MBS Mantra, LLC

Understanding Why Long-Short Equity Strategies Do Not Work

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I have recently been in conversations with numerous Investment Consultants, many of whom have mandates for Long-Short (L/S) Equity strategies, in spite of the recent and continued poor performance of this strategy, and possibly because of its recent performance, as trustees hope for a turnaround.

According to Barclay Hedge, their Equity Long Short Index has the most respondents, 302 out of a total of 1990, which makes sense, as this was the original Hedge Fund Strategy when Long Only funds switched to focusing on Alpha. The L/S strategy Index generated 1.02% in 2016, 2.49% in 2015, 2,94% in 2014, and 13.85% in 2013. There is a wide range in the returns of individual funds, so clearly not all are getting it wrong, and there are probably many styles lumped together into this index.

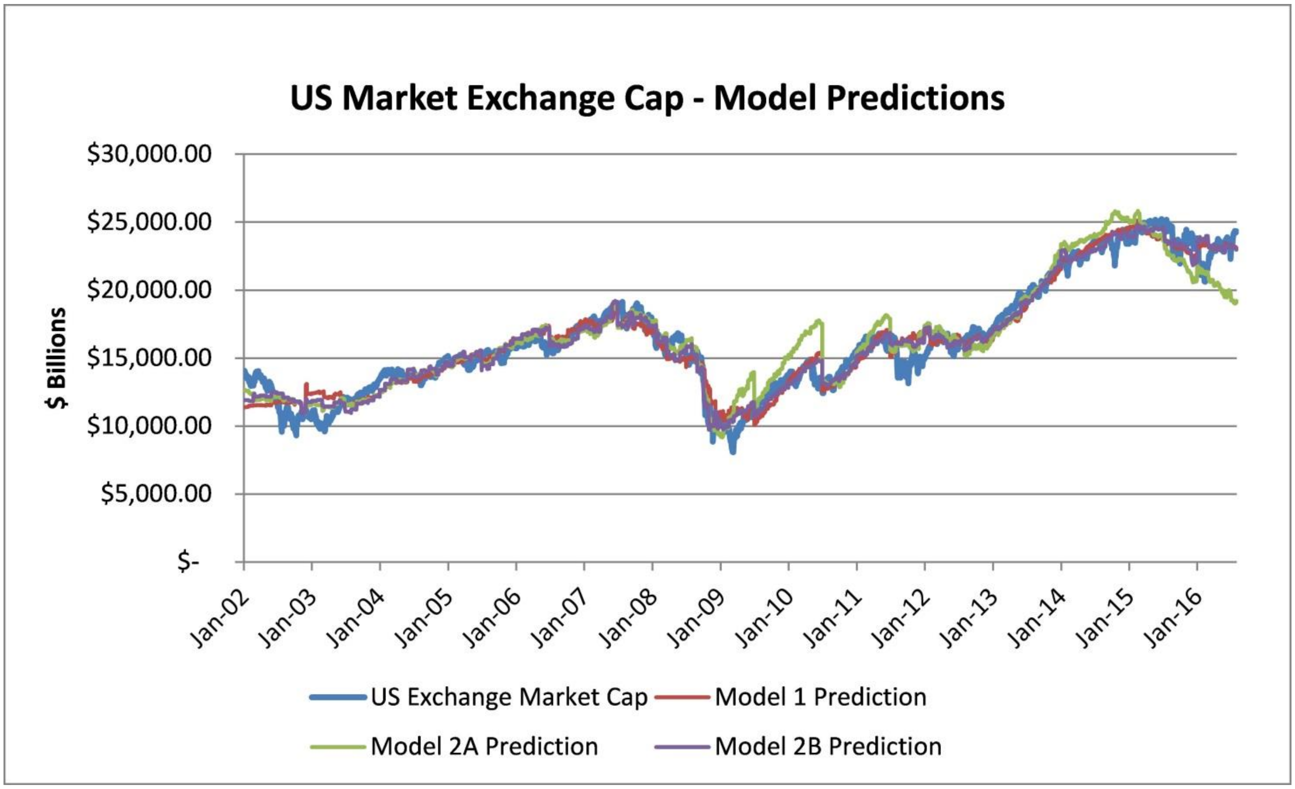
However, even Long Only Active strategies have had a rough go of it, and the returns of the Barclay Equity Long Only Bias Index have also not been very compelling, returning 4.06% in 2016, -1.15% in 2015, 2.99% in 2014, and 21.42% in 2013.

In comparison, passive management in Equities has done well relatively, and the S&P Index itself has had the following returns: 9.6% in 2016 (through Nov), 1.37% in 2015, 13.5% in 2014, and 32% in 2013.

I have been going to a lot of conferences and have also recently met with some college endowments and pension trustees. A number of the conversations veered to my Macro Economics research - my Crisis Notes and 'The Failure of Macro Economics' - and what I thought of the markets.

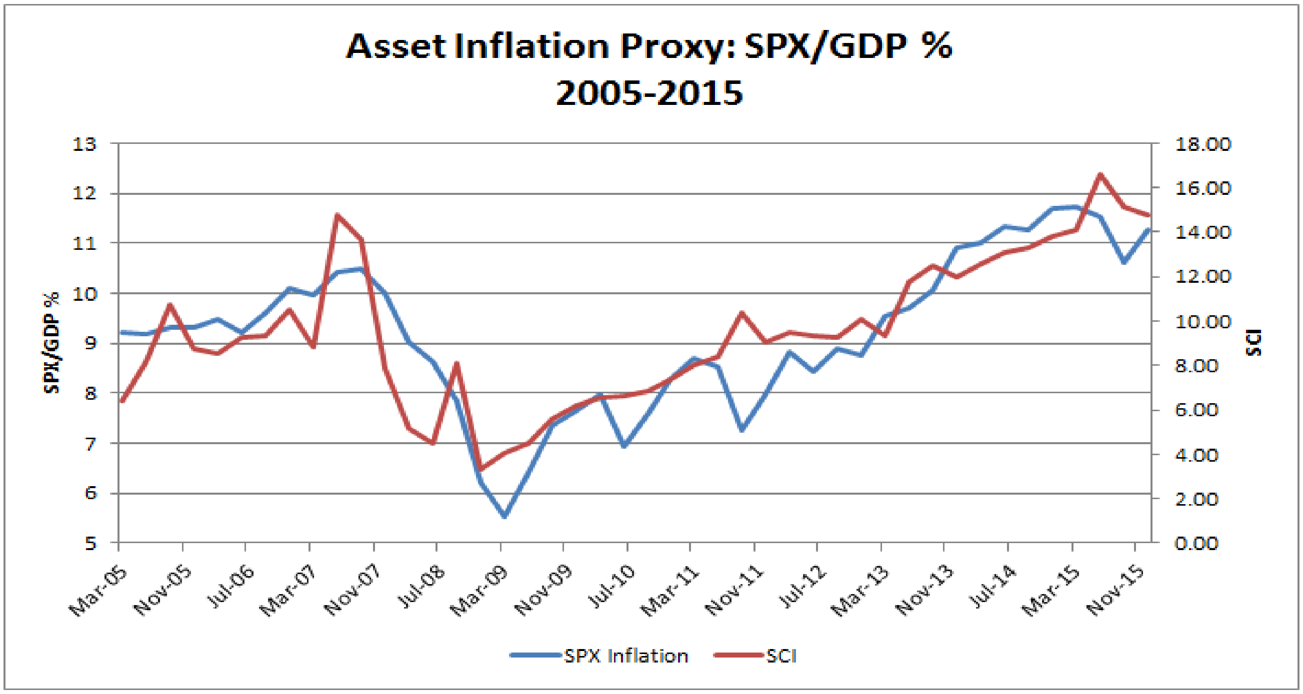
Based on my macro research (See and 'Determinants of the US Stock Market'), I told them that I expected another $1 Trillion and more market capitalization in the US stock markets, as I expected a double-barreled boost that would attract more capital to the US markets - from rising US rates attracting capital due to interest rate differentials (levered carry trades thanks to negative rates in other parts of the world) combined with additional fundamental outflows from the Eurozone and Japan (thanks to ECB and Japanese QE, and just fear from the Chinese and Russians).

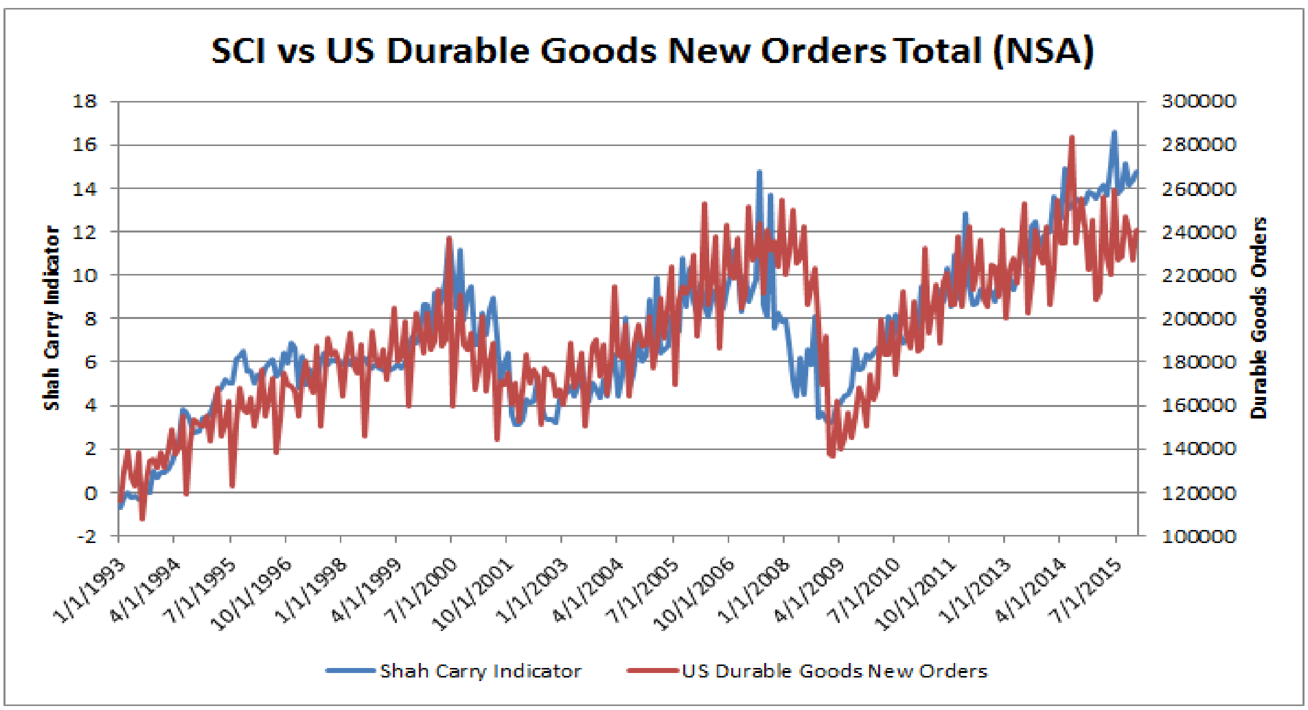
This chart, from Determinants of the US Stock Market, shows the close relationship of US Stock Market Capitalization to the quantity of Injected Capital into the US (my models are based on Injected Capital ONLY). As you can see, the stock markets took off again in 2013. (You'll need to read the original articles to see the definitions of the variables described here.)



I firmly believe that Injected Capital is the reason why the US stock market has kept rising of late, due to (and not in spite of) rising rates, defying fundamental analysis and "rational" PE ratios, and that Injected Capital has also been the primary determinant and driver of the US Economy since the late 1990s.

The next charts, from 'The Failure of Macro Economics' show the impact of Injected Capital: Asset Inflation in the price of Stocks, and also in the level of Economic activity.





I suspect that much of the injected capital has taken roost in ETFs and passive strategies, which have likely grown more than the outflows from Hedge Funds. **Investing in Indices eliminates the differentiation between the returns of individual stocks, as the prices of all stocks in indices rise and fall proportionately with the indices, regardless of their 'fundamentals'.**

The rising tide of capital inflows into the US stock markets has pushed up the price of all US stocks, with little differentiation, also resulting in the marginalization of Active Management. Unless an active manager can identify a company that will go bankrupt and will drop out of an index, identification of the 'Short' in a Long-Short strategy, based purely on differentials in 'fundamentals', becomes a game fraught with failure.

The Failure of Macro Economics has led to both the Failure of Active Management in Equities, and the Failure of Long-Short Equity Strategies. As a broad category, I do not see these turning around.

I would love to hear your comments.

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