The long and short of it: how to play the US market

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Nothing can go up forever, not even the US equity market. But who stands to benefit when things go from FAANGs-fuelled overdrive to a more challenging climate?

'Most of the time – and this is for both sides of the equation – you want a really good investment idea and a really good stock, or a really bad investment idea and a really bad stock,' says Christopher Hillary, who runs the Prosper Stars & Stripes fund on mandate.
'If we look at how the market is changing, the alpha opportunities over the next one to three years are going to be much better than those we saw over the last one to three years. I mean that with an emphasis on the short side.'

Hillary, who is CEO of Colorado-based Roubaix Capital, says the US market will come under increased pressure as the Central Bank removes its supportive strategy. This means many companies which have benefitted from an ultra-accommodative market will become prime shorting opportunities.

'Today's conditions are very different to what we would have encountered 20 to 30 years ago,' he says. 'We have seen a strong move away from value towards growth, which has meant some companies, aided by loose monetary policy, are highly levered.

'With rates rising and quantitative tightening coming into effect, these companies now look vulnerable. Central banks, which up until now have bought $100 billion in the market, will have to sell and that's going to have a huge impact. Similarly, tax reforms, which are long overdue, will also change the way businesses function.

'As we move into 2019, we are going to see a one-time change in business dynamics, and some US companies will struggle to adapt.'

Vulnerable sectors

The top-performing long/short fund dedicated to the US equity market over three years is the Threadneedle American Extended Alpha fund, run by Ashish Kochar and Amit Kumar.
Citywire AA-rated Kochar returned 27.6% in US dollar terms over the three years to the end of November 2018, while the average manager in his peer group lost 3.4%. His co-manager Kumar has authored a book on short selling and believes conditions are ripe for this strategy.

'Concerns about a slowdown, an inverted curve, and a recession have risen in recent months and the Fed is now increasingly expected to slow down on rate hikes.

'Consequently, macro sensitive sectors such as banks have fallen quite a bit recently. Our shorts in semiconductors, banks, energy, and consumer discretionary have performed well against this economic backdrop.'

Looking ahead, Kumar believes market correlations and volatility have increased in recent months making it more difficult for long-only investments, while long/short funds should benefit from hedging via their shorts.

'As we head into 2019, we believe two kinds of companies should outperform: those with strong balance sheets and rich cash positions, and those with disruptive growth potential that have a clear runway for growth over next few years.

'Conversely, companies with leveraged business models are likely to struggle if the high interest rate environment continues,' he says, echoing Hillary's focus on firms which have benefited from market support.

Single-stock opportunities

Charles Kantor, who runs the Neuberger Berman US Long Short Equity fund, says there are likely to be single stocks which can be capitalized on in the US market as the environment changes.
'In general we are seeing more single-stock opportunities driven by a mix of higher earnings, volatility and lower average stock correlations.

'These conditions create more idiosyncratic opportunities – both long and short – in the US equity market, which partly explains our higher-than-average gross exposure in excess of 130%,' he says.

'Most recently, we've tended to focus on individual company shorts in sectors that we believe have greater dispersion; in other words, where we can discover idiosyncratic opportunities to differentiate between "winners" and "losers".

'For example, this year [2018] our largest short exposure has been in the consumer discretionary and IT sectors, where we have seen wide gaps in performance for those companies investing for the future versus those that we believe are falling behind. The single-name short-book performance has exceeded our expectations.'

Much like his long/short peers, Kantor says 2019 will be a year where the finer points of the market will be key. 'We believe the "details" will increasingly matter and investors will allocate capital with heightened selectivity.

'As a result, hedged equity strategies, particularly those with a focus on company-specific fundamentals, consistent exposure management and a consistent team and process, make sense as a way for investors to participate in equity markets while mitigating downside risks.'

Balanced approach

AllianceBernstein's Kurt Feuerman agrees there are good opportunities but the Citywire AA-rated manager, who runs the AB SICAV I-Select Absolute Alpha fund, believes having the ability to short the US market is not a golden ticket to returns in 2019.
'In the years following the global financial crisis, the market for shorts has been challenging,' he says. As such, the team has had less short exposure, both to individual stocks and markets, instead preferring more gross long exposure to participate in the market's upside.

'Prior to the global financial crisis, shorts were more favorable, both in the tech bubble and in the years leading up to 2008. It's important to note that when shorting individual stocks, the team focuses on identifying companies with challenged fundamentals.'

Recent areas of success for Feuerman have been in the commercial and retail real estate sectors, which he has tapped through shorting trusts. As consumption trends change, Feuerman believes there could be more pain ahead for bricks-and-mortar firms.

'Technology is disrupting the way we live and work and rising rates may pose challenges for levered businesses. This, in our view, will negatively impact retail and commercial real estate companies as fewer people frequent bricks-and-mortar stores and as companies need less office space.'

Feuerman is largely positive on the potential of the wider US market in 2019, but he expects growth to slow and challenges to come to the fore.

'US equity valuations continue to look attractive, especially following recent volatility, and capital return should continue to be a supporting factor for the market. While we believe lower levels of absolute returns could be expected going forward, we aren't seeing the excesses that typically precede recessions.

'We recognize that the market is not without its issues, including geopolitical events, trade developments, housing, autos, oil prices, and Fed policy.

'These events are likely to create attractive long and short opportunities and we will continue to optimize the portfolio's exposures in response to changes in the macro narrative. At the moment, we are favoring balanced exposure to cyclical, secular growth, and defensive stocks,' he says.

*NOTE: This article is part of the **State of the Nation** publication which came out in January 2019.*