November-December 2001, Vol. 4, No. 7

SENIOR CONSULTANT
The Voice of the Investment Management Consultant

The Benefits Of Long/Short Investment Strategies In A Low-Return Stock Market Environment

Ricardo L. Cortez, CIMA

In our last article on consulting and hedge fund investing ("Consulting and Hedge Fund Investing," *Senior Consultant,* September/October 2001), we noted that, in our view, one of the major benefits of hedge fund investing in general, and long/short strategies in particular, is the enhanced return potential and risk management in a non-directional, trading range stock market environment. In this article we suggest that the determinants of stock market returns – corporate earnings growth, P/E multiples, and dividend reinvestment – indicate that in the next few years stock market may revert to their long term average – around 10% or less. In this type of environment, we suggest that consultants may want to discuss the benefits of long/short investment strategies with their clients.

THE GOAL OF LONG/SHORT STRATEGIES IS GENERALLY TO INVEST IN UNDERVALUED STOCKS AND TO SELL SHORT OVERVALUED STOCKS, ...

Long/Short Investment Strategies

The goal of long/short strategies is generally to invest in undervalued stocks and to sell short overvalued stocks, thus achieving absolute positive returns and less risk than the overall market. Most long/short managers tend to be net long over a period of time – that is, they usually have a larger long position than short position – for the simple reason that the stock market rises over time. However, many managers have learned that they can use the short position to generate substantial profits in declining or trading range market environments.

Long/short strategies have generally performed well in the difficult stock market environment of the last few years. (See Table 1 on next page for the returns of the Altvest Long/Short Index versus the S&P500 for 2000 and 2001.)

The superior performance of the Alvest Long/Short Index is primarily due to the long/short manager's ability to profit on a portion of the portfolio during market declines. These techniques may add even more value in trading range environments, since the manager can take profits on both stock market rallies and declines.

What Can We Expect From The Stock Market In Coming Years?

Many investors are still expecting stock market performance to return to the high levels of the late 1990's. *Mutual Funds* magazine (January 2002) reports, "Polling data show that a majority of investors still expect stocks to gain at least 15% a year in the long run – more, in fact, than the historical average." How realistic is this?

A recent study by The Bank Credit Analyst focuses on the three drivers of stock performance – corporate earnings growth, P/E multiples, and dividend reinvestment. Their conclusion is that it is more realistic to expect returns more in the 7.5% to 10% range rather than the 15% returns that some investors are expecting.

From 1950 to 1995, total stock market returns averaged 13.1% annually. This was composed of 7.3% corporate earnings growth, 1.5% in price/earnings multiple (P/E) improvement, and 4.3% in reinvested dividends. During the 1996-1999 bull market, the stock market annual return was 27.5%, made up of 7.3% earnings growth, 18.1% in P/E improvement, and 2.1% in reinvested dividends.

Where Do Stock Market Returns Come From?

The Bank Credit Analyst forecasts a 6.0% corporate earnings growth rate in the next decade. The stock market dividend rate is now 1.5%, and the current P/E is 25 times earnings, which is at the high end of its historical range.

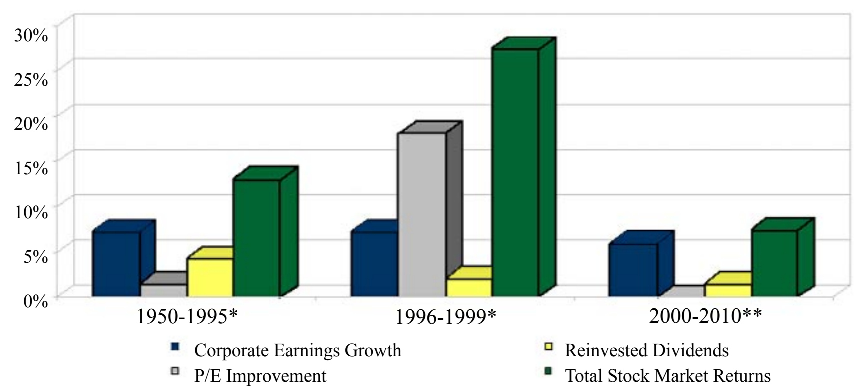
If there were a modest increase in P/E multiples in future years, then expected market returns might be in the 10% area. However, if the P/E remains at 25 or declines, stock market returns are more likely to be in the 7.5% range or even less in coming years.

In our opinion, it is difficult to see either an expansion in P/E multiples from current levels or corporate earnings growth much above that of the 1996-1999

Table 1.
Altvest Long/Short Index versus the S&P500 for 2000 and 2001

Year	Alvest Long/Short Index	S&P500
2000	+15.56%	-10.14%
2001	+ 7.28%	-11.88%

Table 2.
Where Do Stock Market Returns Come From?



	1950-1995*	1996-1999*	2000-2010**
Corporate Earnings Growth	7.3%	7.3%	6.0%
P/E Improvement	1.5%	18.1%	None
Reinvested Dividends	4.3%	2.1%	1.5%
Total Stock Market Returns	13.1%	27.5%	7.5%

Notes: *Numbers are annual.
**Estimates.

Source: *Mutual Funds* (January 2002) and *The Bank Credit Analyst.*

period, particularly in light of the current economic and political environment. If this is true, then we are likely to see a more non-directional, choppy stock market in the next few years. A long/short investment strategy may be a very powerful tool for consultants to consider in this type of market environment. ■

About the Author

Rick Cortez is President, Private Client Group, at Torrey Associates, LLC, and has over 25 years of investment experience. Before joining the Torrey Funds, he was Vice President and head of Goldman Sachs' external manager program. Rick spent 11 years at Prudential overseeing product development, communications, and sales for the Investment Management Services Division. He started his career at Merrill Lynch in their research division and was a portfolio manager and President of Liberty Capital Management. Rick graduated BA cum laude from the City University of New York and attended Columbia University in the Ph.D. program in mathematical logic. He was also awarded the CIMA designation at the Wharton School, University of Pennsylvania, in 1993. Rick is the author of numerous studies and articles on investment management.

SENIOR CONSULTANT

THE VOICE OF THE INVESTMENT MANAGEMENT CONSULTANT

SENIOR CONSULTANT

1457 Crystal Springs Lane
Richmond, Virginia 23231
Ph 804-795-1642 ■ Fax 804-795-7703
WWW.SRCONSULTANT.COM