Some high-net-worth investors are turning to long and short investments in international equities as a way of increasing absolute returns. To explore this strategy, Monitor Editorial Advisory Board member Benjamin Valore-Caplan, CIMA, PRIME consultant, and first vice president of investments with UBS Financial Services, Inc., talked with Nigel Hart, CFA, managing partner and portfolio manager at ReachCapital, a hedge fund company specializing in long/short investing outside the United States. Before joining ReachCapital, Hart served as senior vice president and portfolio manager in the international investment division of Putnam Investments in Boston, where he was co-manager of the Putnam International Voyager Fund and the Putnam European Growth Fund. Before joining Putnam, Hart was a fund manager for Hill Samuel Investment Advisers in Minneapolis and London. He graduated from the University of East Anglia in the United Kingdom with honors in economics.

Benjamin Valore-Caplan: Throughout your career, why have you chosen to focus on equities of companies based outside the United States?

Nigel Hart: International equities constitute a large universe—there are more than 6,000 opportunities in Europe alone—and these markets are generally under-researched and under-appreciated. Also, I was born in England, so my first experience was with U.K. stocks. Later I became interested in continental European stocks and, after that, Asian stocks. I’m very much a product of the Margaret Thatcher generation; participating in her privatizations helped to finance my university career. That got me interested in investing in stocks. Then I moved to London and realized this was the area I wanted to specialize in. I’ve never invested in U.S. stocks.

Benjamin Valore-Caplan: Why did you choose to make the transition from investing only in long equity positions to investing in both long and short positions?

Nigel Hart: Having done both, I prefer long/short equities. Most hedge fund managers start on the proprietary training desks of well-known firms and then progress to running their own firms. But it’s still unusual for managers of long/short equity funds to start from the long-only side because these two types of managers think in different ways. I ran a large small-/mid-cap international fund for a well-known investment management firm and for every 10 companies I visited in Europe, I bought long-only positions in just one or two; shares in the other companies were usually holds or sells. Now, as a...
A good mutual fund

Nigel Hart: A good mutual fund allows an investor to hire an expert who’s totally focused on specific types of businesses, and this gives the investor comfort that in the long run the manager can produce a good return. Of course, long-only managers focus not just on absolute return but also relative return because there are years when markets don’t perform well. But for the average investor who wants some exposure to equities but doesn’t have time to track individual stocks, a mutual fund remains a good collective investment vehicle for gaining that exposure.

On the other hand, an investor whose objective is absolute return, who refuses to lose money under any condition, must focus on long/short equities. The ability to short stocks, to bet that stock prices will go down rather than up, is a helpful extra tool. The ability to make money in a falling market as well as a rising market is immensely valuable. With long/short investing, managers basically have no excuses. Because our universe of equity opportunities is so large, we should be able to make money for clients whether the market goes up or down.

Another consideration related to long-only investing is that these firms charge a fee, a percentage of the fund’s assets. As a business, they try to garner as many assets as they can because that’s how they increase profitability. As a hedge fund manager, my incentives are aligned with those of the individual investors.

We get paid only if we produce an absolute return. In down years, we have to make up losses before we get paid.

Benjamin Valore-Caplan: skeptics of long/short investing—particularly when it’s structured as a partnership or a private placement—argue that it’s just a grandiose compensation scheme for the manager. Would you say more about the alignment of compensation and how you see it as potentially benefiting investors?

Nigel Hart: The economic structure means that in a good year, hedge fund managers are paid very well, but we also invest alongside our clients. We have significant amounts of our own net worth invested in our funds—we do not allow any employee of the firm to invest outside our funds—so we share the profits and the pain. If I find a good opportunity in a European market, it goes directly into the fund; if the investment works out, I benefit and my clients benefit as well. The fee structure is set up so that we only get paid on the profits we make for our customers, so losses are hard for us to tolerate. Every year on the first of January, we reset the benchmark to zero, and we get paid again only if we increase the value of the fund that year. We have an incentive not only to make money in the first place but also to make money for our customers consistently, year in and year out. Otherwise, we could find ourselves out of business.

Benjamin Valore-Caplan: What are the principal challenges faced by short sellers working in non-U.S. equity markets?

Nigel Hart: The biggest constraint is liquidity. Borrowing stock from prime brokers in order to sell short can prove problematic, especially when you’re dealing with smaller companies. You need to be fairly certain that the investment will work out; otherwise, you run the risk of being bought in or having the short run away from you. We also employ stop losses on the short side to ensure that we don’t lose too much money if things go badly for us, and we size our positions according to the relative size of the business’ market capitalization. Liquidity can vary dramatically. For example, on July 7, 2005, four bombs went off in central London and for a period of two or three hours, many stocks did not trade—there were no buys and no sells. Covering short in that kind of environment would be quite problematic. You have to size your positions correctly and be aware of liquidity constraints.

Regulatory and legal constraints generally are not a big factor. In general, shorting has become a little easier over the years.

Benjamin Valore-Caplan: How can long/short investing potentially affect an investor’s overall risk?

Nigel Hart: Any long/short fund should be able to demonstrate good absolute returns and less volatility than would be the case with long-only investing. Volatility is a key consideration in evaluating any hedge fund manager. Investors should look for managers who generate a lot of alpha rather than seeking performance that comes from a lot of beta. The best managers will be picking unique stocks, and their performance will result from their ability to locate good-quality long or short positions rather than relying on long-term investments in a rising market. I would pay a high fee for the services of a good manager of long/short equities.

Benjamin Valore-Caplan: Obviously a long/short manager must possess a demonstrated ability to implement short positions. In addition, for investment consultants with responsibility for due diligence, what are the critical factors that differentiate managers?
Nigel Hart: A good track record—a demonstrated ability to make money in their chosen field, consistency (meaning that they haven’t delved into other areas of investing), low volatility, and a competitive edge. This kind of track record indicates that a manager’s results can be replicated in subsequent years.

Benjamin Valore-Caplan: What is the competitive environment like for firms that specialize in long/short investing outside the United States?

Nigel Hart: The field has become more competitive in recent years. There is more capital chasing European small- and mid-cap stocks than five years ago. But the universe of opportunities is both large and dynamic. Small-cap companies become mid-cap companies and, in some cases, larger-cap companies. There are rapidly growing businesses with talented executives, interesting products, and high profitability. We focus on these types of stocks and try to find them early, but we also look at broken businesses. A large-cap company may become a small-cap company, or it may be taken over or go bankrupt at some point in the future, and we also focus on these companies on the short side. We try to find the pockets in this large universe that will make us money. Small- and mid-cap European stocks have performed well in the past two or three years—they have beaten many large-cap indexes. But we don’t look at the indexes; we just find unique companies.

Benjamin Valore-Caplan: Are you concerned about headlines that claim too much capital is flowing into hedge funds and long/short investments?

Nigel Hart: The terms “hedge fund” and “mutual fund” encompass a lot of different products and strategies. The hedge fund industry is growing, and more people are interested in it, but this doesn’t mean there’s too much capital chasing too few good opportunities. The valuation of the businesses we invest in means these companies have the potential for cost-savings and restructuring, and this allows us to sleep at night when we invest in this space. If in money-losing months our portfolio went down more than the market and we detected that many of our stocks were owned by hot money (the momentum players), we’d be concerned, but we don’t detect that. When we do experience a drawdown, it’s usually a lot less than that of the market overall.

Benjamin Valore-Caplan: Does long/short investing outside the United States differ from long/short investing inside the country? Are there significant structural or regulatory differences?

Nigel Hart: I can’t think of any differences that would be of concern. It’s a level playing field; the barriers to entering a hedge fund are fairly low. But when you invest in international equities, it’s beneficial to understand the history of certain European and Asian markets. In Italy, for example, we’re not likely to invest in businesses located south of Rome, because that’s the poorer part of the country and we’re unlikely to find good-quality investments there.

Benjamin Valore-Caplan: As a manager of long/short investments, how do you view the role of cash in a portfolio?

Nigel Hart: Cash is another investment tool, and it has to be compared with long-only and mutual fund investments. When I managed an international fund at a large investment management firm I was not allowed to let cash build. If cash made up 10 percent of the portfolio, alarm bells would ring. The theory was that we had to invest—we couldn’t miss a rising market because that’s where we made money, despite the fact that the market could go down and cash could help to cushion such a fall.

In our funds, however, we have no restrictions on the weight of cash. If we cannot find good investment opportunities, either long or short, then we can increase the amount of cash in the portfolio to preserve capital; we are not forced to invest. On the other hand, if we find a host of good ideas on the long side, the short side, or both, we can borrow money to invest. A hedge fund can take on leverage, and this can be an effective tool for the right product or portfolio. But our funds haven’t taken on extra layers of leverage because our leverage is built in through investing in these small- and mid-size companies.

Benjamin Valore-Caplan: How do you manage net exposure?

Nigel Hart: Net exposure is driven by the number of long or short investments we find at any given moment. Over the past couple of years, we’ve found many more good long ideas than short. Our portfolio has been net long—from 40 to 80 percent—since 2003. We would describe current short opportunities as more difficult and dangerous, so we’re extremely careful about them. If we find more shorts, net exposure goes down. We were close to being net short in 2001 and 2002. One of the risk-management tools we use is beta. We evaluate the volatility of each stock in the portfolio relative to the volatility of the market. Beta-adjusted, we’ve actually been net short, because we had short investments with higher beta and long investments with lower beta in 2001 and 2002. This strategy has allowed us to preserve capital and to make money on the short side.

Benjamin Valore-Caplan: Is the lower number of short opportunities a macro-economic, or structural, problem?
**Nigel Hart:** Yes. One reason we’re finding more long opportunities is that interest rates in Europe are low and are unlikely to go up very much or very quickly. This means the cost of capital is low, and corporate earnings generally are going up for most companies. In this kind of environment, you’ll naturally find more longs than shorts. If this changes—if interest rates in Europe go up rather quickly and corporate earnings begin to decline—then we’ll have the perfect environment for finding more shorts.

**Benjamin Valore-Caplan:** What does the future hold for long/short investing in general, and what’s in store specifically for long/short investing outside the United States? Will it remain a tool used primarily by sophisticated investors, or will it become more accessible to less sophisticated investors? Will regulations make it more difficult?

**Nigel Hart:** I expect more assets to be managed by hedge funds but still primarily for high-net-worth individuals and foundations. I don’t expect the net-worth requirement to change any time soon, because some hedge funds are riskier investments and require more knowledgeable investors. Still, hedge funds constitute a rapidly growing industry. They could be considered parallel to the mutual fund industry in the mid-1970s. Their largest growth is yet to come despite the net worth requirement, because people are getting wealthier and have more interest in absolute-return strategies than in relative-return strategies. I don’t anticipate any more onerous regulations. I see no justification for further regulation unless the industry experiences significant blow-ups.

**Benjamin Valore-Caplan:** What guidance do you have for investment consultants and their clients in relation to long/short investing?

**Nigel Hart:** Look at hedge funds not as a group, but go inside the hedge fund industry and look for managers who are good investors. Seek out those who are dedicated to and have a passion for this particular space, and then you’ll find the best investors for whatever type of product you want. Visit with these managers and try to understand their investment process. If, after this, you believe they are good investors, give them some capital to work with. Otherwise, stay away.

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