BlackRock®

Time to throw off the long-only habit?

A case for long-short investing with Australian shares

FOR FINANCIAL ADVISERS

Australian shares have been a big part of many Australians' portfolios for years. Upbeat returns over many years and franking credits drove the case for Australian shares. However, 2008's GFC and following aftershocks seem to have caused investors to rethink their Australian share exposure.

Long-only investing is like to going on to the tennis court with one hand tied behind your back.

'Shorting' provides a potential way to make money when share prices fall.

Australians appear to have lost confidence in shares and are instead opting for capital preservation. The safety-first attitude is understandable. The S&P/ASX 200 Accumulation Index fell -6.7% over the five years ending 30 June 2012.

But rather than giving up, we think it is possible to achieve impressive returns from Australian shares. We reject the notion that it is impossible to achieve good returns in a challenging investment climate.

It's time to stop blaming the topsy-turvy Australian equity market. It is possible to achieve strong returns from Australian shares even when things are choppy.

We think that long-short investing is a potential answer in a new world of lower market returns and higher volatility.

Throw off the long-only straightjacket

Our view is that long-only investing can sometimes be a very restricting investment approach. It means giving up a large part of the insight gained from analysing companies.

Long-only investing is equivalent to going on to the tennis court with one hand tied behind your back.

At any point in the investment cycle, there are always companies that are likely to underperform. Being able to act on negative views (by shorting) gives the investment manager another way of trying to add return and managing risk.

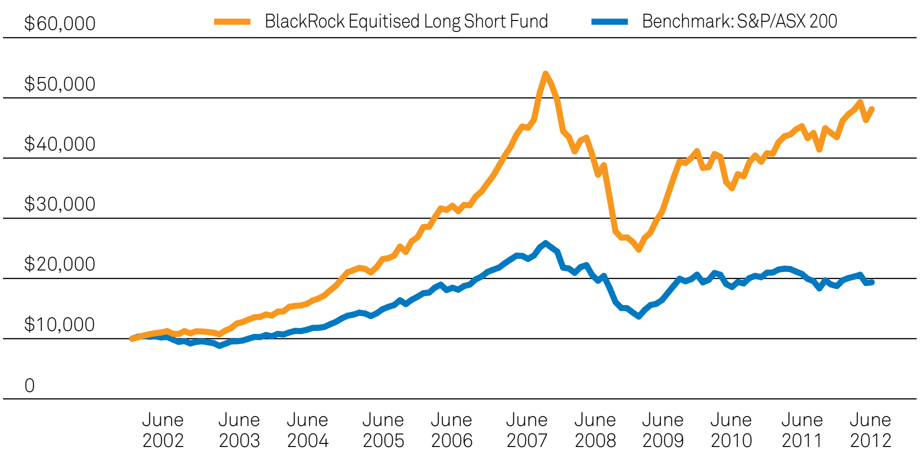
A new way of acting is needed

It's likely that your clients have thought that the only way to succeed in the Australian sharemarket is to own outperforming stocks and underweighting losers. But the return potential (both positive and negative) from the traditional long-only approach pales in comparison with the potential returns (both positive and negative) from combining long investing with shorting.

We know that long-short investing can work. We have been managing long-short Australian strategies for institutional clients for more than a decade and now manage long-short strategies for retail investors too.

Take a look at the chart below. It shows the performance of the S&P/ASX 200 Accumulation Index and the BlackRock Equitised Long Short Fund from the Fund's inception on 18 December 2001 to 30 June 2012. Retail investors have access to the BlackRock Equitised Long Short Fund's investment strategy through the BlackRock Australian Equity Opportunities Fund, which invests in, and has the same underlying strategy as, the BlackRock Equitised Long Short Fund*.

Cumulative performance (BlackRock Equitised Long Short Fund) versus S&P/ASX 200 Accumulation Index



Past performance is not a reliable indicator of future performance. Returns are calculated before fees and taxes and assume reinvestment of distributions as at 30 June 2012. Net performance of the BlackRock Australian Equity Opportunities Fund and the BlackRock Equitised Long Short Fund will vary due to fee differences. Inception date is 18 December 2001.

The BlackRock Equitised Long Short Fund's strong track record does not mean that long-short investing is a guarantee of success. That's not the case. It does, though, show that long-short investing has been capable of delivering significantly above-market returns in challenging investment conditions.

Explaining shorting is not the easiest thing in the world and so we thought we would help the client education cause by explaining in a little more detail how shorting works.

Explaining short-selling to your clients

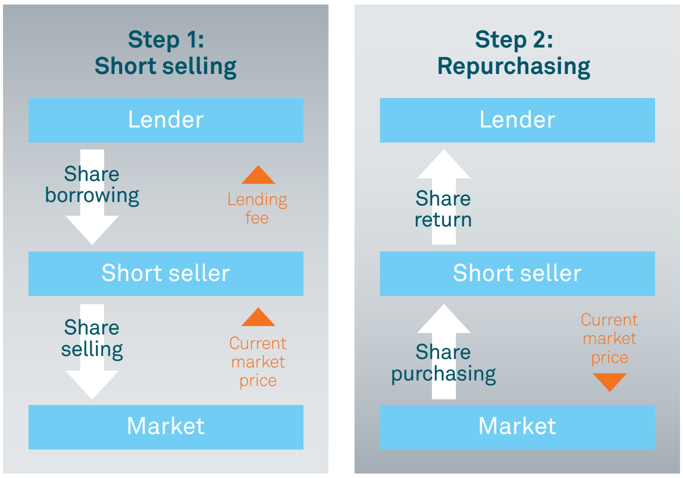
The concept of short selling shares is neither new nor unusual, having been around since the early days of share markets.

Most stock markets and countries have rules and laws that regulate short selling.

A short seller borrows a company's shares (from an investment bank or broker, for example) and then sells them, with the intention of buying them back at a cheaper price.

Thereafter, the short-seller returns the loaned shares back to the lender and books profits from the transaction, as the figure below shows.

Mechanics of short selling



Source: BlackRock

A hypothetical example of the short selling process works something like this:

An investment manager may have been tracking a mining company, Company A, through 2011 and is struck by its impressive earnings profile and share price performance. At the same time, though, the investment manager becomes convinced that due to slowing Chinese demand, raw materials prices will soften. They think that Company A's earnings growth and share price will taper off.

To act on this belief, the investment manager decides that they want to short sell Company A's shares in September 2010. However, the manager does not own any of Company A's shares. This is overcome by borrowing the shares from a Company A shareholder who lends them for a fee; say 1% p.a. (in the same way banks charge borrowers). The manager then sells the shares.

The proceeds from selling Company A shares in September 2011 at $22.00 per share (for example) are placed on deposit at money market rates, of 5% p.a. for illustrative purposes. Interest income accrues to the manager, the short seller.

Any dividends declared on the borrowed Company A shares accrue to the lender. Over the year to September 2011, the dividends declared are 48c and 29c per share.

The manager buys back the shares in September 2011 at $15.00 per share, and returns them to the stock lender to close the transaction.

In summary, the manager makes $7.00 on the trade, receives 5% * $22.00 = $1.10 in interest, pays $0.77 in dividends, and pays 1% * $22.00 = $0.22 in borrowing fees. Thus, the profit on the hypothetical trade is $7.00 + $1.10 - $0.77 - $0.22 = $7.11.

On the other hand, if the share price went up, the manager would lose money. Say that in September 2011 Company A announced a dramatic improvement in sales and a positive outlook for 2012. The share price rises to $25.00, and the manager, believing the share price will continue to rise, buys back the shares and loses $3.00 on the trade. The profit on the hypothetical trade would then turn into a loss of ($3.00) + $1.10 - $0.77 - $0.22 = ($2.89).

The "New World" is here to stay. The time to join is now

Many of the old ways of investing aren't working as well as they once did. Long-only investing may be one of them.

We think it's time to embrace ways that are better suited to these times. Long-short investing with Australian shares is one of them, in our view.

Before deciding whether to invest in a long-short investment strategy, investors should speak to a financial or other professional adviser to ensure that they fully understand the risks associated with such strategies, including the risks associated with short selling.

Further information

www.blackrock.com.au

*The BlackRock Equitised Long Short Fund is only available to wholesale clients.

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