Thornburg's Approach to Long/Short Equity

A conversation with portfolio manager Connor Browne, CFA, on Thornburg's new liquid alternative product

Connor worked on Thornburg's growth portfolios before being named managing director and portfolio manager of Thornburg Value Fund and U.S. Equity Strategy in 2006. He has also been portfolio manager of Thornburg Long/Short Equity Strategy since its 2008 inception. Connor began his career at Thornburg as an intern in 2000 and joined the investment team full-time in 2001. He graduated cum laude from Princeton University with a BA in economics and a certificate in finance.

Q: What type of investors should consider the Thornburg Long/Short Equity strategy?

Connor Browne: First, we think the product should appeal to allocators who employ LP structure long/short equity hedge funds today that come with heavy incentive fees, little transparency, and limited liquidity. We're offering the same product, but at a lower price, with more transparency and greater liquidity.

Second, for individual investors who have enjoyed a long run up in U.S. equity markets, it makes sense to start protecting against a pullback and to reduce the market risk in their portfolio. In today's very low interest rate environment, it could be risky to do that just by moving some equity exposure into bonds.

We use the broad investment team here at Thornburg to source investments both long and short, working to create a portfolio that can generate equity-like returns over-the-cycle, but with significantly less market exposure than broad equity stock indices.

Q: You mentioned fees. Hedge funds for the most part are expensive and in terms of performance seem to have over-promised and under-delivered. What's different in Thornburg's Long/Short Equity portfolio?

CB: In the institutional marketplace, we think investors are frustrated with the traditional hedge fund model. We provide this new vehicle as an alternative that offers the same solution without an incentive fee. The traditional hedge fund compensation structure is 2% of total asset value and 20% of earned profits. Our fixed management fee of 1.25% is much lower.*

I also think investors—both institutional and retail—are interested in transparency as well as liquidity, being able to sell or liquidate their investments when they choose, rather than being locked up and limited to quarterly redemptions, as most hedge funds require.

Q: In terms of asset allocation, how does the Long/Short Equity strategy fit within the typical investment portfolio?

CB: It's a risk diversifier, particularly a downside risk diversifier. By investing both long and short, we're able to create opportunities to add value through our stock selection, and, in our experience, with significantly less risk than the overall market. Again, over the long term, over a full market cycle, we're working to achieve broad equity index-like returns with significantly less risk.

*See page four for additional information.

Q: What are the mechanics of that in practice?

CB: The Long/Short Equity portfolio generally has a net equity exposure between 30% and 50%. Over time, the beta—or the market-related risk—should be in line with our net exposure. That is to say, you should expect a beta of between 0.3 and 0.5 for the strategy against the S&P 500 Index.

How do we keep the beta so low? Let's say we receive $100 from a new investor. We're actually investing more than $100 in stocks we believe will go up in price, or long. At the end of the second quarter we had about $106 invested long for every $100 in assets. Meanwhile, we will also invest in stocks that we believe will go down in price, or short. At quarter end, we had about $75 invested short for every $100 in assets.

By being $106 long and $75 short, we've reduced our net exposure to the market's gains or losses to about $31 ($106 minus $75 equals $31)—that's how we calculate net exposure. If we were providing no value with our stock picking, and the market went up 10%, you might expect us to go up 3%. And if the market went down 10%, you might expect us to go down just 3%. That's the net exposure of the portfolio. It's a really important measure of the portfolio's positioning.

Keep in mind, the primary source of risk in an equity investment is whether the markets are going up or down. Usually, the principal component of upside or downside in a stock is its correlation to the market and what the market is doing.

But as active managers we're working to add value with stock selection, which we have found can generate more return than just broad equity markets would, or interest rates would in the case of fixed income. We're taking $100, investing it almost twice, in stocks we expect to go up and in others that we expect to go down. We're limiting our expected beta to half while creating the opportunity through active management for interesting, real returns.

Q: The S&P 500 is obviously long only. Is there a better benchmark against which to compare the Long/Short Equity strategy?

CB: Part of the reason I like the S&P 500 is that a manager shouldn't get credit for downside protection against an index unless you compare yourself to that index in all environments. We think that we've done a good job of adding value with active management through stock selection in what has not been the ideal market environment for a low net-exposure strategy. That can be measured when you look at our results on a risk-adjusted basis versus the S&P 500.

We've also compared our results to the HFRI Equity Hedge Index, and we of course measure ourselves against our peer group, the Morningstar Long/Short Equity Category as well. Our results have looked strong against both peer groups over just about every period. But I believe the most relevant way to look at returns is relative to broad market indices, mainly the S&P 500, over a full market cycle.

When we examine our performance over shorter measurement periods, we look at the total returns of both our long book and our short book relative to the S&P 500, to see whether we're adding value on each side of the book. A rough way to think about the combination of that would be to take our net equity exposure and multiply that by the S&P 500 return for a given period to see if we're adding value above or below what you'd expect based on our long and short exposures.

Q: Can you describe your investment process?

CB: We harness the investment research engine here at Thornburg to thoroughly understand a business. Roughly a dozen different analysts cover one stock or another in the long book. So our investment process is similar to that of the other strategies at Thornburg—a fundamentals-based, bottom-up process, both quantitative and qualitative in nature. Our work as generalists across geographies, sectors, and asset classes applies to the Long/Short strategy as well. And in addition to our dedicated research for the Long/Short Equity portfolio, we get leads and benefit from the broader Thornburg investment team's work on companies, both those that we already know or that are being checked out for the first time. If another strategy here thinks a stock might be overvalued, they let us know, and we can do further research to potentially flesh out a short thesis.

We always invite the entire Thornburg investment team to all of the pitches for stocks that will go into the strategy, both on the long and short side. In fact, we get pretty good participation, even though this is the only Thornburg strategy that could benefit from a short pitch. We usually have quite a few other team members who notice things, know the area, or have invested in the stock's competitors, suppliers, or customers. They want to learn more and to add value to our investment research in prospects on the short and long sides.

Q: Do ideas start as short or long ideas?

CB: Both.

Q: Between the long and short buckets, which is contributing more alpha?

CB: Both have contributed significant alpha, especially over the last five years. After two great alpha generation years on the short side (2015 and 2016), we've had a tougher time on the short side so far in 2017, but strong performance this year on the long side. Longer term, we've generated strong alpha on both sides of the book.

Q: Talk about the number of stocks in both the short and the long books.

CB: Our long book tends to have 30 to 40 holdings, which is about where we'd expect to run our focused portfolio. Usually our largest weight is between 5% and 10%.

The short book will also be comprised of 30–40 stocks, with an average weight of about 2%, which is lower than the average weight on the long side.

Q: What are your overseas exposures?

CB: Today, about 85% of our gross exposure is U.S., so 15% of our gross exposure would be ex-U.S. But, our net exposure would be almost all U.S., because we're short as much stock outside the U.S. as we are long.

We like having the flexibility to go outside the U.S., but we'd typically expect to be majority U.S. focused.

Q: Is the Long/Short Equity strategy allowed to take small short or long positions in debt securities?

CB: Yes, though those positions have been small. There's usually been at least one such holding over time, but even when there's been more than one, the total exposure has always remained less than 10%. It's usually less than 5%.

Q: How are stock baskets used within your long as well as your short books?

CB: The long book broadly could be described as "growth at a reasonable price," though broken down into our three baskets: growth industry leaders; consistent growers; and emerging growth companies.

Q: What are the usual weights of those baskets?

CB: They vary. We want to have exposure to each of those baskets. But the most important thing, we think, is to line up our short baskets reasonably well with our long baskets. We want to make sure that we have a diversified portfolio in the long book as well as in the short book, and that the diversification of our short book looks something like the diversification of our long book, so that we can have protection in different types of environments.

Our short baskets comprise "cycle victims," which are sensitive to market downturns or adverse trends in their businesses, which may have benefited from secular growth tailwinds. But as we've seen in a number of industries, the winds can shift as new technologies start to disrupt the older ones, or perhaps the older ones become commoditized.

The "stumbling stalwarts" basket includes companies that are less cyclical in nature and the market is giving them a high valuation for apparently being very protected and consistent. But we think that may not be the case.

And the "falling stars" basket has high growth companies trading at very high valuations that, for one reason or another, we think are facing competitive threats or where their addressable end-market is not as large as the stock market is implying.

Q: Do you also shoot for a rough parity in the long and short books in terms of market capitalizations?

CB: Yes. We have 180% gross exposure and a bit over 30% net long exposure, about half that of our peer group average.* So, when you take longs and subtract out the shorts, all you have left is around 30%. As you're adding up to the 30%, our small-caps net out to zero, while our mid-caps net out close to zero. Our net exposure, therefore, is mainly large-cap and to a much smaller degree mid-cap long.

Q: Are there parameters for allocating by stock market capitalization?

CB: We don't have hard limits, but we do have historic ranges around our small-, mid-, and large-cap exposures. The vast majority of our net exposure currently is large partly because small caps are riskier. We're always mindful of how much net exposure we have to small caps.

We're very mindful of risk in the portfolio generally, whether it's geographic, sector, market cap, or various factor risks. We don't have explicit limits on any of these types of exposures. But we're always mindful of them and strive to strike the right balance between them. ■

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*As of 6/30/2017. Subject to change. Visit thornburg.com for the most current information.

Liquid Alternative Offerings

Thornburg Long/Short Equity Strategy

- Mutual Fund: THLSX
- Institutional Separate Accounts

As of 6/30/2017, the Thornburg Long/Short Equity Fund's expense ratio was 1.50%, excluding shorting costs. Per the most recent prospectus the total annual fund operating expenses are 3.01%. Thornburg Investment Management and/or Thornburg Securities Corporation have contractually agreed to waive fees and reimburse expenses through at least February 1, 2018, resulting in a net expense ratio of 2.74%. For more detailed information on fund expenses and waivers/reimbursements, please see the fund's prospectus.

HFRI Equity Hedge Index is an equal-weighted performance index composed of strategies that maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. Equity Hedge managers would typically maintain at least 50% exposure to, and may in some cases be entirely invested in, equities - both long and short.

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Investments carry risks, including possible loss of principal. Additional risks may be associated with investments outside the United States, especially in emerging markets, including currency fluctuations, illiquidity, volatility, and political and economic risks. Investments in small- and mid-capitalization companies may increase the risk of greater price fluctuations. A short position will lose value as the security's price increases. Theoretically, the loss on a short sale can be unlimited. Investments in derivatives are subject to the risks associated with the securities or other assets underlying the pool of securities, including illiquidity and difficulty in valuation. Non-diversified funds can be more volatile than diversified funds. Investments in the Fund are not FDIC insured, nor are they bank deposits or guaranteed by a bank or any other entity.

Morningstar Long/Short Equity Category – Long/short portfolios hold sizeable stakes in both long and short positions in equities, exchange traded funds, and related derivatives. At least 75% of the assets are in equity securities or derivatives, and funds in the category will typically have beta values to relevant benchmarks of between 0.3 and 0.8 over a three-year period.

Upside/Downside Capture Ratio – A ratio that shows whether a given fund has outperformed—gained more or lost less than—a broad market benchmark during periods of market strength and weakness, and if so, by how much.

The S&P 500 Index is an unmanaged broad measure of the U.S. stock market.

Alpha – A measure of the difference between a portfolio's actual returns and its expected performance, given its level of risk as measured by beta. A positive alpha figure indicates the portfolio performed better than its beta would predict. In contrast, a negative alpha indicates under-performance, given the expectations established by the beta.

Beta – A measure of market-related risk. Less than one means the portfolio is less volatile than the index, while greater than one indicates more volatility than the index.

Shorts (or short position) – When shorting, an investor sells a borrowed security with the expectation its price will fall. At a future time, the investor purchases the security (ideally at a lower price than borrowed) and returns it to the original broker. A short position refers to a security that has been borrowed and sold (shorted), but not yet repurchased.

Before investing, carefully consider the Fund's investment goals, risks, charges, and expenses. For a prospectus or summary prospectus containing this and other information, contact your financial advisor or visit thornburg.com. Read them carefully before investing.