First Sentier Investors

Enhanced opportunities
The long and short of it

September 2022

The Australian Small and Mid Cap Companies team is pleased to offer the Australian Small Companies Long Short Opportunities Fund – a long short strategy available to retail investors which seeks to deliver consistent, absolute returns through all investment cycles.

The Australian Small and Mid Cap Companies team has been successfully managing a long short strategy for institutional clients since October 2008. This long short strategy derives maximum benefit from the team's in-depth research, by investing in companies that are likely to go up in value, as well as extending the opportunity set to include companies that are expected to go down in value.

This paper explains why the new Australian Small Companies Long Short Opportunities Fund may be attractive to retail investors, and looks at how a long short strategy works in practice.

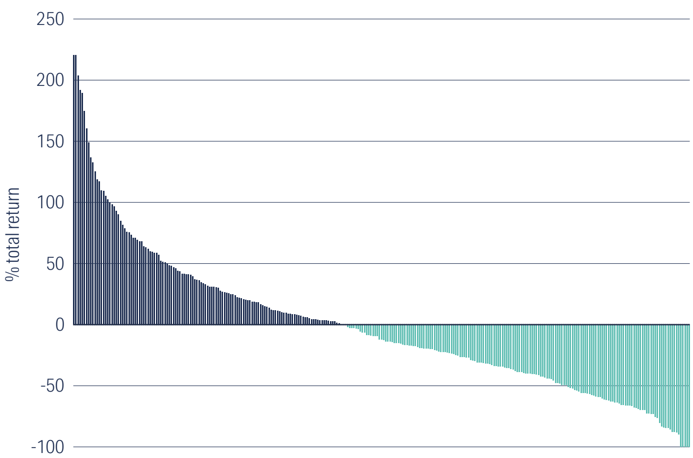
Investing in small companies

There are many listed small companies operating across all areas of the Australian economy. Some of the higher-quality companies will one day grow into large, successful, mature businesses. Identifying these stocks at the beginning of their journey provides investors with the potential for significant capital growth opportunities along the way. As small companies flourish, revenue and earnings growth are typically expanding at their fastest point in the company's lifecycle – growth that larger, more mature companies can find difficult to replicate from a higher base.

On the flip side, there are many poor-quality listed small companies. Just as some companies will become large, successful businesses, other companies will flounder, or fall victim to unfavourable market conditions or poor management decisions. Investing in these companies can result in significant or total capital loss.

The chart below shows the three year total returns of companies in the S&P/ASX Small Ordinaries Index. Clearly there are many stocks which performed very well. However there are also many posting significant losses. Conventional long only strategies can only achieve positive absolute returns by investing in stocks which rose in value. What if positive absolute returns could be made from the falling share prices of companies on the right hand side of the chart?

Company total returns in the S&P/ASX Small Ordinaries Index
Three years to 30 June 2022



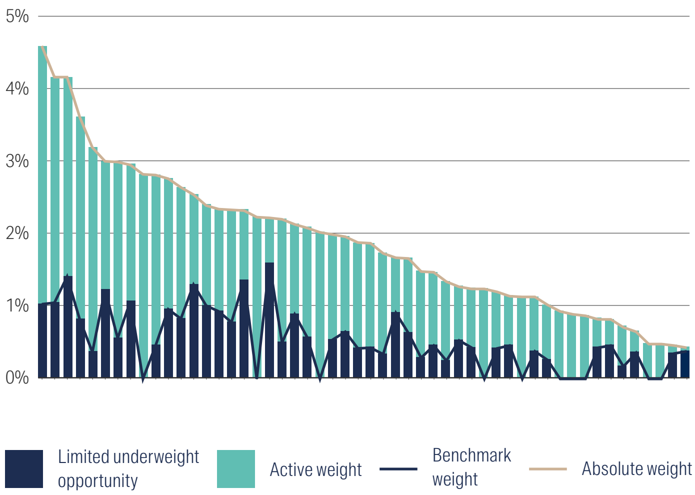
Source: Factset. At 30 June 2022. Total returns shown.
Illustrative purposes only. Not all company returns shown. Past performance is not an indicator of future performance.

Traditional long only strategies

In traditional long only strategies, managers are 'overweight' versus the benchmark in stocks that are expected to outperform, and 'underweight' versus the benchmark in stocks that are expected to underperform. The extent to which a portfolio outperforms or underperforms its benchmark is a common measure of an investment manager's skill.

It is relatively straightforward to implement an overweight positions in a security. For example, if a manager wants to target a 3.5% overweight position in a stock with a 1.0% weighting in the index, they simply buy the security up to a weighting of 4.5% in the portfolio, as illustrated in the first bar in the chart below. The desired overweight position can be established in any stock, irrespective of the stock's index weight. Overweight positions in the Australian Small Companies Fund are illustrated by the green bars in the chart below.

Australian Small Companies Fund holdings



Source: First Sentier Investors. 30 June 2022. Portfolio is Wholesale Australian Small Companies Fund. Benchmark is S&P/ASX Small Ordinaries Index.

The long only constraint

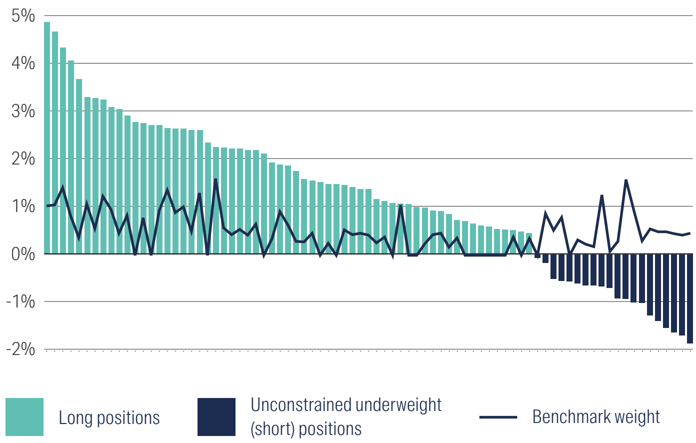
One of the limitations of long only portfolios is that managers can only achieve the maximum underweight position by not holding a stock. In other words, the scale of possible underweight positioning in stocks is limited by their index weight, illustrated by the dark blue bars in the chart above. This limitation is known as the 'long only constraint'.

The long only constraint means managers are typically unable to establish meaningful underweight positioning in stocks that are perceived to be over-valued and expected to underperform. Importantly, being underweight by not holding a stock will never provide positive absolute returns; it will only enable the fund to outperform its benchmark.

Expanding the opportunity set

The long only constraint has prompted investment managers to develop 'long short' strategies. These strategies have become increasingly popular, as investors seek ways to expand the outperformance opportunities in their portfolios. Long short funds overcome the long only constraint by short selling stocks. This allows managers to establish the desired underweight position in any stock, irrespective of the stock's index weight as illustrated in the chart below.

Holdings vs benchmark in the existing Institutional Long Short Strategy



Source: First Sentier Investors. 30 June 2022. Portfolio is existing Long Short Institutional Strategy. Benchmark is S&P/ASX Small Ordinaries Index.

Going short

Short selling is effectively the opposite of conventional stock market investing, where positive absolute returns can be made from share prices falling, rather than rising. Short selling involves borrowing shares and selling them, with the intention of buying them later at a lower price and returning them to the lender. The concept can illustrated by the stylised example below:

1. The shares of *Company A* are trading at $5. The investment manager believes the shares are overvalued and likely to fall in value.
2. The manager borrows 1,000 shares from a stock broker and sells them all on the open market for $5,000.
3. Shares in *Company A* fall to $3, as the investment manager anticipated.
4. The manager repurchases the 1,000 shares on the open market for $3,000.
5. The 1,000 shares are returned to the lender.
6. The manager retains a profit of $2,000 from the trade.

In this example, the manager will profit from any decline in the share price, as the cost of the share repurchase will be less than the proceeds received upon the initial sale. Short selling can therefore be an effective way for managers to implement their negative views on stocks.

One thirty thirty

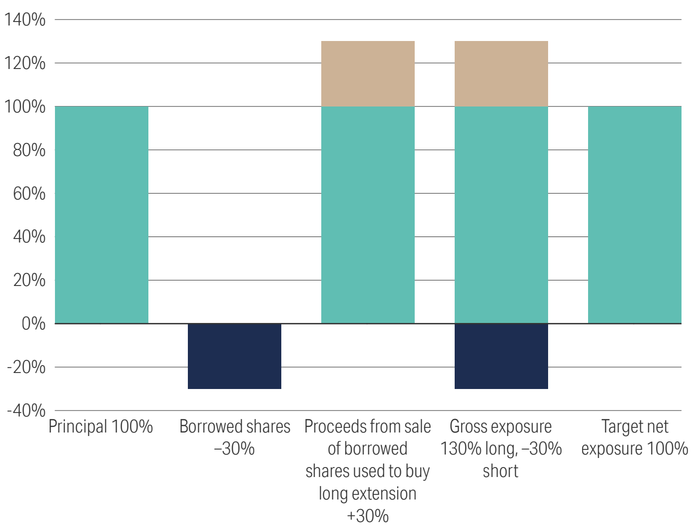
From a portfolio management perspective, there is an additional benefit of short selling stocks. Here, proceeds of short sales are used to reinvest in companies that are expected to outperform. In the previous example, the $5,000 received from short selling shares in Company A can be reinvested in companies expected to outperform, thereby further improving the fund's potential returns. These strategies are commonly known by such names as 130–30, where 30% of short positions in the portfolio allow for a 130% gross long position. The concept is illustrated below.

The fund borrows $5,000 of shares expected to underperform.

The fund sells the shares on market and receives $5,000 cash.

Rather than keeping the proceeds as cash, the fund invests the $5000 in shares that are expected to outperform for the duration of the share loan.

Achieving 130–30



Source: FSI. Chart for illustrative purposes only.

Why the Australian Small and Mid Cap Companies team

As mentioned previously, the Australian Small and Mid Cap Companies team have been managing a long short strategy for institutional investors since October 2008. The team completes detailed, fundamental research on all companies in the small cap investment universe. Effectively, the team spends as much effort researching stocks that are likely to underperform as those that are likely to outperform. Consequently, developing a long short strategy is a natural extension of the successful long only investment process and differentiates the strategy from many others in the Australian small companies space.

In short

The small companies sector in Australia is well diversified and has the potential to generate attractive returns for investors. The inherent risk associated with investing in small companies means that diversification is particularly important. This is why many investors gain exposure to small caps in a professionally managed fund. Professional managers typically have the resources required to complete detailed analysis on small company stocks and can identify those likely to outperform or underperform over time.

Introducing short positions into a portfolio can allow small company portfolio managers to fully express their insights on both overweight and underweight positions. This can result in improved portfolio efficiency and return outcomes for investors. In addition, the proficient use of shorting allows managers to target a higher level of performance for a comparable level of risk than a traditional, long only small companies portfolio.

When managed correctly, long short strategies in the small companies sector can potentially generate superior risk-adjusted returns. The pricing inefficiency of the sector, together with the ability to hold the desired overweight or underweight position on selected stocks, presents a compelling case for long short investing.

Investors should be aware that the use of short selling creates additional risk for the Fund compared to a long only portfolio. As the Fund engages in short-selling, the Fund may be exposed to 'short position' risk where there is no limit on the maximum loss that can be incurred when short selling. For more information on 'short position' risk and how the investment manager manages these risks refer to the Fund's Product Disclosure Statement.

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The performance data vs benchmark shown is for a representative existing Institutional Long Short Strategy. Differences between the representative account specific constraints or fees and those of a similarly managed fund would affect results. Past performance is not indicative of future performance.