BostonPartners

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A Global Approach to Long/Short Investing

Summary

Even after a five year run up in the U.S. equity markets, many investors still have ample memories of the financial crisis of 2008. Investors are uncertain of where to invest that will offer some protection against market volatility and also mitigate drawdown risk. As a result, "liquid alternatives" have seen tremendous asset flows. According to Morningstar[1], investors shifted more than $40 billion of assets to liquid alternative mutual funds over the course of 2013, a 43.9% increase from the prior year.

Long/short equity mutual funds are particularly popular and have seen flows increase from $18 billion into 28 funds in 2008 to over $50 billion into 97 funds in 2013. A variety of approaches are employed by managers offering long/short equity funds, including covered calls, market neutral and 130/30 strategies as well as thematic or macro based funds.

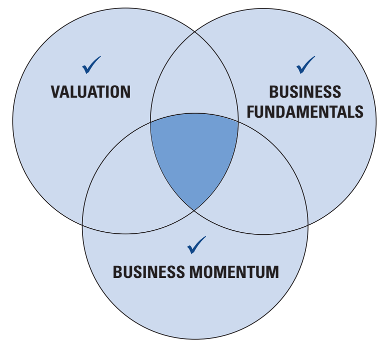
In this paper, we argue that a successful long/short strategy can be achieved by emphasizing positive security selection, regardless of geographic location, macro trends in the developed markets or even industry specific themes. Although many investors building global equity portfolios use ETFs to gain exposure to certain markets or sectors, that means they settle for benchmark returns minus fees. We believe there are many opportunities for good stock pickers who know what to look for on both the long and short sides.

What has proven to work in Boston Partners' portfolios is a disciplined fundamental approach which identifies companies that possess what we call the "genetic signature" of an attractive stock: strong business fundamentals, a catalyst or momentum factor and an attractive price. On the short side, we use a similar analytical approach to determine if a company is likely to see a price decline due to excessive earnings risk, balance sheet risk, and/or valuation risk.

1. Source: Morningstar Direct Asset Flows.

In our view a successful investment process is analytical, not informational. Many investors focus on the macroeconomic headline risks and ignore the favorable microeconomics of companies. Key to the process is filtering information and knowing which "noise" to ignore. We forsake forecasting and instead focus on identifying good stocks that consistently exhibit the characteristics of the "genetic signature."

"Three Circles": An attractive valuation, strong business fundamentals, and positive business momentum. Portfolios with all three characteristics tend to outperform over time.



Finding Alpha in Global Markets

We believe that potential alpha does exist within global equities, as evidenced by the following illustrations. The illustrations show that within the MSCI World Index, there is a huge performance spread between the stocks that are performing in the top half and those in the bottom half. With the right process and the right team in place to identify market inefficiencies and create a positive performance spread between longs and shorts, a global long/short strategy can be a very effective part of a portfolio.

Table 1: Top and Bottom Performers in the Index

Spreads Between Top Performers and the Bottom Performers in the MSCI World Index.

	(Cap Wtd.) MSCI World	(Equal Wtd.) 1/2 Best	(Equal Wtd.) 1/2 Worst	
	Return	Return	Return	MSCI World Spread
2003	33.11	90.90	20.84	70%
2004	15.76	53.19	1.93	51%
2005	9.50	38.13	-5.47	44%
2006	20.07	48.81	0.08	49%
2007	9.04	33.29	-17.40	51%
2008	-40.71	-17.92	-62.65	45%
2009	29.99	71.37	0.11	71%
2010	11.76	35.86	-3.73	40%
2011	-5.54	13.79	-25.87	40%
2012	15.83	37.60	-1.71	39%
2013	26.68	57.35	7.74	50%
Average				50%

Source: Boston Partners. Data as of December 2013.
Please refer to the back page of this booklet for other important information.

The aggregate performance of an Index only shows part of its true performance. For example, in 2013 the MSCI World Index gained 26.7%. Yet 785 companies of the 1,611 companies in the MSCI World Index outperformed. The average return of the outperformers was 57% versus 7.7% for the stocks in the bottom half of the Index, creating a 50% performance spread between the winners and losers.

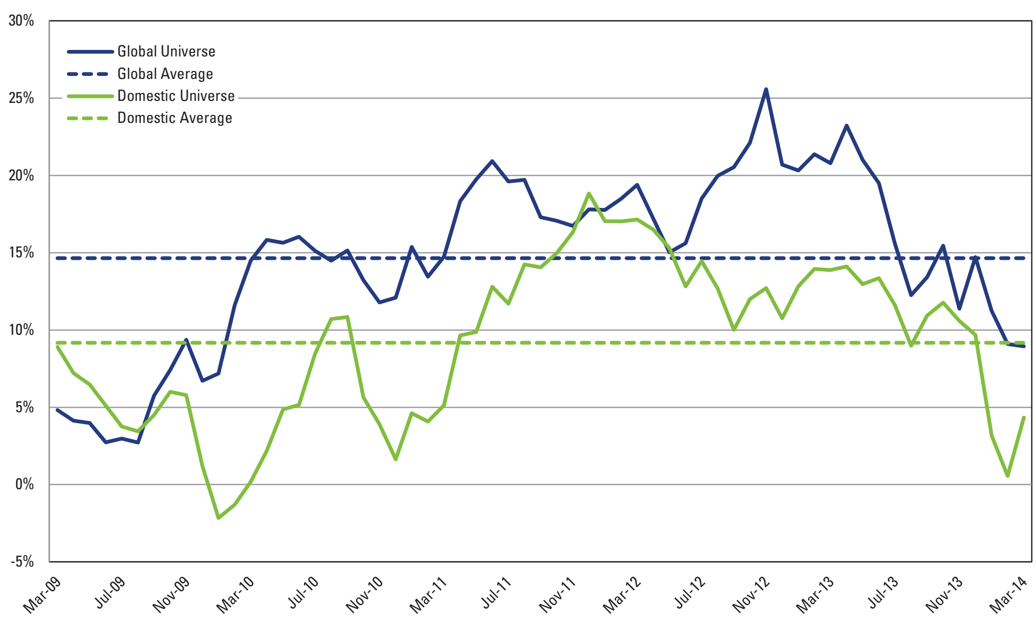
Alpha was available in the global equities market last year for investors that utilized an investment process designed to find it. At Boston Partners, we utilize a robust quantitative model which applies a score to over 8,000 global equities on a weekly basis based upon the three attributes that collectively represent what we believe to be the "genetic signature" of a good stock: strong business fundamentals, positive business momentum, and attractive value.

Each stock is scored on those three criteria, and subsequently those scores are aggregated into a single composite score for every stock. The team then uses those composite scores to group the global equity universe into deciles, thus every stock in our 8,000+ global equity universe is ultimately grouped into one of ten deciles. We usually source candidates for inclusion in the long side of our Global Long/Short Fund typically within the top three deciles and usually find candidates for inclusion in the short side of the portfolio within the bottom three deciles.

As the illustrations demonstrate, there is the potential for alpha, and we believe it can be generated via a systematic approach which is utilized to identify and buy stocks with the "genetic signature" and sell short those stocks with opposite, failure characteristics. Through the implementation of this process, we have observed a persistently positive performance spread between the best-ranking (top three) deciles and the worst-ranking (bottom three) deciles.

Table 2: Global Versus Domestic Average

Rolling 1-Year Performance Spreads - Attractive versus Unattrative Deciles



Source: Boston Partners. As of March 31, 2014. U.S. Universe: All U.S. exchange traded securities with market cap greater than $200 million. Global Universe: Companies in the MSCI World, MSCI World SC, Russell 3000®, and MSCI EM Indices at any point during the calendar year with market cap greater than $250 million and at least one analyst estimate (two estimates required for EM-domiciled companies); Global Universe excludes ADRs.

Interestingly, we have observed wider performance spreads between top and bottom deciles within the global equity universe as compared to the U.S. equity universe. This is depicted in table 2 on page 3, as the solid lines represent rolling 1-year performance spreads between the top and bottom three deciles. Additionally, the dotted lines represent the average performance spreads in global equities (~15%) and U.S. equities (~10%) over the last five years. Based on wider observed spreads, we believe the alpha opportunity in global equities to be even greater than in U.S. equities.

Boston Partners' approach to long/short investing is centered upon the spread depicted on page 2. As such, we utilize an investment strategy that is designed to systematically uncover stocks that possess the "genetic signature" of an attractive stock. Contrarily, our strategy also uncovers those stocks with the opposite, failure characteristics. Stocks deemed both attractive and unattractive through the lens of our "3 Circles" approach are vetted by a deep team of fundamental analysts. Ultimately, our goal is to generate alpha by delivering a long/short spread to our clients.

Efficient Market Hypothesis has its Flaws

Before going into more detail about what it takes to produce alpha, let's reconsider the Efficient Market Hypothesis (EMH). There are several major implications of accepting the EMH. One is that in order to outperform, investors need to have an advantage with respect to information gathering or forecasting. To outperform the market you have to know something that no one else does if you are to take a position ahead of the market. The vast majority of institutional investors make information gathering and forecasting the cornerstone of their decision making process. They not only engage in an unwinnable research arms race for information as they fight for superior insight on each and every stock in their portfolio, but then compound the mistake by trying to forecast an unknowable future.

We believe in an alternative approach to achieve outperformance. An analytical research process rather than an informational process should lead to better portfolio design. In other words, an investment process designed to filter information more effectively, rather than forecast more precisely. The information and data available to investment managers is vast. Technological and regulatory changes in the investment industry have commoditized information and levelled the playing field across managers large and small.

"Information consumes the attention of the recipient. A wealth of information creates a poverty of attention."
— Herbert Simon, Nobel Prize Winner

Herbert Simon, a Nobel Prize winner, summed it up when he said that "information consumes the attention of the recipient. A wealth of information creates a poverty of attention." So in our view the key is to distill and transform information into useful knowledge.

Another implication of the EMH is its emphasis on alpha versus beta, and the ill-conceived notion that the two can be cleanly separated. This in turn has spawned the growth of ETFs in order to gain beta exposure, with the addition of "alpha only" managers. The underlying presumption here is that alpha is more or less a commodity that can be fabricated on a research assembly line. In reality, there is no such thing as "consistent alpha," just as there is no such concept as a perfectly consistent golf swing. Though alpha potential clearly exists it is episodic, with the greatest opportunities available by leaning against the wind of popular sentiment, when market stress is at an extreme.

The EMH has also influenced modern risk management – for the worse. As a consequence of this hypothesis as well as the Capital Asset Pricing Model (CAPM), risk assessments emphasize statistical measures of return variation, which in fact offer no insights about "real risk" - the risk of losing capital (drawdown risk). Uncertainty and risk are quite different in nature. Uncertainty is unavoidable because the future is unknowable and the value of a security is wholly dependent on future events. In contrast, real risk (the risk of loss) is avoidable, because it stems from three sources that can be analyzed here and now: paying too high a price, earnings disappointments and bankruptcy risk. These sources are obscured by top-down portfolio volatility measures (such as mean variance optimizers) which confuse uncertainty with risk.

Falling stock prices and consequent increasing volatility imply rising risk in a conventional framework; in fact the risk of loss declines as prices drop, since the return potential and margin of safety both rise and the downside decreases, the lower the price paid. One of the important lessons of the financial crisis of 2008 is that risk management is best implemented via a bottom-up approach and there is no substitute for diversification and an effective sell discipline (the ability to admit that you might be wrong).

If Alpha is everywhere, then why don't most managers beat the market?

If alpha potential is everywhere, the ability to outperform exists. So why is it a widely held belief that the average manager cannot outperform the Index?

Most managers lose to the benchmark for three key reasons. First, they make forecasting the centerpiece of their investment process; they spend a great deal of time gathering information and trying to forecast better than everybody else. They ignore the "genetic signature" of a good investment – its basic characteristics - by getting lost in the details. Looking for the "genetic signature" of a company that will be a good investment does not imply finding every piece of information about a company. It does mean focusing on the information that allows an investor to determine whether a stock has the genetic code.

Secondly, there is substantial empirical evidence that the "genetic signature" of outperforming stocks contains an underlying set of common features — they tend to be inexpensive, of high quality, and they have positive momentum. Many managers seek one of these characteristics, but few look for all three, which we think is the key to long term outperformance.

The third reason why managers fail to meet the benchmark is that they have behavioral biases; the battle faced by managers and analysts every day is how to counteract those biases. Worst among these is "confirmation bias," where investors spend most of their time gathering data that confirm their forecasts while ignoring data that contradict their theories.

Another is the narrative or good-story bias where investors develop detailed and precise descriptions of their investment theory, and as they provide more detail it becomes more believable - but actually it is less likely according to the laws of probability. Adding additional detail to a story makes it less probable, even though humans gravitate to detailed stories because they seem more credible and plausible. A manager has to be aware of these biases and make an effort to counteract them in a consistent way.

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Conclusion: Generating Alpha in the Global Equities Market

In our efforts to provide alpha to our clients, we constantly seek the “genetic signature” of a good investment to tilt the odds in their favor, using a clinical, process-driven approach focusing on what we know and understand. We do not waste time on future predictions and instead concentrate on micro, not macro factors. In addition, we have an established globalized fundamental and quantitative research platform.

Investors should look for an investment team that can demonstrate measureable experience with shorting, which is as important as having demonstrated skills on the long side. Having said that, you have to be willing to tolerate periods of underperformance. Compound interest is maximized over the long run by avoiding large losses, not by beating the benchmark every single day. Finally, key to the process is a comprehensive and sophisticated long/short support infrastructure in research analytics, trade order management, legal/compliance, prime brokerage and back office. Putting all this together is the key to finding securities with the “genetic signature” of a good stock that should provide alpha.

About Boston Partners

Boston Partners specializes in traditional value investing, with an investment process and philosophy that was established more than 25 years ago. The source of our investment returns is security selection achieved through bottom-up fundamental analysis guided by quantitative methods. The team's process systematically blends fundamental research with quantitative screening to identify undervalued stocks throughout the capitalization spectrum.

About the Author

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Mr. Feeney is Co-Chief Executive Officer and Chief Investment Officer for Robeco Investment Management. He is responsible for the firm's strategic, financial and operating decisions, and all aspects of investment management including the firm's fundamental and quantitative research groups. He was one of the original partners of Boston Partners Asset Management in 1995. Prior to assuming these roles, he was Director of Research. Mr. Feeney joined the firm upon its inception in 1995 from Putnam Investments where he managed mortgage-backed securities portfolios. He began his career at the Bank of Boston where he was a loan officer specializing on highly leveraged loan portfolios. Mr. Feeney holds a B.S. degree in finance (Summa Cum Laude, Phi Beta Kappa) from the University of New Hampshire and an M.B.A. with High Honors from the University of Chicago. He holds the Chartered Financial Analyst® designation and is past President of the Fixed Income Management Society of Boston. He has twenty-nine years of investment experience.

Boston Partners Disclosure

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The MSCI World Index covers the full range of developed, emerging and All Country MSCI International Equity Indices across all size segmentations. MSCI uses a two-dimensional framework for style segmentation in which value securities are categorized using a multi-factor approach, which uses three variables to define the value investment style characteristics and five variables to define the growth investment style characteristics including forward looking variables. The objective of the index design is to divide constituents of an underlying MSCI Equity Index into respective value and growth indices, each targeting 50% of the free float adjusted market capitalization of the underlying market index. Index returns are provided for comparison purposes only to show how the composite's returns compare to a broad-based index of securities, as the index does not have costs, fees, or other expenses associated with its performance. In addition, securities held in the index may not be similar to securities held in the composite's accounts.

Past performance is not an indication of future results.

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