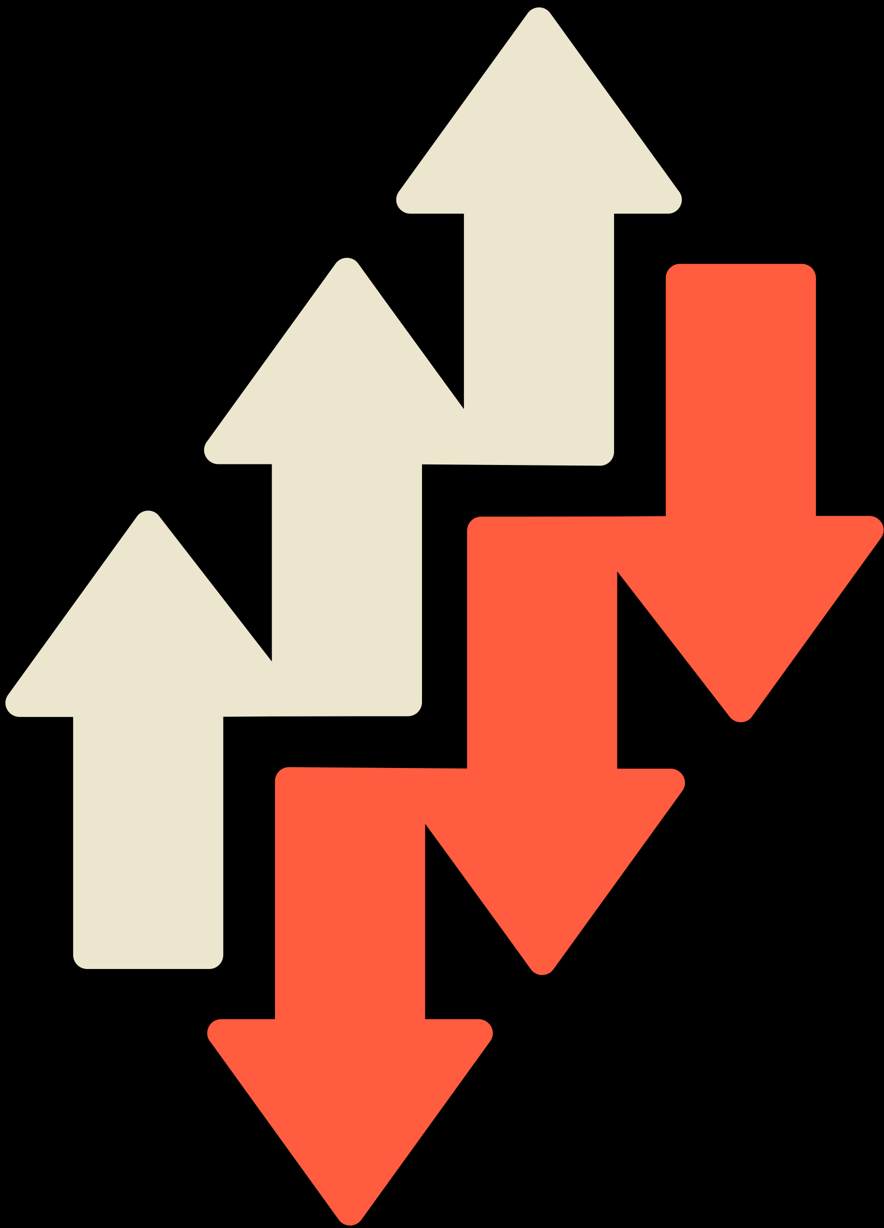
Long-Short *Masterclass*

The Inside Network
INVESTOR ACADEMY

Summary Report

31 March 2021
Collins Square, Melbourne



Fundamentals and applications of long-short investing

Long-short Masterclass 2021

VOLATILITY BRINGS OPPORTUNITY

With the volatility and uncertainty caused by the COVID-19 pandemic, advisers have naturally been searching for options to solidify portfolios and protect from another unexpected market collapse. As the name suggests, long-short strategies invest long and sell short equities. Compared to long-only strategies, they tend to have lower sensitivity to equity market movements and offer diversification.

The discipline in a long-short strategy is to wear two very different hats. Long holdings are based on tried and tested processes and fit within the fund managers style, be that growth, GARP or value. On the other hand, the universal view is that shorting should not be based only on valuation and should be more than a contrarian style determined to destabilise markets. There is a long list of potential benefits from investing in a long-short strategy.

In this Masterclass we heard from five experts who explored the various ways they tackled long-short investing, the strategies they employed, the differing risk profiles and benefits of each strategy.

This report provides a short summary of each presentation and the key learning outcomes. During the Masterclass we covered every aspect of the sector including:

THE SESSION INCLUDES FIVE MODULES ACROSS THE FOLLOWING:

1. Defining the universe of long-short strategies
2. The fundamentals of long-short
3. Understanding the unique long-short risk profiles
4. Generating alpha through a market-neutral approach
5. Incorporating long-short into portfolios

Education Partners

WILLIS TOWERS WATSON

Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has 45,000 employees serving more than 140 countries and markets.

SAGE CAPITAL

Sage Capital is a specialist Australian equities long short investment manager with an investment process developed over 26 years. Lead by long short veteran Sean Fenton, Sage Capital utilises a style and cycle neutral investment process that aims to provide a superior risk/return trade-off and more consistent returns to investors over time.

MONASH INVESTORS

Monash Investors was established in 2012 by one of Australia's most experienced fund managers in Simon Shields, the previous head of equities at both UBS and CFS, and Shane Fitzgerald a senior equity analyst from UBS and JPMorgan. The firm's objective is to achieve targeted positive returns of double digits p.a. after fees, over a full market cycle while seeking to avoid loss of capital over the medium term.

FIRETRAIL

Firetrail is an investment management boutique founded in 2018 that specialises in high conviction investing. Firetrail's mission is to generate outstanding long-term outperformance for its investors The firm was established with a goal to align its people with clients. Importantly, the firm is majority owned by its investment staff and the team is invested alongside its clients in the investment strategies.

LONSEC

Lonsec plays a fundamental role in building the investment capabilities of financial advisers, fund managers, superannuation funds and individuals. Our business encompasses managed investments, listed securities and superannuation research, awards and ratings, portfolio consulting, managed accounts and data and analytics. The Lonsec group is positioned at the nexus of Australia's financial advice and investment industry, enabling us to provide practical, actionable insights that add real value to our investment and advice solutions.

A snapshot


not to short, that is the
ether 'tis nobler...
Con
liquidity to mar
bid-ask spreads
y fund ma
ogy of bo
The Inside Network
Simon Shields

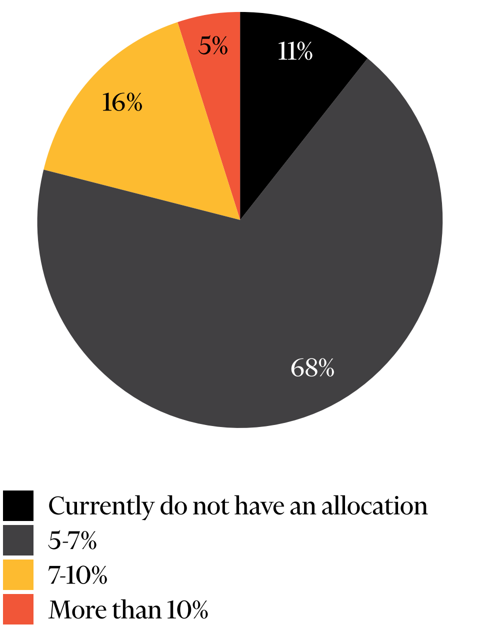

The Inside Network
Stephen Robertson


Jamie Nemtsas

Module 1:

Defining the universe of long-short strategies

WHAT IS YOUR CURRENT ALLOCATION TO LONG/SHORT STRATEGIES?



The first module was presented by Sean Hollins, of Willis Towers Watson (WTW). WTW is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. Sean Hollins, Senior Investment Consultant at Willis Towers Watson, focuses on liquid alternatives.

Long short investing is a strategy that utilises a large universe of investment styles. Hollins outlines five main investment styles that come under long short investing:

1. Active extension (130/30);
2. Long biased;
3. Variable beta;
4. Market neutral (fundamental and statistical arbitrage);
5. Event-driven

Long short investing does however come with its issues. Short positions can "runaway", so there is a certain level of skill required in managing risk. Typically, around three times as much time is required managing short positions than long positions. Borrowing shares from a broker or utilising derivatives comes at a cost which isn't the case with long positions. If markets rise over time, this can be quite a costly exercise and can impact returns.

The strategy may come up against behavioural resistance and against risk averse investors. And let's not forget there are the real risks of a short cover squeeze should the position be on the wrong side. Other issues to be mindful of include unexpected takeovers and borrowing restraints.

Hollins explained that the benefits of investing in long-short funds include factors such as capital protection through hedging, which smooths returns, and reducing the reliance on long stock picking and market direction to produce alpha. Exposure to alpha is equivalent to exposure to idiosyncratic risk and finally the ability to take relative views and arbitrage, makes long-short investing worth the while.

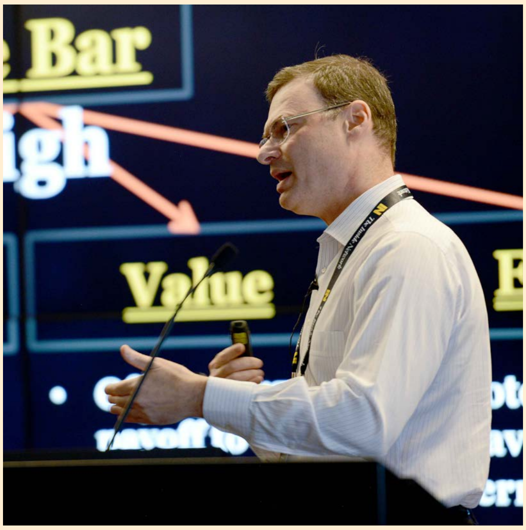
Risk management and dealing with volatile or falling markets is equally as important. Hollins says fund managers can be either reactive or pre-emptive. Implementing risk systems for monitoring and managing them remains key. They must also take into account hedging: top-down overlays and the use of derivatives or baskets of stocks, are you betting against your own long holdings? The big question, however, is what is the framework when selling? Both quantitative and qualitative factors must be given consideration.

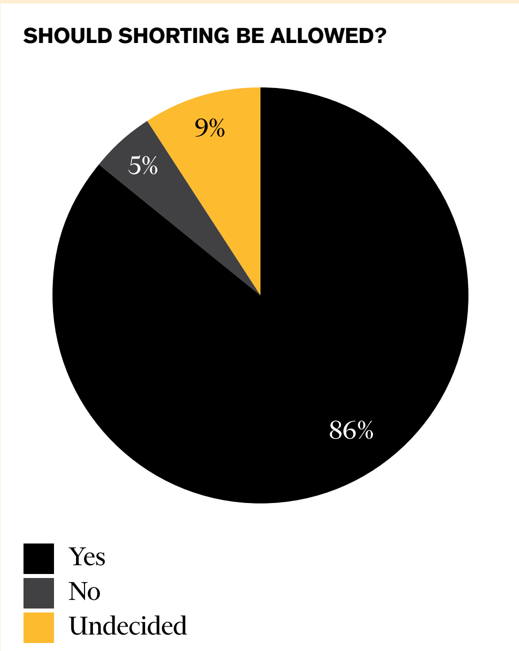
THE KEY LEARNING OUTCOMES FROM THE PRESENTATION WERE:

1. Short selling options for every situation and portfolio;
2. Downside risk doesn't disappear in long-short;
3. Special skill sets required for success in long/short.

Module 2:

The fundamentals of long-short investing





The second module was presented by Simon Shields from Monash Investors. Established in 2012, the fund is a variable beta strategy that uses shorting to expand their investable universe and leverage opportunities as they present.

Monash Investors first highlight the pros and cons of shorting from the view of an opportunistic and flexible manager. Some of the positive sides highlighted were its provision of liquidity to markets, improving bid-ask spreads and assisting in price discovery. On the flipside, some of the cons highlighted included the unintended increase in the supply of shares to the market, the tendency to sometimes take advantage of the naïve and the reputation short sellers receive often dubbed "mischief makers". Simon often uses the analogy "of borrowing a friend's car to drive in a hailstorm" to highlight how shorting can sometimes be viewed by the market as a morally wrong way to profit.

Short selling isn't just about profiting from falling prices, it is an important strategy that improves market efficiency, demands transparency from company management and reduces volatility and risk of loss. The approach does not affect the health of an individual company.

Simon went on to discuss how Monash Absolute Investment Fund has performed, some changes to the portfolio, and the fund's major stock positions. The best performing short positions were: Flight Centre (ASX:FLT) which fell -67%, Corporate Travel (ASX:CTD) which fell -42% and Freedom Foods (ASX:FNP) which fell 74%.

The key to successful shorting according to Monash Investors' philosophy: "Most stocks are fairly priced most of the time, but significant mispricing does occur. Sometimes these stocks can be identified in advance because of recurring business situations or patterns of behaviour - we focus on these opportunities."

Simon hosted a thought provoking table discussion which considered the merits of companies ranging from Flight Centre and Afterpay, to a comparison of the fast growing tech platforms, Hub 24 and Netwealth.

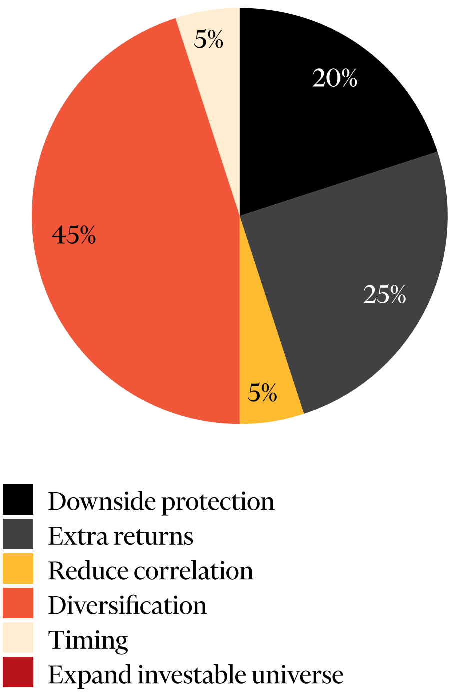
THE KEY LEARNING OUTCOMES FROM THE PRESENTATION WERE:

1. Behavioural biases lead to regular market mis-pricings;
2. Unique benefits of a flexible, variable beta approach to shorting;
3. The shrinking opportunity set on the ASX and the role of shorting to expand this.

Module 3:

Understanding the differing risk-reward profiles

WHAT IS THE PRIMARY REASON YOU WOULD ADD THE LONG-SHORT STRATEGY INTO YOUR PORTFOLIO?



Sean Fenton, Portfolio Manager at Sage Capital, presented the third module. Sage Capital is a specialist long-short equity manager, with Sean well-known for running the Tribeca Long-Short Fund. His experience in running 'active extension' strategies that seek to complement long-only equity, means he can explain key differences between the many long-short options available and their role within different types of portfolios.

In this Masterclass session, Sean discussed the advantages of using long-short strategies together with the different types used, and how to measure their performance. One of the biggest issues for Australian investors, according to Fenton, is the highly concentrated benchmark which limits investment options and encourages lower levels of diversification.

Sage Capital are style-neutral due to the simple fact; the strategy presents multiple opportunities that can't be defined by the basic value vs. growth lens. Equities are split into groups that respond in a similar fashion to the systematic risks of the market. These groups are: Defensives, Domestic Cyclicals, Global Cyclicals, Gold, Growth, REITs, Resources and Yield. Fenton says there are a few strategies that can be used to achieve its benchmark outperformance goals. These are:

- Active Extension strategy is a cross between a long-only managed fund and a long-short fund, with the objective to outperform a benchmark with similar market exposure to a long-only fund. Typically, in the range of 130/30 to 150/50. As the name suggests, these 'extend' traditional share portfolios by having a view on every company in the index.
- A market neutral or absolute return strategy where short positions and long positions offset each other. This type of structure gives investors exposure to the manager's stock selection skills, while eliminating exposure to the underlying equity market.
- Variable Beta reduces the market risk of investing with a long-only fund that must be close to fully invested. Variable beta funds can decrease their market exposure to protect against a market downturn by increasing their short positions or cash. Variable beta funds should provide "smoother" returns than simply investing in the index.

One of the key differences of an active extension strategy is that it Is benchmarked to the underlying Index, or ASX200, rather than to an absolute return objective. Ultimately, this means portfolio managers must have a view on every company in the index, as a decision not to hold the same level as the benchmark allocation Is an 'active' decision, and therefore a potential contributor to performance.

In his table discussion, Fenton challenged delegates to consider the outlook for AGL Energy, the diversified utilities company, and which stock would be a suitable 'hedge' or pair trade in the 'Defensive' group of companies to offset the associated risk. Moving squarely into the growth camp, he highlighted the valuation emerging in Seek Ltd and sought to determine if an appropriate valuation is in this unique environment, particularly following the sale of their Chinese business.

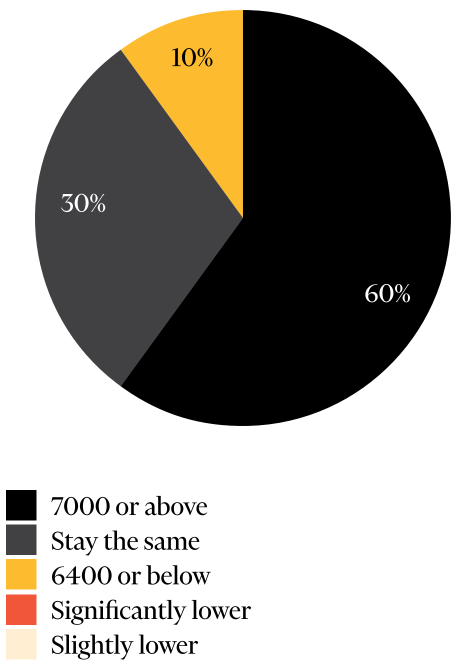
THE KEY LEARNING OUTCOMES FROM THE PRESENTATION WERE:

1. Diversification benefits of active extension
2. Shrinking opportunity set on the ASX
3. Key risk management due diligence areas

Module 4:

Generating alpha through a market-neutral approach

WHERE DO YOU SEE THE AUSTRALIAN EQUITIES MARKET IN THE NEXT 12 MONTHS



Patrick Hodgens from Firetrail Investments delivered Module four, discussing their unique approach to generating alpha through a market-neutral approach. Patrick is Portfolio Manager of the long-short Absolute Return Fund, and guided delegates through the important and differing risk management processes required for a market neutral approach, compared to the more long-oriented alternatives.

Kyle and Patrick went through three main factors that the team use to generate alpha:

1. Opportunities and risks are elevated
2. Uncorrelated returns
3. Designed to be different

With the pandemic came uncertainty. And with uncertainty came volatility rising to levels not seen since the GFC. Higher share price dispersion creates opportunities for active stock pickers, according to Hodgens. Corporate activity has also picked up. All of this translates into an increased opportunity to add alpha on both the long and short side. Patrick flagged the bull case for equities for 2021 i.e. synchronised global growth, continued fiscal and monetary stimulus, rise in company earnings and corporate activity continued. He also highlighted many reasons to be cautious, such as high growth expectations, inflationary pressure rise, retail investor exuberance and higher risk IPOs entering the market. Commenting on the latter, he suggested that several IPOs coming to market in recent years are likely to fail.

Patrick explained that it is for this reason, alternatives can supplement traditional asset classes to achieve desired risk/return outcomes. Market neutral funds can diversify portfolio exposure to traditional asset classes and reduce overall risks. Returns that are uncorrelated to equity market movements, provide the overall portfolio some downside protection. To highlight this strategy, the absolute return fund seeks to generate positive returns in all market environments. It is market neutral (net market exposure generally between +/-5%) and constructed in a way where returns are not dependent on the performance of the underlying share market. It achieves this via long and short positions.

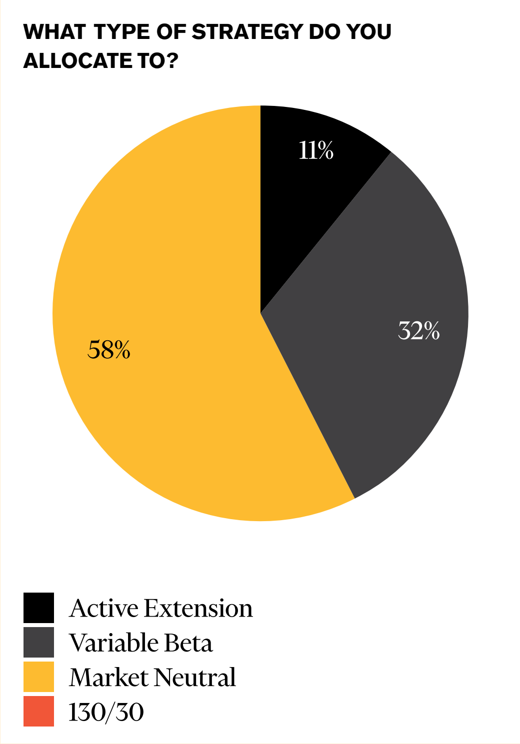
Commenting on the importance of risk management on the short side, where losses can ultimately be unlimited, Patrick highlighted several portfolio rules. Specifically, the group does not seek to be involved in 'crowded shorts' where shares to short sell are in high demand. Nor do they want to short companies exposed to market 'thematics' or concept stocks, as they are becoming more widely known.

THE KEY LEARNING OUTCOMES FROM THE PRESENTATION WERE:

1. Spreading risk Is the key to successful shorting;
2. Good stock picking will remain the key driver of returns
3. Short selling should be tactical and earnings based.

Module 5:

Incorporating long-short into portfolios



In the final session, Peter Green, brought everything together to highlight how long-short strategies and their varying risk profiles can be incorporated into portfolios. Peter is Director of Research in charge of Australian Equity strategies at research house Lonsec.

Green took delegates through the entire decision-making process from the diverse opportunity set, to the importance of having a 'deep bench' of opportunities. He highlighted the huge differentiation in each part of the sector and the associated risk profiles that come with each approach. 'Every strategy is different' according to Green, and therefore the needs of the individual investor must first be considered.

The key benefits that Lonsec see in long-short strategies is the idiosyncratic or stock specific risk and therefore diversification they can offer. This is opposed to benchmark hugging active managers that dominate many Australian equity portfolios. He compared the use of well-known active extension, variable beta and market neutral options, identifying whether they were best suited to the 'alternatives' or equities buckets within portfolios.

Of great consideration were constraints around the lifecycle of long-short products, with the short-side ultimately restricting how much one strategy can manage and trade effectively. Similarly, the importance of bench strength to replace said manager once they reach capacity; of which there are limited options in Australia.

Key due diligence considerations raised by Green included the individual managers approach to leverage, the limits and how this is determined, their approach to hedging market or systemic risk of drawdowns, and most importantly their approach to shorting. Is the manager seeking alpha from short positions, or are they being used to fund long positions, are they pair trading, or opportunistic only? The key to success, according to Green was finding good stock pickers.

THE KEY LEARNING OUTCOMES FROM THE SESSION WERE:

1. Long-short strategies have different roles for different Investors types;
2. Don't set and forget long-short equity strategies in model portfolios;
3. Be wary of capacity restraint when deciding to Invest.

The Inside Network