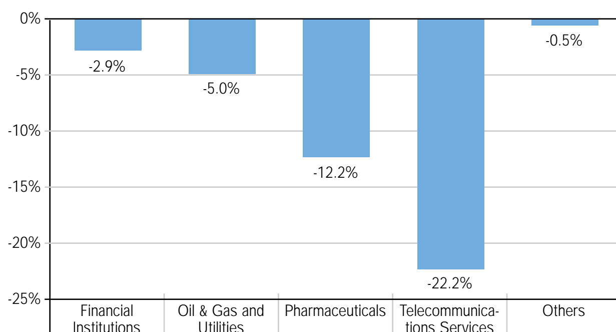
The onus is more on small and mid cap companies as many larger cap companies already adhere to US GAAP. Morgan Stanley Research highlight the Telecoms, Utilities and Financial Institution sectors as being most subjected to potential variations in reported numbers due to sector specific accounting issues. Research conducted on the top 27 European companies by market cap shows the relative impacts of these changes (see figure 7). France, Germany, Italy and Spain are also highlighted as previous disclosure rules differ most significantly from IFRS. Funds with a particular bias to those sectors and countries may have to factor in these issues more diligently.

Without going into the technicalities of how this will impact valuation metrics such as return on equity, dividend yield and price to earning ratios, suffice to say that fund managers relying on valuation screens to generate ideas of potentially mis-valued stocks will have to amend their screening metrics. This is of particular relevance during the transition phase as various complex exemption rules apply, giving companies some leeway in how they execute certain accounting reclassifications. These new rules may also bring about changes in management behaviour as they face potentially tough choices in balancing their business needs versus reporting needs. In particular, their attitudes towards stock options, hedging derivative portfolios and off balance sheet financing. Fund managers with an edge in company analysis benefiting from close contact with industry insiders are likely to reap greater rewards during the transition period. Managers with a wider scope and more skilled in ascertaining cross country and sector valuation gaps may reap the benefits once IFRS is set in place and fully reliable. Only a small fraction of companies have started to pre-advise, and sell-side analysts are still waiting for guidance from companies as there is much uncertainty as to how these changes will be dealt with. We can expect more noise in the market to come about. As a result of this, it is important to bear in mind that the real underlying value of companies and their cash generating abilities will not change. Managers focusing on cash based valuations, who understand the true value of their holdings through their analytical edge and are able to stay the course, will be rewarded in the long run.

How changing industry dynamics are impacting European long/short equity managers

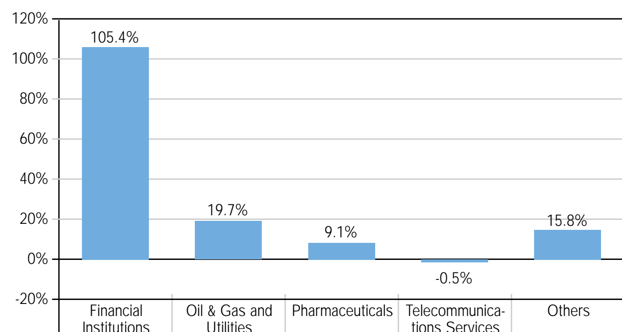
Recent research by JP Morgan points to an erosion of opportunities in areas «where hedge funds are very active, derivative markets very deep and where the same trading rules have been used for some time». Although this may hold true in the long run, we feel that the changing dynamics of the European equity landscape repudiate that threat somewhat for directional strategies such as long/short equity. Although hedge funds have grown enormously, they still represent but a small fraction of total actively managed European equities. The structural inefficiencies in the equity market are changing, facilitating more numerous

Graph 6 | Estimated IFRS shareholders' equity: % change compared to local GAAP by sector



Source: Company Data, Morgan Stanley Research

Graph 7 | Estimated IFRS net income: % change compared to local GAAP by sector



Source: Company Data, Morgan Stanley Research

informed opinion makers to impact stock prices.
We segment the asymmetry of information needed for managers to generate alpha into two components:

- The faster dissemination of more information.
- The correct analysis and piecing together of such information to better speculate on future price action.

One source of information available to fund managers is broker research, which has undergone numerous changes since 2000. Many of the more experienced analysts used the bear market 2001-2003 to exit the industry, reducing the average age of analysts on the street. Of those that did not retire, some have resurfaced on the buy side and within the European long/short equity hedge fund community. Interests of sell side analysts are becoming more closely linked to their trader's P&L's and less aligned with investment bankers. Published research will therefore keep shifting towards an increase in the publication frequency of incremental news and decrease in overall depth of company analysis. In addition, the Sarbanes Oxley Act/Spitzer investigations accelerated stricter control in equity research editorial. The wording used and opinions published by analysts are being highly regulated to the point of almost eradicating non factual speculation from published research. It is much harder to read between the lines unless the broker is called and asked for his opinion directly. This may result in more diverse opinions being formed by fund managers as subjective judgement is not as efficiently disseminated into the market.
Clearly, all the above aspects affecting the European equity landscape are just as relevant for traditional active equity managers. However, it has been demonstrated in the past that manager skill is superior in the long/short space as it attracts a superior calibre of investors. Seeing as the above dynamics place greater emphasis on manager skill (as opposed to information asymmetry) long/short managers should be even better positioned to generate alpha than their long only competitors.
The impact of prime brokers in the industry seems to be getting far more important in facilitating all non investment decision functions for managers. This is especially the case with leverage, access to stock borrows, access to investor bases and advice on how to set up a hedge fund. This further reduces barriers to entry for managers wanting to start up on their own, but by no means does this mean it is easier to start a hedge fund. Returns have become much harder to generate, shorts have become more crowded and it has become more difficult to raise initial assets.
It is becoming even more critical to generate superior absolute returns in order to facilitate asset raising. Consequently, the shutdown rate within the first six months of a new launch shows signs of increasing.
The natural development cycle of European hedge funds will accelerate: As assets flow in, more skilled professionals and more robust infrastructure can be afforded. In turn, these firms are better able to generate superior risk adjusted returns. This may lead to maximum capacity limits being tested faster and the Tigers of tomorrow establishing themselves sooner.
Trends in the European hedge fund space point to a rapid institutionalisation of the industry. Traditional asset management houses are aggressively building out their «alternative» business offerings, many of them as separate business entities. Other firms who have gradually built their platform of hedge fund products are becoming more prominent and have started adding on absolute returns focused long only products.
Setting up a new fund is far easier a task to undertake within the fold of a larger «traditional» house or on a platform of hedge funds. Also the supply of new talent differs significantly from the US. As Europe is much younger in the development curve, there are no «cubs» as of yet to spin out from larger «tigers». Long only managers who venture out into the long/short world as well as former analysts and bankers make up the bulk of the new talent entering the alternative space. The support of a larger infrastructure is important to them as a nurturing environment as they brave this new world and seek to make a new name for themselves through those much sought after superior performance track records.

In conclusion, we believe the European long/short equity space to remain a very compelling investment proposition. The strategy allows for a variety of styles and biases, which, coupled with a superior skill-set, places the savvier players in a good position to profit from various opportunities in the European market. These opportunities will abound as the face of the European equity landscape continues to change dynamically. The structural efficiencies in the market are also changing as the business model of various participants goes through transitional phases and the influence of hedge funds continues its stampede to the fore of financial markets.

Keynote addresses by Jim Rogers, David Mullins and Harry Kat

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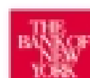

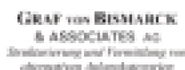

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