MIKE TITLEY
Business Development,
Laurium Capital

Short selling: The misunderstood source of alpha

The search for alpha in a drifting market

Returns within the South African market have been subdued across most asset classes over the past three years to end July 2018. The South African Capped SWIX equity index, including dividends, yielded 4.1% per annum, while cash returned 7.3% per annum. Even listed property, which has generated impressive double-digit returns over time, lost its shine in the past few quarters, resulting in an annualised return of -0.9% per annum over the last three years. So where does one look for the alpha that investors need to generate the real returns required to live above the rising inflation breadline (three-year CPI of 4.9% per annum)? One obvious step is to select active asset managers that are supposed to sweat the asset classes harder and try to extract the opportunities that lie within them. One may take this a step further by allocating a portion of assets to a hedge fund.

Hedge funds access a bigger toolbox

Hedge funds have an advantage over long-only funds in that they seek to generate positive performance from falling markets and more specifically falling stocks. This investment strategy is referred to as short selling. Put simply, short selling, in the context of the equity market, is the practice where investors borrow securities and then sell the securities without ever owning them. Investors sell them in the hope that the price of those securities will decline, and they will then profit by buying back those securities at a lower price.

The median net performance of the long-short equity hedge fund universe has been 5% per annum for the three years to June 2018, net of fees. Year to date (31 July), the Laurium Capital Long Short Hedge Fund has returned 7.7% net of fees versus the FTSE/JSE Capped SWIX All Share Equity Index of -4.4%. Since its inception 10 years ago, the Fund has generated 11.6% per annum versus the total return of the FTSE/JSE All Share Equity Index of 10.8%.

The stigma around short selling

Over time, the practise of short selling has attracted negative publicity.

The scenario of benefitting from the falling price of an entity, where other investors are losing capital, has led to emotional debate. When one focuses on the investment side of this debate, we believe there is a place for short selling.

The positives of short selling

Shorting adds value to hedge fund portfolios in several ways:

- It allows a fund to reduce net equity exposure without selling the corresponding long positions.
- It generates liquidity in the marketplace by creating more activity and interest in a stock.
- Selling short may be seen as an active form of shareholder activism, versus avoiding a company, which is often overlooked.
- It is one of the few ways to extract returns for investors in a bear market.

When one removes the emotive element, shorting may be viewed as another method of realising mispricing opportunities in the market. Just as a 'long-only' manager seeks to buy shares at below intrinsic value and sell them above intrinsic value, the short seller seeks to sell shares that he has borrowed above intrinsic value and buy them back (and repay the borrower) at or below intrinsic value. When a share is shorted there is no capital outlay in the way there is for a long position. The short seller 'borrows' the scrip and pays the lender interest for it. The share is then sold in the market realising cash for the seller, which could be used by the hedge fund to purchase another security, or cover (buy back) an equity short position. Hence, short selling provides investors with the ability to generate performance without having to outlay the full capital up front. In this way, shorting allows the portfolio to leverage or gear by using the proceeds of the short sale.

Where one investor buys a stock and gains, the seller experiences the opportunity cost of having not continued to hold the stock. Short selling is the inverse of this, where the seller gains, the buyer loses. It is not short sellers pushing the stock price down, but rather market forces based on the economic fundamentals of the asset that drive it to fair value.