In this presentation, I begin by providing an intuitive explanation of the basic long–short portfolio, sometimes called the market-neutral portfolio. I outline several guidelines for success in using the long–short method of portfolio construction and then discuss the challenges involved with long–short investing. Although long–short investing is exciting and long–short managers have moved up the learning curve, successful long–short investing is no walk in the park. Focusing on the details and getting the nuances right are incredibly important. I summarize by discussing the acute need for genuine innovation in the world of long–short investing.

Long–Short Investing

Investment management is evolutionary. For example, the defined-benefit pension fund community, which is typically a conservative lot, has gone through a dramatic transformation in its equity investing approach. In Peter Bernstein’s Capital Ideas, he discusses the evolutionary nature of investment management.1 In the 1970s, stock selection was prevalent; in general, investors ignored benchmarks. In the 1980s, however, investors embraced benchmarks (and hence index funds). In the 1990s, investors wanted both active management and systematic elements, so the benchmark became embedded in an active portfolio. Since 2000, the active systematic model has been transcended and investors are again seeking to extract the benchmark from the active portfolio. Consequently, systematic investment managers are offering pension funds a range of structured product options, such as long–short plus asset exposure along with core portfolios and active diversification (so-called completeness funds).

Myth and Reality. Investors are much more comfortable today with the idea of shorting stocks than they were 10 years ago. The focus on educating investors has helped them expel their irrational fears of shorting (and to a certain extent their fear of leverage), which has allowed them to shift their focus to rational fears. Long–short (also known as market neutral, zero beta, and bi-alpha) is not an asset class or strategy; rather, it is a method of portfolio construction. Long–short offers a higher return than conventional long-only active management because it has a higher information ratio (Sharpe ratio). In long–short, the benchmark is extracted to make it a more efficient strategy. Essentially, a traditional long-only active

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Editor’s Note: The joint Question and Answer Session of Mr. Freeman, Lee S. Ainslie III, and Marc Lasry appears at the end of Mr. Lasry’s presentation.
strategy can be represented as a combination of a long–short portfolio with some asset class exposure.

**Mechanics and Mathematics.** In long–short, investors expect to profit from both the relative outperformance of the long holdings and the underperformance of the short holdings. They also expect to benefit from the uncorrelated risk of the long and short holdings. When the two separate strategies are combined, additive properties appear on the valuation side of the portfolio and diversification properties appear on the risk side, which increases the Sharpe ratio for the long–short strategy. For example, suppose the alpha of the longs is 2 percent and the alpha of the shorts is 2 percent. The alpha of the long–short strategy is 4 percent:

$\alpha_{long} = 2\% \quad \alpha_{short} = -2\% \quad \alpha_{combined} = 4\%$

The risk of the long–short portfolio, however, equals the square root of the risks squared. So, if the risk of the longs is 2 percent and the risk of the shorts is 2 percent, then the risk of the portfolio is 2.8 percent:

$\sqrt{2\%^2 + 2\%^2} = 2.8\%$

The *caveat emptor* is that compared with a long-only portfolio, long–short may mean less risk *per unit of alpha* but still results in more risk because twice as much capital is being actively managed.

An important problem with the institutional use of long–short strategies is that many institutional investors have not yet determined their level of risk tolerance. For example, remember how many plan sponsors terminated out-of-favor value managers in 1999 because value strategies were perceived as too risky? Because of their organization structure, the strong influence of outside board members, and the pressure to achieve near-term performance, the comfort level is just not there yet for institutional investors to use more-aggressive strategies, including long–short. Collectively, long–short managers need to continue their efforts to educate and reassure many institutional investors.

**Deadweight.** Deadweight is the drag on performance caused by traditional benchmarks and is the bane of traditional active management. Deadweight is any portfolio holding at or below benchmark weight. Deadweight is a problem for long-only active managers who choose to embed the benchmark in the portfolio to lower tracking error risk, but deadweight can be avoided with a long–short strategy.

When I started working at Barra in 1985, I did a research project for Barr Rosenberg. He asked me to construct a portfolio that had very low tracking error and very high alpha. Such a portfolio seemed incongruous to me, but he contended that risk forecasts and alpha forecasts are independent. Theoretically, I believe his position, but its implementation is a challenge. To construct a portfolio with low tracking error and high alpha, more of the benchmark—say, the S&P 500 Index—has to be forced into the active strategy to reduce portfolio risk. Ultimately, if the portfolio has only 40 bps of tracking error, it will look almost exactly like the S&P 500. So, for the portfolio to earn 400 bps of added value, the payoff on the remaining active bets has to be heroic. A paradox of increased risk management is that encouraging managers to embed more of the benchmark into the portfolio makes their strategies increasingly capital inefficient.

Two types of deadweight exist. The first is positive hurdle: the capital needed to reach benchmark weight prior to a positive active position. For example, if an investment manager likes Microsoft Corporation and wants to take a 2 percent active position and Microsoft is 5 percent of the benchmark, 7 percent of the client’s capital is needed to create a 2 percent active bet. The other type of deadweight, defensive drag, is any position below benchmark weight in an active portfolio. If the manager does not like Microsoft and wants to take a 2 percent bet against it and Microsoft is 5 percent of the benchmark, the manager still has to invest 3 percent of the client’s capital to achieve that underweight. That is, the manager must invest in a stock that he or she expects to underperform.

When managers report to clients, they think in terms of the 10 largest positions in their portfolio. But the 10 largest positions are not germane to an active manager’s mission. Active managers need to think in terms of their 10 largest *active* positions. For example, in Table 1 the largest active bet is in General Electric Company (4 percent underweight). Note that some of the active portfolio bets are zero (e.g., Philip Morris Companies). The manager of this portfolio has a 2 percent positive active bet in Intel Corporation, but the manager had to use 9 percent of the client’s capital to build the Intel position to the benchmark weight before establishing the active bet. The cumulative deadweight column shows that 91 percent of this client’s capital is invested either in an index-weight position needed to achieve a positive active bet (active hurdle) or in a stock that the manager expects to underperform (defensive drag).

The benchmark for a long–short portfolio is typically 90 day T-Bills or LIBOR, neither of which has any security positions; any position taken either long or short immediately becomes an active bet, as shown.

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in Table 2. The manager can buy the benchmark through futures and can create the 9 percent long position with cash generated by selling stock to create the 9 percent short position. The manager can recreate the same bets as the traditional active portfolio illustrated in Table 1 with basically one-tenth of the client’s capital. Thus, long–short strategies are much more capital efficient than traditional strategies.

**Unwritten Rules.** The “club” of institutional long–short portfolio management has several unwritten rules. In general, leverage is limited to a maximum of 2:1. Institutional investors want to maintain dollar neutrality, as well as beta neutrality, between the long and short positions. Investors want careful control of the net industry and/or sector exposures in the portfolio. To the extent possible, investors want their managers to minimize the capitalization bias of the long versus the short, diversify holdings across the portfolio (more than 100 positions per side), and in general, have a target annual volatility of less than 8–10 percent a year.

Because investors’ fear of excessive turnover still exists (a largely irrational fear because the cost of trading has dropped significantly in the past 10 years), institutional investors encourage managers to impose ceilings on the number of transactions and the amount of turnover. Institutional investors also ask managers if they are willing to cap their assets

### Table 1. Benchmark and Portfolio Weights and Ensuing Deadweight of Traditional Portfolio

<table>
<thead>
<tr>
<th>Company</th>
<th>Benchmark Weight</th>
<th>Portfolio Weight</th>
<th>Active Bet</th>
<th>Active Hurdle</th>
<th>Defensive Drag</th>
<th>Cumulative Deadweight</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Electric Company</td>
<td>12%</td>
<td>8%</td>
<td>-4%</td>
<td>8%</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
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<td>-1</td>
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<td>9</td>
<td>17</td>
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<td>9</td>
<td>11</td>
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<tr>
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<td>12</td>
<td>3</td>
<td>9</td>
<td>35</td>
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</tr>
<tr>
<td>Microsoft Corporation</td>
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<td>8</td>
<td>-1</td>
<td>8</td>
<td>43</td>
<td></td>
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<tr>
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<td>7</td>
<td>-1</td>
<td>7</td>
<td>50</td>
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</tr>
<tr>
<td>Philip Morris Companies</td>
<td>7</td>
<td>7</td>
<td>0</td>
<td>7</td>
<td>57</td>
<td></td>
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<tr>
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<td>0</td>
<td>7</td>
<td>62</td>
<td></td>
</tr>
<tr>
<td>IBM</td>
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<td>8</td>
<td>2</td>
<td>6</td>
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<td>5</td>
<td>0</td>
<td>5</td>
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<td></td>
</tr>
<tr>
<td>Johnson &amp; Johnson</td>
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<td>6</td>
<td>1</td>
<td>5</td>
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</tr>
<tr>
<td>Bristol-Myers Squibb Company</td>
<td>4</td>
<td>5</td>
<td>1</td>
<td>4</td>
<td>82</td>
<td></td>
</tr>
<tr>
<td>AT&amp;T</td>
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<td>3</td>
<td>-1</td>
<td>3</td>
<td>85</td>
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</tr>
<tr>
<td>DuPont</td>
<td>4</td>
<td>5</td>
<td>-1</td>
<td>4</td>
<td>91</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100%</strong></td>
<td><strong>100%</strong></td>
<td><strong>0%</strong></td>
<td><strong>37%</strong></td>
<td><strong>54%</strong></td>
<td><strong>91%</strong></td>
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</table>

### Table 2. Benchmark and Portfolio Weights and Ensuing Deadweight of Long–Short Portfolio

<table>
<thead>
<tr>
<th>Company</th>
<th>Benchmark Weight</th>
<th>Long Portfolio</th>
<th>Short Portfolio</th>
<th>Active Hurdle</th>
<th>Defensive Drag</th>
<th>Cumulative Deadweight</th>
</tr>
</thead>
<tbody>
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<td>-4%</td>
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<td></td>
</tr>
<tr>
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<td>-1</td>
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<td></td>
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<td></td>
</tr>
<tr>
<td>Intel Corporation</td>
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<td></td>
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<td></td>
</tr>
<tr>
<td>Exxon Mobil Corporation</td>
<td>3</td>
<td>0</td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Microsoft Corporation</td>
<td>0</td>
<td>-1</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Merck &amp; Company</td>
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<td>-1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Philip Morris Companies</td>
<td>0</td>
<td>0</td>
<td></td>
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<td></td>
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<tr>
<td>Royal Dutch Petroleum</td>
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<td>0</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>IBM</td>
<td>2</td>
<td>0</td>
<td></td>
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<tr>
<td>Procter &amp; Gamble Company</td>
<td>0</td>
<td>0</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Johnson &amp; Johnson</td>
<td>1</td>
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<td></td>
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</tr>
<tr>
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<td>1</td>
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<tr>
<td>AT&amp;T</td>
<td>0</td>
<td>-1</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>DuPont</td>
<td>0</td>
<td>-1</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>0%</strong></td>
<td><strong>9%</strong></td>
<td><strong>-9%</strong></td>
<td><strong>0%</strong></td>
<td><strong>0%</strong></td>
<td><strong>0%</strong></td>
</tr>
</tbody>
</table>
under management that are invested in long–short strategies. Institutional investors also look for the use of principal trades. In general, they want conventional long–short players to offer equitization, which allows them to port alpha from the long–short program into the U.S. equity program. They accept (encourage) performance-based fees and require sophisticated performance attribution.

**Challenges**

Even if managers follow the “rules,” the details and nuances of long–short investing still present many challenges.

**Leverage.** In practice, effective leverage is about 1.9:1 for each dollar of client capital: 95 cents long, 95 cents short, and 5 cents held in reserve for the futures account if the client wishes to have a futures overlay. Sometimes the amount held in reserve can be more than 5 cents if the tracking between the short portfolio and the market is high.

Beta control, although important, is part fact and part fiction. Managers have no way of determining if they are beta neutral. At Freeman Associates Investment Management, we tend to think of beta in the classic sense—not necessarily in terms of statistical beta but in the sense of hedging risk relative to a specific market. But in long–short, the point is that there is no market. Thus, the beta of the long portfolio versus the beta of the short portfolio is rarely if ever equal to the beta of the short portfolio versus the beta of the long portfolio because the variances of the long portfolio and the short portfolio typically differ. To solve this problem, the manager must specify either the long or short portfolio and calculate the beta of that portfolio and then calculate the beta of the other portfolio. This sequential approach is not ideal because the long and short portfolios should be constructed simultaneously. Often managers use an outside benchmark (such as the S&P 500) and make the beta of the long portfolio equal to 1.0 with respect to the S&P 500 and then make the beta of the short portfolio with respect to the S&P 500 also equal to 1.0. But even that approach does not guarantee that the beta of the long versus the beta of the short will be 1.0.

The dollar-neutrality and industry-neutrality aspects of beta policy do provide some control over portfolio risk, but predicted betas are no real help with beta control because the predicted beta can vary significantly from the actual beta. This point was made very clear to me when I gave expert testimony in the litigation of a case about a zero-beta strategy. When the tanks rolled into Kuwait in 1991, the portfolio that was the subject of the litigation had a beta of 3.0. When the plan sponsor questioned the manager about the portfolio’s volatility, the response was that over the long term, the beta would average zero but that sometimes it would differ significantly from zero. And that statement brought on the lawyers, of course. Leading academics, industry experts, and Nobel laureates all gave testimony in the case. In response to being told how important beta is to the investment management process, the judge made the astute observation that we must all be idiots because every one of us had a different definition and, consequently, value for that portfolio’s beta.

Another challenge for the long–short strategy is that many value-added opportunities are not beta neutral, industry/sector neutral, or capitalization neutral. A process can be created that neutralizes all the alpha signals (for example, dividend yield, insider-trading activity, or analyst revisions) with respect to these betas, industries, and capitalizations. But the question remains: What is the manager leaving on the table when he or she transforms these alpha signals into risk-adjusted alpha signals? Performing this transformation is simple from a statistical perspective; however, assessing the effect on information content is quite difficult.

Long–short investing has had its own volatility shocks, and problems have arisen when many long–short manager returns were much more volatile than anticipated. The problem is that long–short managers do not have a good analytical framework for controlling the risk of long–short portfolios. True mean–variance solutions are extremely difficult to create and typically require ex ante segregation of long holdings versus short holdings. In general, the result is a lot of complicated linear programming rules, and the quadratic risk control element is thrown away, which is unfortunate. Furthermore, if a manager has static industry assignments or sector assignments and either emerging or submerging industry groups, these industry groups can blow big holes in the portfolio before the risk vendor incorporates them into its risk analysis software. Finally, if a manager is optimizing the long–short portfolio, he or she better assume that the tracking error forecast will be at least 50 percent too low. The manager should also have at least two risk models because optimizing with one risk model gives a low-bias optimization. A single optimizer will find some spurious correlations and show where value can be added in units of risk taken, but the portfolio will then be subject to a significant level of unanticipated risk. The optimized forecast should be re-evaluated using a second risk model to arrive at a less-biased forecast of active volatility.

**Operational and Organizational Issues.** The increasing availability and price attractiveness of principal trading has been a real boon for long–short
investing. Basically, with principal trading, long–short managers get 100 percent execution on the buys and sells. The broker takes the other side of all transactions (hence the term principal) so there are no up-tick or zero-tick concerns. Managers get 100 percent execution and have no other implementation costs. But first, managers have to learn how principal trading works and how to cultivate the relationships with brokers that make it work over the long run. And managers still have to closely monitor the liquidity of their trade lists. If a manager wants to sell a particularly illiquid stock, he or she is generally better off taking that stock outside the principal bid and selling it individually. And to do principal trading, managers have to be willing to accept rules from the principal bids that stocks that move on the open will get knocked back to them. If managers load ticking time bombs into principal trades because they have an insight that the broker does not have and the broker gets burned, it may be a long time before the broker comes back with low bids.

Long–short strategies are particularly amenable to performance-based fees. In my opinion, performance-based fees are the single most important reason for long–short managers to put size limits on the assets they manage. Early on I was a believer that performance-based fees aligned the interests of the manager and the plan sponsor in broad ways. I no longer hold that belief. Although I really like performance-based fees, they have a windfall element that may not be beneficial to the payer. I do not think the plan sponsor community or the investment community understands the ramifications of all aspects of performance fees, but nonetheless, they continue to embrace them.

One of the most frequently asked and incorrectly answered questions about long–short is the following: Where does your added value come from, the long side or the short side? The answers tend to be anecdotal rather than analytical. Decomposing the return is very difficult, primarily because it requires identification of a fair benchmark for both the long and the short portfolios. Often managers will compare their returns with the S&P 500 or the Russell 1000, even if the long or short portfolio’s industry composition, average capitalization, or position weightings look nothing like either benchmark. Before an investor asks, or a manager answers, this attribution question, the individual should make sure that he or she understands what constitutes an appropriate benchmark for the long and the short. Otherwise, the attribution is just hand waving.

Need for Innovation

The current problems with the long–short strategy can be attributed to the fact that too many long–short managers are doing the same thing. Cannibalization is common because of idea sharing and idea stealing. Almost across the board, long–short had a bad time in 1997 and 1998, but theoretically, nothing associated with long–short portfolio management should lead managers to have highly correlated returns. The only thing that makes them have correlated returns is if they have correlated active strategies or correlated risk models, which they do!

For investors, building a program of truly diversified long–short managers is their biggest challenge. Hedge funds and long–short programs will be saved by the ability of plan sponsors, or the managers of managers, to build programs that diversify away active risk. Going back to one of my earlier statements, long–short strategies have less risk per unit of alpha than long-only strategies, but long–short strategies still present more risk in an absolute sense. Tolerating this risk is difficult, and I do not think many investors appreciate the patience needed for even moderately risky strategies. Figure 1 depicts the reasonable range of active results over time for a long–short manager with 4 percent expected alpha (solid line) and 5 percent predicted risk. The 80 percent confidence interval is defined by the parabola labeled “5% Predicted Risk Program” (dashed line). Notice that the confidence interval remains below zero for the first 30 months, so investors should not be surprised if this supposedly highly skilled manager has negative cumulative alpha for three years. In the case of a less-skilled manager who offers 4 percent active returns with 10 percent risk (dotted line), investors could reasonably have negative cumulative alpha for more than seven years.

Anecdotally, a number of long–short managers have apparently been terminated, often at the bottom of a style trough, when still performing well within the range statistically consistent with their stated objectives. Such terminations are probably the result of inadequate diversification among long–short managers in any given program.

Ultimately, the number of long–short managers is irrelevant as long as they are all doing the same thing. Long–short needs new active strategies, not more managers. To build a new long–short process, managers should not look in the same old places, such as Compustat CDs or the I/B/E/S tape; these research sources have been beaten to death.

Long–short managers are similar to an endangered species. Endangered animals in a zoo seem safe, but they are not because the number of breeding pairs is limited. Within a fairly short period, the
genetic stock starts to deteriorate. Similarly, the world of long–short needs new ideas to flourish. I believe long–short would welcome the entrance of more growth-based strategies, more idiosyncratic approaches, and generally any smart people who can do things differently. This “new blood” will help stabilize long–short programs in the long run.

Long–short is a fascinating approach to active management. The demands on investment talent are high, but the fees paid to such managers are also high if supported by strong added value. Long–short will continue to attract the best professionals in the investment industry. If anyone has an idea for a long–short strategy that is not based on forecast earnings to price, analyst revisions, or forensic accounting, that person should put his or her product together and get it into the market. Long–short is not a zero-sum game, and everyone involved will benefit from new approaches to add value.
Question and Answer Session

John D. Freeman
Lee S. Ainslie III
Marc Lasry

Question: When doing investment analysis, do you consider how long a company will be in bankruptcy?

Lasry: Yes. Our hardest task at Avenue Capital Group is to try to figure out how long a company will be in bankruptcy. We are trying to decide whether we want to invest at the beginning, middle, or end of the process. The time value of the investment affects the return the most. We have experienced situations in which we think the company will be in bankruptcy proceedings for one year, but it turns out to be a five-year bankruptcy because of the number of appeals. If that time in bankruptcy is longer than we expected, our return can suffer.

Question: Does litigation slow down the bankruptcy process?

Lasry: In the bankruptcy format, unsecured creditors can vote on a proposed reorganization plan. If the most senior creditor is impaired (i.e., not expected to be fully paid under the reorganization plan) and that creditor votes in favor of the plan, then the plan is accepted. And if the plan provides for unsecured debt to get 90 cents or 80 cents on the dollar and unsecured debt votes in favor of the plan, then the plan is accepted. But the threat that unsecured creditors can tie up the proceedings by filing a lawsuit always exists.

In 1990–1992, the bankruptcy courts were flooded with cases in which they had to decide the value of a company in bankruptcy. These valuation hearings would last anywhere from three months to one-and-a-half years. These valuation hearings simply don’t occur much anymore, and when they do, they last about two weeks. Courts are no longer worried about getting reversed on appeal, so today a bankruptcy process may last only 18–24 months.

For example, the Pacific Gas and Electric Company (PG&E) bankruptcy looked like it might last three to five years because of the large number of lawsuits. Originally when investors were buying the PG&E distressed debt, it was trading at 50–60 cents on the dollar because everybody was assuming a four-year bankruptcy. The bondholders have been pleasantly surprised that the situation has turned out to be only a two-year bankruptcy.

Question: Do you work with the bankrupt company’s management?

Lasry: It depends on whether the company went into bankruptcy because of the management or because of outside factors. If it was because of the management team, then the creditors will most likely work very hard to make sure a different management team is put in place, which will take a little longer. If it was because of outside factors, then we will work with management, which makes the process quicker because the debtor and the creditors’ committees are on the same side.

Question: Which is more astute, the debt market or the equity market?

Lasry: That is a tough question because the equity market looks more at future value whereas the debt market looks more at what is happening today. Those in the debt market want to know when they’re getting paid—over the course of the next year or the next two years.

If I had to make a bet, though, I would bet on the debt market simply because at the end of the day, if the debt market is trading at huge discounts, I know what that means: In the short run conditions look pretty bleak. I can’t understand how the equity market continues to value certain companies the way it does.

For example, do equity analysts really know what’s going on with Lucent and other similar situations? At Avenue Capital Group, we have shorted Lucent because we believe the stock is overpriced. We did the same thing for Xerox Corporation and had our head handed to us on a plate. I can look at Lucent and have an opinion that if the share price goes from $6 to $12, for example, the price of Lucent’s debt should move up to par. The problem is that the stock price can move from $6 to $12, and the debt can only go from 60 cents to 80 cents on the dollar. So, I have lost a lot of money on my short stock position and have not made much money on my bond position.

We are not comfortable shorting a stock because many irrational investors in the market get pretty excited over the fact that Lucent is going from an EBITDA (earnings before interest, taxes, depreciation, and amortization) of $5 billion to an EBITDA of −$2 billion. Based on news like that (and when we look at that situation, we have to ask ourselves what that means in terms of real changes in the asset value of the company), the stock can move up 5 or 6 points and the debt can move up also, maybe 5 or 10 points. We just don’t short a stock and simultaneously buy its debt.

Although we’d like to pursue that strategy at times, we found that in the past it has hurt more often than it has helped.

Question: Do you lock in a spread after a plan of reorganization has been filed?
Lasry: Yes, we do that quite frequently. We can short the stock then because we know what price we’ve created for it. We also know that we have stock that can be delivered against the short position. The question is: When is that stock going to be deliverable?

Question: If long–short management trumps long-only management even with a mediocre manager, why shouldn’t more managers jump into the long–short boat?

Freeman: There is plenty of liquidity in the equity markets for more people to do the same kind of things we do at Freeman Associates, and we do need to make the pie bigger—to attract more people to long–short. We can do that by having a more diversified family of long–short investors. As a group, we need to cultivate more diversification of active strategies. There is definitely more room on the value side of long–short, but there’s also a need to make long–short successful with strategies that have low correlations with quantitative value strategies.

Ainslie: I disagree about our need to attract more managers into the long–short equity world. The fee structure is attractive, and many new managers are pouring into the business. But only a few have experience on the short side, which is a bit of a different animal from the long side. In my mind, the hedge fund fee structure is the modern-day equivalent of “heads I win; tails you lose.” The view of most hedge fund managers is “Let’s take your money and take some risk. If we generate profits, then I will take my cut. But if we lose money, sorry, it’s your money.” People argue that the high-water mark compensates for that situation, but in reality, when managers are down significantly, they typically go out of business and the high-water mark is worthless. This asymmetric profile motivates managers to take risk that may not be appropriate.

I do not worry about any of today’s larger funds running into difficulty, like we have seen more than once over the past three or four years. My fears for the hedge fund industry are that a number of newer, smaller managers do not quite understand the risks they are taking or they are taking inappropriate risks. I worry that such new managers will be the fodder for forthcoming headlines.

Question: Given what occurred in the past few years, aren’t the big hedge funds taking on more risk than the new small boutique managers?

Ainslie: There is a vast difference between the type of risk and the degree of risk that many of the large funds are taking today compared with a decade ago. The leverage and the directional bets that the largest funds were taking just five years ago are staggering by today’s standards. Fortunately, some very talented individuals made decisions that were proven correct more often than not. But these managers would only have had to make a few missteps to generate very disappointing results. For the larger funds today, the returns probably will not be as impressive as the returns of the large funds of the past, but I doubt that any of the major funds will have significantly negative returns either.

There are certainly some advantages to being smaller, but my fear is that many people who are starting funds do not have a strong grasp of the risks they are taking. Risks on the short side, in leverage, and in position concentrations are new for many. Investors need to be wary and do thorough due diligence on these smaller funds.

Lasry: There’s a world of difference between managing money and managing a business. The problem with small funds is that in the beginning, the person managing the money is also the person managing the business. If you can’t do both, you will have significant problems. In the past few years, many people have raised money and are running $50 million–$200 million funds. These people have never been in a bear market or a market with a great deal of volatility. If you don’t know how to manage those risks, you’re going to find a lot of surprises.

Question: Is distressed-debt investing different now, with the large concentration of issues in the telecom industry, than in the past, when specific company problems were spread among various industries?

Lasry: It is different. In 1990–1991, the majority of the companies with major problems ended up filing for bankruptcy, whereas today, even though a large number of companies are filing or defaulting, a massive number of companies are trading at distressed levels. The challenge is to make a credit decision as to which companies will not file.

If you can buy debt at 50 cents on the dollar and if your credit analysis says the issuing company is a good bet and the analysis is correct, the debt’s price should rise to maybe 80 cents on the dollar and the company will never enter bankruptcy proceedings. That’s something that didn’t occur in 1990–1991. On the telecom side, we’ve been extremely comfortable buying Juniper Networks, Ciena Technologies, and Nextel Communications at 60 cents or 50 cents on the dollar. These companies are not in bankruptcy, and we don’t think they’re going to file for bankruptcy even though their debt is trading at distressed-debt levels.

Question: What portion of your return comes from style bets on the long and the short sides?

Ainslie: Over time, the vast majority of our return has been generated by the alpha of our stock picking.

Question: How about growth and value, those traditional styles?
**Ainslie:** I have a hard time thinking of us as a value or a growth manager. By being hedged within each industry sector, growth and value biases are largely hedged. So, when one style goes in or out of favor, it has little impact on us. We certainly think of ourselves as managers who understand and respect the economic values implied by stock prices and enterprise values, and we certainly value growth and are willing to pay what we believe is an appropriate premium for growth. But I have a hard time saying that we are either a growth or a value manager. In fact, in 1994, a consultant attempted to answer this question. He took the long side of our publicly filed portfolio, ran it through an analytical program, and pronounced that we were a growth investor because our average P/E was greater than that of the S&P 500 while our dividend yield was less. In 1999, we went through the exact same exercise, but this time we were pronounced to be a value investor. While our P/Es and our dividend yield had hardly changed from 1994 to 1999, the market had changed markedly. So, whether or not we are value or growth investors is clearly relative.

**Question:** Do you know of any formal studies that look at a single long–short manager versus hiring two managers—one on the long side and one on the short side?

**Freeman:** No, I don’t. There aren’t that many pure short-sell managers to make that type of study worthwhile anyway. They certainly weren’t popular at the end of the 1980s, having gotten run over by the 1980s bull market, and they haven’t done much to establish themselves in the 1990s.

And in terms of risk, if you have a separate long manager and a separate short manager, you’re basically throwing away the opportunity to get the benefits of diversification. You also lose the benefits of the prime brokerage arrangement and the capital efficiency gained by shedding the deadweight of active traditional management when you undertake a long–short approach. I have to believe that doing long–short in a combined setting is far more effective.

**Question:** What keeps you up at night?

**Ainslie:** Individual stock decisions. That is really all we care about. I am thinking about individual positions and where we could be doing a better job in the risks we are taking and trying to make sure the investments we have are appropriate for what we are trying to achieve. Macro concerns do not worry me at all.

**Question:** Are you seeing more problems with well-established companies or with dot-com-types that never had real numbers to begin with?

**Lasry:** What we’re seeing today, at least on the distressed side, is that world-class companies, such as Macy’s, are having problems. We’re seeing established companies with real cash flows and exceptionally large companies either filing for bankruptcy or having substantial financial problems. PG&E filed for bankruptcy, and it certainly is an established company, as is Enron.

When you can buy a company such as AEI, which is the fourth largest coal producer in the United States with about 200 million of EBITDA, between 2.0 and 2.5 times earnings, real opportunities exist in the market. Nextel has cash flow of $2 billion—that’s its EBITDA number. It does have $14 billion of debt, but based on where it is trading in the marketplace, you’re buying it at a 3–4 multiple. So, real opportunities are out there today, and I think that they’re going to continue. These opportunities are actually greater today than they were in the early 1990s.

**Question:** Do you ever short distressed debt?

**Lasry:** We often ask ourselves whether we should also be short. Rarely do we short, and the maximum value of our funds that we have shorted was about 5 percent. It is very hard for us to find compelling shorts, and most shorts that we look at are around 50 cents on the dollar. So, if we’re going to go short a bond at 50 cents, we’re doing that because we think ultimately it is worth 20 cents on the dollar. At least with shorting distressed debt we know what our downside is—par. But the problem is that we’re already starting at a –20 percent current yield because if the bond has a 10 percent coupon, that bond has to drop at least to 40 cents for us to just break even. If we could come up with great shorts at par, we would. But you don’t really know about them when they’re trading at par. You find out about them when they’re trading at 50–60 cents, and it is much harder for us to short those.

**Question:** What is your strategy with regard to the stock that is created in a reorganization plan of your distressed companies?

**Lasry:** We sell it. Our average holding period is about 18–24 months. We’re not very good at valuing stock, and to me, once a company comes out of bankruptcy, its stock is once again in the universe of all other stocks. Although I may think it is a cheap stock relative to where we created it, 5,000 other stocks are in the universe, and I just don’t know where those are traded. We’re not equity guys. We’re distressed-debt guys. So, we get out of a stock pretty quickly.

**Question:** How long do you hold a distressed issue if the company’s financial situation begins to improve and the value of the bond increases?

**Lasry:** If one of our distressed issues starts trading at 12–14 percent of par, we get out. But if one of our holdings is trading at 20 percent or 15 percent of par, we’ll hold on. I think we’re very good at valuing when an issue should be trading in the 20–80 cents range. When the issue starts moving above 80 cents and then suddenly trades at 12 percent of par, that’s no longer within our level of expertise. We can do it, but other people do a far better job than we can.