This article addresses the 130/30 strategy from a practitioner's point of view. The article does the following: defines basic characteristics of the strategy, covers empirical and anecdotal points relating to the popularity of the strategy, explores common themes exhibited by successful entrants in this space, and offers a brief comparison with portable alpha.

Basic Characteristics
A long-only, actively managed equity portfolio usually is comprised of equity and cash exposure. In this traditional investment process, the portfolio manager assembles his purchases to track an underlying index or benchmark. Guidelines for acceptable divergence from the benchmark are agreed upon between the investor (i.e., plan) and the manager. The expected divergence of the managed portfolio vis-à-vis the benchmark often is characterized by risk tolerance or quantitatively by a target tracking error. These issues can negatively impact a manager's ability to generate excess return.

A solution to this problem that has been gaining traction in the institutional community is a 130/30 investment strategy. The 130/30 strategy employs equal amounts of long enhanced exposure and short exposure so that the target net long exposure of the portfolio always is 100 percent. Therefore, 130/30 actually is just one example of this strategy, which also is being referred to as short extension, alpha extension, directional long/short, etc. We have seen strategies range from 110/10 to 140/40.

Constructing a 130/30 portfolio is straightforward. Assume the portfolio manager is managing a $100 mandate. The 130/30 manager buys $100 of equities; he then shorts $30 of equities. The portfolio now stands at $100 long/$30 short. The 130/30 manager uses the proceeds from shorting $30 of equities to buy an additional $30 of long equities. He now stands at $130 long equity exposure and $30 short equity exposure. The 130/30 manager has created a portfolio with a gross exposure (long exposure + short exposure) of 160 percent. The portfolio has a net exposure (long exposure - short exposure) of 100 percent, which is the same target net long exposure of a fully invested traditional manager.

Unlike absolute return oriented alternative investment strategies, 130/30 portfolios are relative return strategies that track underlying equity benchmarks. The use of enhanced long exposure and short exposure within this strategy requires the investment manager (or plan, if implemented via a separately managed account) to employ a prime broker.

Expected information ratios meaningfully improve with the use of 130/30 strategies as a result of more efficient portfolio construction. With the additional 60 percent of active weights, a portfolio manager can strive to increase expected alpha by 60 percent (or more). Beta can equal or approximate that of a comparable long-only strategy (roughly 1.00), with a tolerance built in for daily fluctuations. The expected tracking error ranges, to date, with live portfolios (from mostly quantitative managers) have been in the 2 percent to 6 percent range. As an aside, one would expect industry average tracking errors to increase as fundamental managers continue to gain traction in this strategy.

130/30 strategies can be managed against U.S., international, and global equity benchmarks and can be implemented within separately managed accounts, Investment Company Act of 1940 registered mutual funds, limited partnerships, etc.
There are more than 40 investment managers currently live with 130/30-type strategies and they are managing an estimated $50 billion or more. More managers are in the development stages. Quantitative investment managers were the early movers within the space and institutional clients were the early adopters. These managers utilized their quantitative processes and research findings to demonstrate the value-added of the strategy to institutional investors. In turn, institutions have asked other types of investment managers about 130/30 strategies. This reverse-inquiry (along with the expectation of enhanced excess returns on a risk-adjusted basis) has created a groundswell of interest in the strategy. Fundamental long-only investment managers now are beginning to explore 130/30 strategies. Alternative investment managers also are interested, and some already have launched strategies.

We have witnessed several common themes among investment managers who manage 130/30 strategies. As previously mentioned, long-only managers with an existing roster of institutional clients have been receiving inquiries on the strategy. In some cases this interest has encouraged managers to launch 130/30 strategies as a defensive maneuver toward preserving assets under management. In other cases, alternative investment managers are viewing the strategy as an opportunistic entry point to new clients and a way to accumulate plan assets. An important ancillary benefit for some historically long-only managers is that running 130/30 portfolios has increased their ability to attract and retain qualified professionals that may otherwise be lured away by alternative investment managers. Some investment managers enjoy managing money in a less constrained manner and want to grow their capabilities in the short investing space.

Fee structures have not yet normalized for 130/30 mandates, but we have seen a bifurcation occurring on the institutional side of the business. One school of thought endorses a flat management fee only structure, which compensates the investment manager based upon expected returns. The fee charged usually is commensurate with the increase in the expected return profile of the 130/30 strategy relative to the same investment manager’s long-only investment offering. The second school of thought is to add a performance fee to the base fee. In these cases, the base management fee generally is the same or at a slight premium to a long-only strategy. The additional performance fee for returns beyond the benchmark varies widely by manager.

**Ingredients for Success**

We advise investment managers on all components of 130/30 strategies, including marketing, portfolio construction, trading, investment vehicle options, and operations. We also work closely with many plan sponsors (both corporate and public) that are contemplating allocating assets into 130/30 programs. From our ongoing dialogues and experience working with clients, we have identified the following themes as ingredients for successful 130/30 products:

- Investment managers must have robust stock selection because the 130/30 strategy magnifies it. A well-thought-out process to identify candidates to short is the first step, if the investment manager will be attempting to generate alpha from short exposure. Please note that a number of investment managers are contemplating using short exposure for risk mitigation purposes only, therefore creating a 130/30 product that only expects to add alpha with the enhanced long positions.
- Because of the additional long exposure, the portfolio manager also must have excess alpha capacity on the long side to exploit the potential of a 130/30.
- Portfolio construction and risk management also take on added
TABLE 1 Differences between Portable Alpha and 130/30 Strategies

<table>
<thead>
<tr>
<th>COMPONENT</th>
<th>PORTABLE ALPHA</th>
<th>130/30</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beta</td>
<td>Low cost and selected</td>
<td>Benchmark by default</td>
</tr>
<tr>
<td></td>
<td>based on needs</td>
<td></td>
</tr>
<tr>
<td>Alpha</td>
<td>Customized and ported</td>
<td>Manager stock selection</td>
</tr>
<tr>
<td>Investor's perspective</td>
<td>Engineered return streams</td>
<td>Extends a long-only manager's ability to add alpha to a portfolio, “hedge fund with training wheels”</td>
</tr>
<tr>
<td>Implementation</td>
<td>Complex with multiple</td>
<td>Similar to actively managed equity portfolios</td>
</tr>
<tr>
<td></td>
<td>variables and instruments</td>
<td></td>
</tr>
</tbody>
</table>

130/30 versus Portable Alpha

How do 130/30 strategies differ from portable alpha products? We wish to end this article by briefly addressing a point of confusion that often arises. Portable alpha and 130/30 strategies each are appropriate for certain objectives, but they are not the same and should not be used interchangeably. The alpha and beta components, and how they are coupled, form the differences between these strategies and are laid out in table 1. Further, cost and flexibility are important factors in deciding whether portable alpha or 130/30 is more appropriate for an investor’s needs.

Conclusion

130/30 strategies are relative return products that employ gross exposure greater than 100 percent; however, they target net long 100 percent of assets and are managed to a beta of about 1.00. They continue to gain momentum with both investment managers and asset allocators because they loosen artificial constraints. Quantitative managers have achieved first-mover status in implementing the strategy, but fundamental managers are gaining traction. Plan sponsors were the early adopters but now retail products are finding their way into the marketplace. As this exciting trend gains acceptance, we expect 130/30 strategies to present the opportunity for significant asset growth for managers and an evolution of options for investors.

Michael Kilgallen is a director with Citi Global Prime Brokerage in New York, NY. He earned a B.S. in business management from Saint Peter’s College. Contact him at michael.kilgallen@citi.com.

Jason Segal, CFA®, is a managing director with Citi Global Prime Brokerage. He earned a B.A. in economics at Wesleyan University and an M.B.A. from The Wharton School, University of Pennsylvania. Contact him at jason.segal@citigroup.com.

A.J. Marazza is a vice president with Citi Global Prime Brokerage. He earned a B.S. in management at Pennsylvania State University and an M.B.A. at Carnegie Mellon University. Contact him at aj.marazza@citigroup.com.

Endnotes

1. We have seen 120/20, 125/25, and various other iterations of a leveraged long/short portfolio in place. However the industry has coalesced around 130/30 as a norm.