

130/30 Funds Go Back to Basics

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By Steven Marlin, Reporter

As the initial luster surrounding quant-based 130/30 funds wears off, more fundamentally-based, bottoms-up managers adding the leveraged strategy to their long-only positions, Rick Keller, CEO of Keller Investment Group, told Markets Media Monday.

JP Morgan's U.S. Large Cap Core Plus Fund, for example, which takes both long and short positions but not in fixed percentages, has posted a three-year return nearly six percent higher than the S&P.

"This fund is fundamentals, bottom-up stock picking," Keller said. "As of the end of the quarter, it only had a 17 percent short position."

130/30 funds, which use financial leverage by shorting poor performing stocks and purchasing shares that are expected to have high returns, have cooled off following an initial rush to them by institutions. A 130-30 ratio implies shorting stocks up to 30 percent of the portfolio value and then using the funds to take a long position in the stocks the investor feels will outperform the market.

"We had heard in the institutional area that single greatest request for new management styles was for 130/30 managers," Keller said. "The problem was that most of the 130/30 funds were quant-based, not fundamentals-based, and both in 2007 and 2008 most quant strategies have had a very difficult time."

However, said Keller, "fundamentally-based managers that use stock selection to short overpriced stocks and use the proceeds to buy undervalued long positions have been able to add value."

"The concept of the 130/30 fund sounds great," Andrew Betts, a financial adviser at Bickling Financial Services, told Markets Media Monday. It would seem that a fund manager could just buy the best companies and sell the worst ones and boost their overall return. Unfortunately it hasn't worked that way for most funds."

"The problem is that the stocks that are least likely to go up are not necessarily the same as those most likely to go down," Betts said. "The analysts that are good at determining the former are not often as good at determining the latter. A 130/30 fund still has a beta of one and is just as exposed to general market swings as a long only mutual fund. However with 1.6 times the number of stock positions when you combine long and short, you should expect that expenses will be higher."

"Over the next 12 months, I would not expect outperformance by 130/30 as a class above long only mutual funds," Betts said. "However I would expect that many of these funds would have lower volatility than their long only competitors, so they could augment the right portfolio."