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Short strategies are worth exploring in portfolio

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Until the bursting of the 1990s technology bubble, many investors felt that the equity markets could consistently deliver double-digit returns. As markets plummeted, shorting stocks became a welcome tool in combination with traditional long-only strategies.

Shorting a stock is the practice of borrowing stock, selling it and hoping to buy it back later at a lower price, then returning the stock to the original owner; that allows investors to make money as a stock declines in value.

Theoretically, shorting a stock is risky, as the potential loss is unlimited since a stock can go up infinitely. Conversely, a stock's appreciation potential when purchased is theoretically infinite, and the maximum loss is the amount of the investment.

Coupled with a long position (meaning you own the stock), shorting strategies can make a total portfolio more conservative. Managers that are successful in long-only investing rely on positive information they have learned about companies.

Long-only managers with negative information about companies just won't buy stock in them. But short-only managers see negative information as an advantage, because they can sell the stock now and expect to buy it back later at a lower price.

Although some managers -- almost always in hedge funds -- manage a short-only portfolio, most shorts are combined with a long portfolio. In a long-only portfolio, most of the portfolio returns are dictated by the market.

Most managers are looking for slight outperformance of their benchmark (for example, the S&P 500, Russell 1000, the EAFE), without taking a big risk. Stock markets can be volatile, and an active manager's long-only portfolio generally will have volatility similar to their benchmark.

However, if a portfolio is comprised of roughly half-long and half-short stocks, the volatility will be reduced dramatically, and the performance no longer will depend on market movements.

An investor expects the manager to utilize positive and negative information appropriately, and that value will be added. This is called a "market-neutral" portfolio and is typically a hedge-fund strategy.

The mechanics of implementing a market-neutral portfolio are simple. In a typical $50 million market-neutral portfolio, the manager sells short $50 million of stock, generating a nearly $50 million position in cash, which is used as collateral.

At the same time, $50 million in stock is purchased. The return will be comprised of the return of the long portfolio, plus the return of the short portfolio, plus the return of the cash portfolio, less the costs of money management and other expenses.

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Other managers will have a long bias and will use shorts as a hedge to the portfolio. These long-short managers are typically 60 percent to 80 percent long, and 20 percent to 40 percent short.

The returns of a long-short portfolio are less volatile than the stock market, and typically will underperform in strong markets and be defensive in down markets. Normally, long-short strategies are in hedge-fund vehicles as well.

One approach is called a "short-extension strategy," with formulas such as 120/20 (meaning, 120 percent in long strategy, 20 percent in short), or 130/30. In a 120/20 strategy, a $50 million portfolio would be comprised of $60 million in stocks that are purchased and $10 million in stocks simultaneously sold short.

This portfolio has no cash and is net 100 percent long, the same as the market or typical long-only portfolio. It simply allows a manager to not only buy on positive information, but short on negative information as well.

Hedge funds have used the short-extension strategy for years, and mutual funds began using the strategy in the last couple of years.

Shorting isn't a dirty word and can be helpful in reducing portfolio volatility and allowing managers to better use negative information to benefit a portfolio.

Perhaps investors should warm up to these strategies, as stocks have not only gone almost straight up since late 2002, but can be a sound hedge in the long term.

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