Debunking a View on Performance of Long-Short Equity Managers

Do long/short equity managers add/destroy value by significantly managing gross and net exposure?

Do long/short equity managers add more alpha in market drawdowns or recoveries?

Authors: Brendan James, CFA, Kristen VanGelder, CFA, and Adam Blitz, CFA

There is a view that long/short equity ("LSE") managers tend to destroy value through their exposure changes in big market moves. This belief goes even further to suggest that the magnitude of negative alpha from exposure management in stressed periods may even fully offset the positive alpha from stock selection in more benign periods. Particularly for LSE managers whose investment process focuses on bottom-up stock selection, we had historically accepted this belief, viewing large exposure changes in reaction to major market moves as neutral expected value at best, and distracting and/or value destructive at worst.

While it's easy to point to examples of managers either reducing exposures at an inopportune time or perfectly timing a market bottom, to seek to approximate the impact of exposure changes across LSE-focused managers in our data, we performed a deep dive analysis of whether exposure changes have, on average, been additive or destructive to performance. Specifically, we focused on the three most recent large (>10%) multi-month market drawdowns: Q4 2018, Q1 2020, and Jan-Sep 2022. We also looked at the recovery periods, which we subjectively defined as the 12 months following the trough month of the market drawdown. During those drawdowns and in the subsequent 12 months, we have found it most insightful to split the analysis into net exposure management and gross exposure management.

As you will see, based on our assumptions as described in this report, our analysis shows that while the view that LSE managers destroy value through net exposure management is somewhat affirmed, the magnitude is small, at only -26bps per manager per drawdown. More importantly, we found that this negative contribution was more than offset by the value added from gross exposure management during market drawdowns, with an average of 67bps per manager per drawdown over the last three (>10%) market swoons.

Net Exposure Management

Net exposure management is the more straightforward of the two calculations. For each month, we calculate how much a manager's average net exposure for that month has

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changed since the start of the drawdown. That result is multiplied by the benchmark return for that month. So, if a manager has 90% average net exposure in a given month and started the drawdown at 100% net exposure, their change in net exposure is -10%. That -10% * the benchmark return[1] = value added/subtracted for the month through net exposure management.

The calculation of average net exposure (90% in the above example) has some nuance since managers only regularly report exposure information as of a single day (month end/start of next month). While the simplest calculation would be to take an average of the start and end of month exposures, we instead weight our average 75% to the start of month exposures. We view this as a conservative assumption but not needlessly punitive. Managers' exposure management generally looks worse with a 75%/25% weighting than with a 50%/50% weighting because it suggests they are slower to react to market performance, but it's not as extreme as weighting average exposure 100% to the manager's start of month exposure, which would suggest that a manager makes no net exposure changes each month until the last day of the month.

As an example, here is one representative LSE manager's net exposure management through the 2022 drawdown (January through September 2022, plus the ensuing 12 months of recovery, measured against the S&P 500 Index ("S&P")).

Date	Start of Month Net Exposure	End of Month Net Exposure	Start of Drawdown Net Exposure	Average Monthly Exposure (75% Weighted Towards Start of Month Exposure)	Change in Net Exposure Since Start of Drawdown (Average Monthly Exposure - Start of Drawdown Exposure)
Jan-22	80.2%	72.1%	80.2%	78.18%	-2%
Feb-22	72.1%	66.1%	80.2%	70.60%	-10%
Mar-22	66.1%	70.6%	80.2%	67.23%	-13%
Apr-22	70.6%	73.5%	80.2%	71.33%	-9%
May-22	73.5%	58.1%	80.2%	69.65%	-11%
Jun-22	58.1%	60.3%	80.2%	58.65%	-22%
Jul-22	60.3%	51.9%	80.2%	58.20%	-22%
Aug-22	51.9%	53.2%	80.2%	52.23%	-28%
Sep-22	53.2%	49.0%	80.2%	52.15%	-28%
Oct-22	49.0%	52.4%	80.2%	49.85%	-30%
Nov-22	52.4%	54.5%	80.2%	52.93%	-27%
Dec-22	54.5%	55.4%	80.2%	54.73%	-25%
Jan-23	55.4%	58.9%	80.2%	56.28%	-24%
Feb-23	58.9%	64.4%	80.2%	60.28%	-20%
Mar-23	64.4%	71.3%	80.2%	66.13%	-14%
Apr-23	71.3%	74.4%	80.2%	72.08%	-8%

[1] For each of the LSE managers from our data we have chosen an individualized benchmark that, in Evanston Capital Management, LLC's subjective view, fits their strategy, such as the NASDAQ for tech managers.

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Date	Start of Month Net Exposure	End of Month Net Exposure	Start of Drawdown Net Exposure	Average Monthly Exposure (75% Weighted Towards Start of Month Exposure)	Change in Net Exposure Since Start of Drawdown (Average Monthly Exposure - Start of Drawdown Exposure)
May-23	74.4%	68.2%	80.2%	72.85%	-7%
Jun-23	68.2%	71.7%	80.2%	69.08%	-11%
Jul-23	71.7%	88.2%	80.2%	75.83%	-4%
Aug-23	88.2%	86.9%	80.2%	87.88%	8%
Sep-23	86.9%	80.1%	80.2%	85.20%	5%

And then taking the last column above to calculate value added/subtracted (calculated as: Change in Net Exposure * Benchmark Return).

Date	Change in Net Exposure Since Start of Drawdown	Benchmark Return (S&P)	Contribution From Change in Net Exposure
Jan-22	-2%	-5.17%	0.10%
Feb-22	-10%	-2.99%	0.29%
Mar-22	-13%	3.71%	-0.48%
Apr-22	-9%	-8.72%	0.77%
May-22	-11%	0.18%	-0.02%
Jun-22	-22%	-8.25%	1.78%
Jul-22	-22%	9.22%	-2.03%
Aug-22	-28%	-4.08%	1.14%
Sep-22	-28%	-9.21%	2.58%
Oct-22	-30%	8.10%	-2.46%
Nov-22	-27%	5.59%	-1.52%
Dec-22	-25%	-5.76%	1.47%
Jan-23	-24%	6.28%	-1.50%
Feb-23	-20%	-2.44%	0.49%
Mar-23	-14%	3.67%	-0.52%
Apr-23	-8%	1.56%	-0.13%
May-23	-7%	0.43%	-0.03%
Jun-23	-11%	6.61%	-0.74%
Jul-23	-4%	3.21%	-0.14%
Aug-23	8%	-1.59%	-0.12%
Sep-23	5%	-4.77%	-0.24%
			-1.30%

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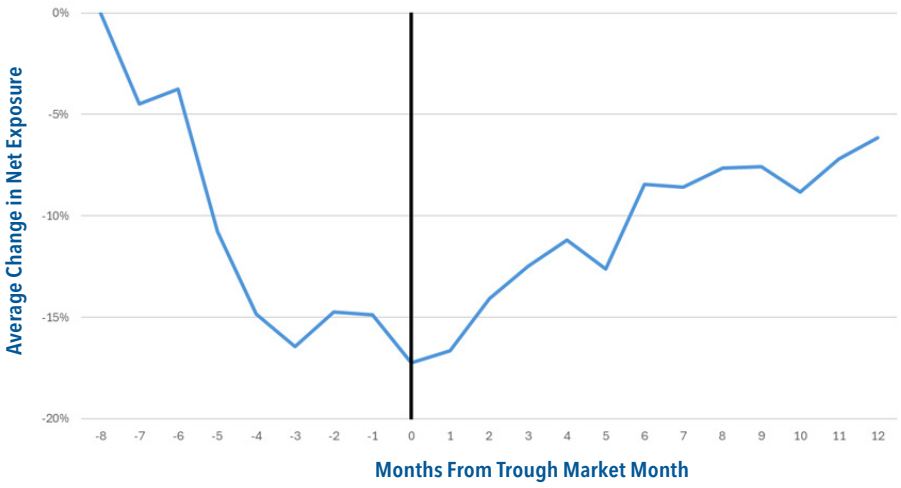
In this case, the manager lowered net exposure by as much as 30% and was back to full net exposure 10 months after the trough of the market drawdown. Primarily because of underexposure through the early months of the recovery, the manager's net exposure changes detracted value, roughly -1.30% to gross returns over that 21-month time period.

Our description above that "the manager lowered net exposure by as much as 30%..." suggests that the decision was entirely active. That may not strictly be the case, as some net (and gross) exposure changes are to be expected in a market drawdown even if the manager does nothing. For example, take a manager that has AUM of $100, is long $100 of stock, short $50 of stock, and thus has a net exposure of 50%. If all stocks drop 10%, they will then be long $90 and short $45, losing $10 on their longs but making $5 on their shorts. Their new AUM will be $95, since they've lost $5 overall, and their new net exposure will be ($90 long - $45 short) / $95 AUM = 47.36%. Even though their net exposure has dropped passively, in our analysis we do not make any distinction between active and passive changes because (1) passive changes are relatively small, even in big market moves, and (2) the manager has the power to add back exposure, so doing nothing and letting exposures change passively can itself be viewed as an active decision.

Upon completing the above analysis for each LSE manager for each drawdown period, we noted some consistency across these managers in their approach to net exposure management. In general, net exposures fell beginning in the first month of each market drawdown and then gradually recovered as markets recovered. The average path, across all of these LSE managers and all drawdown periods, is shown below:[2]

Average Change in Net Exposure Across All Long/Short Managers and All Drawdowns, Normalized to Trough Market Month



[2] Net exposure changes are "normalized to trough market month," meaning they are shown relative to when markets bottomed. The 3 drawdown periods are of different length, so this adjustment makes net exposure changes more comparable across the 3 drawdown + recovery periods.

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The speed and magnitude of these moves are different depending on the individual manager and the specific drawdown-to-recovery period. For example, in 2018 and 2022, net exposures rose more slowly during the recovery than the initial net exposure contraction; accordingly, managers ran with lower net exposure through the entire period. In 2020, this comparison was much better. Managers ran with 1% lower average net exposure during the drawdown, then 8% **higher** average net exposure during the recovery.

Drawdown Period	Average Net Exposure Change in Drawdown	Average Net Exposure Change in Recovery
2018	-4%	-8%
2020	-1%	+8%
2022	-15%	-16%

We estimate that the minimal change in net exposure in the March 2020 drawdown, and then net exposure expansion into a strong market recovery, added about 2% to managers' gross returns. In contrast, net exposure management detracted -1.6% on average in 2018 and -1.2% on average in 2022. So, in total across the three most recent market drawdowns, we believe the managers performed 0.8% worse, on average, than if they had kept net exposure steady throughout (at the same level it was directly preceding each market drawdown).

Summed up in one sentence: These LSE managers move net exposure a lot, but these moves haven't historically aggregated to meaningful performance enhancements relative to static net exposures.

Gross Exposure Management

Lowering gross exposure reduces a manager's *opportunity* to produce alpha. Simply stated, by reducing gross exposure from 100% to 70%, a manager will produce 30% less alpha (gross of fees). Of course, this statement is overly simplistic for a variety of reasons. The most impactful reason for our drawdown analysis is that the alpha expectation for a manager varies over time and different market environments. While impossible to estimate precisely, we have found some broad trends to be true. For instance, we think that LSE managers tend to have worse alpha in market drawdowns and better alpha as markets recover. Active managers on average tend to de-risk during a drawdown which can lead to names with heavier active manager ownership falling more than the market and names with heavier-than-average short interest rising more than the market. As markets settle and recover, this dynamic can revert as managers re-build positions or initiate new positions they believe have larger than normal deviation from estimated fair value. This alpha dynamic is important because the amount of alpha managers expect to produce should help determine managers' gross exposures. If a manager enters a market drawdown in which negative alpha is expected, then lowering gross exposure should add value.

All this is to explain that gross exposure management has the extra, complicating factor of *expected* alpha on top of the net exposure management analysis.

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These LSE managers, on average:

1. Had lower gross exposure during market drawdown and recovery periods;
2. Produced negative alpha from gross exposure during the drawdown phases, but then produced strongly positive alpha during the recoveries; and
3. Thus, they added value by reducing gross exposure in market drawdowns partially offset by not grossing back up quickly enough in the recovery phases.

There is significant variance manager to manager, and some of the strongest alpha producers do, in fact, gross back up quickly in recoveries. Overall, though, like net exposure, the total effect across these LSE managers and market drawdowns is fairly muted. Our average LSE manager performed about 2% better overall (gross of fees) due to their gross exposure management over the course of the three most recent, large market drawdowns.

Performance if Exposures Maintained Through Drawdown

While we like to think of net exposure and gross exposure management separately, we can take a blunt approach to this analysis and ask: how would these LSE managers have performed had they maintained the same exposures at which they entered the market drawdown? To do so, we simply gross up long and short return attribution for each month of the drawdown-to-recovery period as if such managers had maintained those initial exposure levels. This theoretical return stream is, on average, about 1%-2% worse per drawdown-to-recovery period, meaning exposure management decisions were additive to performance. This is consistent with the results of the more granular net and gross exposure analyses, where net exposure management was a slight detractor and gross exposure management was accretive and more than offset the drag from net exposure changes.

In addition to slightly better combined returns from gross and net exposure changes, LSE managers also had quite a bit lower volatility due to their active exposure management. This isn't necessarily surprising since, on average, these LSE managers lowered both their net and gross exposures. By combining the two results, it becomes clear that **these LSE managers have, on average, adjusted their exposures in a way that slightly increased returns (versus maintaining static exposures) *and* lowered volatility.**

Conclusions

While the exposure management patterns in the three equity market drawdowns we examined were consistent with our expectations, their net effect on manager performance was smaller than anticipated.

Net exposure changes from just before a drawdown to the market trough may seem large in the data presented, but over the course of a drawdown and the ensuing recovery, net exposure changes end up averaging out to 20% or less. The performance effect was mildly

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negative in 2018 and 2022 but positive in 2020, when managers, as a group, did a better job increasing net exposure after the March 2020 market bottom. Overall, net exposure management detracted 26bps per manager per drawdown over the past three large equity market drawdowns.

Gross exposure changes are different in that we think the optimal change to gross exposure does not depend upon market direction, but rather, depends on whether the manager has positive or negative expected alpha. In many cases, alpha is negative through the market drawdown phase, so reducing gross exposure is a good decision. Alpha during recoveries tends to be positive, sometimes strongly so, meaning that reduced gross exposure is an opportunity cost in those months. So, in recovery periods, the view that LSE managers destroy value through their exposure management is somewhat affirmed, although the magnitude is much smaller and hardly destructive. More importantly, we found that this negative contribution was more than offset by the value added from gross exposure management during market drawdowns. Overall, the combined effects of gross exposure management across all these LSE managers in full drawdown-to-recovery periods are positive, adding up to an average of 67bps per manager per drawdown over the past three market swoons.

Keep in mind that these numbers are based on quite a few assumptions including the drawdown dates we have chosen, defining the recovery period as exactly 12 months post-market trough, the benchmarks selected for each manager (and thus the alpha calculated), net exposure throughout the course of each month, and therefore are imprecise. That said, we believe the analysis is sufficient to conclude that active exposure management has had a positive, albeit modest, overall effect on these LSE managers' performance in these three periods.

A more concrete takeaway is that managers have reduced volatility through exposure management. On average, the LSE managers' annualized volatility was 2% lower during the drawdown-to-recovery periods we analyzed due to their exposure management decisions. This may seem obvious given the fact that managers are reducing exposures, but it is an important result given that active exposure management does not seem to have adversely affected returns. **Our analysis indicates that the LSE managers, as a group, have been able to decrease volatility *without sacrificing returns* through large equity market drawdowns dating back to 2018.**

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About the Authors

BRENDAN JAMES, CFA

Senior Vice President - Investments
Member of Evanston Capital Risk Management Committee

Brendan James is a Senior Vice President – Investments, and a member of the Risk Management Committee at Evanston Capital. He is primarily focused on portfolio management analytics and quantitative research as well as supporting the firm's private and venture capital investing efforts. Brendan previously worked at Evanston Capital from 2012-2019 and rejoined the firm in 2021. Before rejoining Evanston Capital, he was a trader at Akuna Capital, a quantitative and options-based proprietary trading firm. Brendan earned his BA in Economics and Political Science from Northwestern University and a BS in Computer Science from Oregon State University. He is a CFA charterholder and a member of the CFA Institute and the CFA Society of Chicago.

KRISTEN VANGELDER, CFA

Partner, Deputy Chief Investment Officer
Member of Evanston Capital Executive Committee, Investment Committee

Kristen VanGelder is a Partner, Deputy Chief Investment Officer, and a member of the Investment Committee. She joined Evanston Capital in 2003, became a member of the Investment Committee in 2010, and was named a Partner of the firm in 2012. She has more than 20 years of alternative investment experience, including manager selection, asset allocation and portfolio construction. She leads the firm's research efforts to source and evaluate prospective investments and to monitor and manage existing investments. She is also responsible for making position-sizing and portfolio construction recommendations. Kristen earned a BA in Economics from Northwestern University. She is a CFA charterholder and a member of the CFA Institute and the CFA Society of Chicago.

ADAM BLITZ, CFA

Founding Partner, Chief Executive Officer & Chief Investment Officer
Member of Evanston Capital Executive Committee, Investment Committee

Adam Blitz is a Founding Partner, the Chief Executive Officer, Chief Investment Officer, and a member of the Investment Committee of Evanston Capital. He has more than 25 years of institutional investment management experience with an emphasis in quantitative analysis, trading and risk management. Prior to helping establish Evanston Capital, he worked in the Prime Brokerage area at Goldman, Sachs & Co., where he was responsible for developing, selling, and managing funding and financing products to offer to hedge funds. He also worked closely with the risk management group within Prime Brokerage, which is responsible for determining the appropriate amount of leverage to extend to hedge funds from both a regulatory and risk-based perspective. Before joining Goldman Sachs, he was the Head Trader at AQR Capital Management, a multi-strategy quantitative investment manager. At AQR, Adam was responsible for implementing all of AQR's market-neutral strategies and traded a wide variety of financial instruments, including equities, bonds, currencies, futures, and swaps. Adam also assisted in risk management and strategy research at AQR, including extensive modeling and analysis of strategy and fund-level volatilities and correlations. Adam also was previously employed in the Asset Management Division at Goldman Sachs, where he was a member of the Quantitative Research group. Adam earned his BS in Economics from the University of Pennsylvania's Wharton School. He serves as a member of the Board of Advisors of Northwestern University's School of Education and Social Policy, is a CFA charterholder, and is a member of the CFA Institute and the CFA Society of Chicago.

evanstoncapital

1560 Sherman Avenue, Suite 960 | Evanston, IL 60201
P. 847-328-4961 | F. 847-328-4676 | E. investorrelations@evanstoncap.com
www.evanstoncap.com

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