

Edge with hedge: primer for equity long/short funds

Contents

Summary.....	1
What are equity long/short hedge funds?	1
What to look for in equity long/short funds.....	11
Performance in different market regimes.....	12
Risk/return profile.....	12
Most common equity long/short strategies.....	13
Bottom line.....	16

Summary

Equity long/short hedge funds focus on trading listed equities aiming to profit from both rising and falling share prices. Managers select stocks to buy and short, typically guided by deep fundamental research. In this primer we explain key equity long/short strategies, their anticipated risk/return profiles, and how these have historically performed in different market environments. We also highlight key investment considerations for allocators to the strategy.

What are equity long/short hedge funds?

INTRODUCTION

Equity long/short is one of the oldest and most well-known hedge fund strategies and continues to represent one of the largest groupings of funds within the hedge fund industry. Within Aurum's Hedge Fund Data Engine, the strategy is presently the largest, representing close to 20% of industry assets. Many date the birth of the modern hedge fund (and indeed the very term "hedge fund") to the equity long/short fund launched by former financial journalist Alfred Winslow Jones in 1949. By adding the ability to short—selling borrowed equities to purchase and return them at a later date and profit from any fall in price—and the use of leverage to the toolkit of traditional equity investors, the strategy represents an extension to long-only equity investing.

Equity long/short funds build portfolios of listed stocks, taking long and short positions based on deep, fundamental research. This can involve everything from analysis of financials, earnings, and competitive edge, but also direct management meetings, customer checks, site visits, scrutiny of supply chains, and, increasingly, alternative data and ESG considerations. Portfolio managers target long investments in firms they perceive to exhibit strong leadership, sound balance sheets, and attractive valuations, while shorting those they believe have poor governance, deteriorating fundamentals, or inflated prices.

While fundamental, company-specific research forms the basis of most equity long/short strategies, some portfolio managers incorporate technical signals, such as charting and flow data analysis, while others consider macro factors and are willing to express directional views on industries or themes. Ultimately, success hinges on skilled research, disciplined risk management, and the ability to profit from both winners and losers.

BREAKING DOWN THE UNIVERSE

With a large number of equity long/short funds—over 1,000 in Aurum’s Hedge Fund Data Engine, how can the diverse strategy group be categorised? Net market exposure—a measure of how exposed a portfolio is to equities, calculated by subtracting short exposure from long exposure—is arguably the most meaningful differentiator between these funds. Funds tend to fall within one of the following three broad categories of net exposure:

- **Market neutral**, with net exposure within a relatively narrow range around zero, typically -10% to 10%.
- **Low net**, with net exposure ranging from 10% to 30%.
- **Mid or variable net** (a “Jonesian” model), with net exposure of between 30% and 60%.

Funds that consistently target net exposure of less than -10% are categorised as short-biased. While short-biased funds had a period of popularity during the dot-com bust of the early 2000s, very few remain in operation today. Funds targeting net exposure of greater than 60% are classified as long-biased and are grouped within the Long Biased—Equity category in the Aurum Hedge Fund Data Engine.

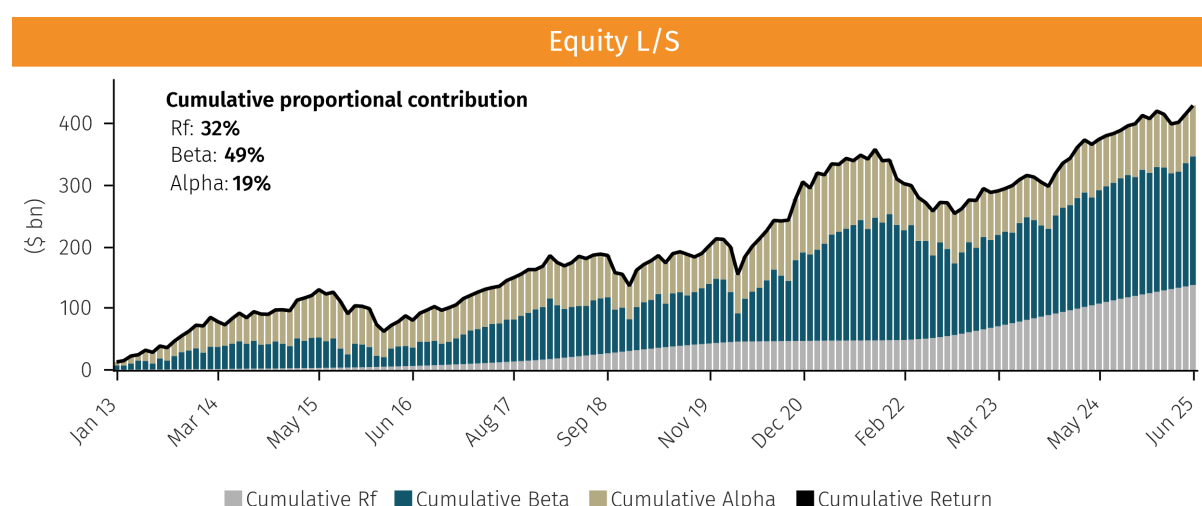
Gross market exposure is a measure of leverage, calculated by adding long exposure to short exposure. It tends to be inversely proportional to net exposure, with lower net funds usually managed with higher levels of gross exposure. Generating returns almost inevitably requires assuming some sort of risk. If market risk has been largely mitigated, then achieving an attractive level of return typically necessitates the use of leverage, which can be the dominant risk for market neutral and low net funds. Market neutral funds—particularly those seeking to neutralise factor, as well as market, risks—may be managed with gross exposures in excess of 400%. By contrast, mid net funds can be managed with more conservative gross exposures levels typically less than 150%, though are naturally more exposed to market risk.

Returns can be decomposed into

- **Alpha**, a measure of stock selection and portfolio management skill relative to a benchmark, and
- **Beta**, a measure of sensitivity to a benchmark.
- **Risk-free rate**, a theoretical benchmark of the return on an investment with no risk of financial loss.

While both the long and short sides of portfolios can be sources of alpha, the returns of higher net funds typically comprise of a meaningful combination of alpha and beta, while alpha tends to represent the dominant source of returns in lower net funds. Similarly, the use of index hedges on the short side limits the potential for alpha generation, since index shorts track the market and so provide beta exposure rather than idiosyncratic stock-specific returns. However, index shorts may be appropriate in certain circumstances—for example, during the “Merger Monday” period of the mid-2000s, when M&A activity was rampant and shorting individual stocks was particularly risky. With low fee equity index funds widely available, investors are understandably reluctant to pay high fees for beta, so the level of fees charged by funds should be commensurate with the level of alpha targeted or achieved.

DECOMPOSING DOLLAR PERFORMANCE INTO ALPHA, BETA AND RISK FREE (RF) COMPONENTS



Source: Aurum Hedge Funds Data Engine, Bloomberg.

This chart decomposes the dollar returns of equity long/short funds as classified by Aurum's Hedge Fund Data Engine into beta, alpha and risk free ("Rf") components, as follows: $\alpha = \text{actual return} - R_f - \beta * (\text{market return} - R_f)$.

Where R_f is the risk free rate as defined by a rolling 3-month LIBOR-SOFR, where market return is that of MSCI World Index USD ('the market index') and where beta has been calculated with respect to each underlying fund observed on a 60m rolling basis to the market index. The monthly alpha, beta and Rf components are then applied to each underlying fund's dollar performance for a particular month, and then at a master strategy or industry level the individual fund dollar contributions are aggregated up.

For note, beta can be negative in certain cases, creating negative dollar attributions. These are offset by corresponding positive alpha contributions.

While some equity long/short funds invest globally and across sectors, most concentrate on a particular region or sector, providing another practical basis for grouping funds. Regional and sector specialists often have an informational edge over generalists, stemming from deeper expertise within a more focused universe of stocks. However, focusing on a narrower universe comes at a cost, as the opportunity set within regions and sectors can be cyclical and inherently more limited. As a result, investors may need to exercise greater patience with regional and sector funds. In addition, regional and sector funds can face increased business risk during periods of unfavourable market conditions for their niche.

Although less commonly used for classification, investment style is another important feature of many equity long/short funds. Common styles include value, growth, quality, and growth-at-a-reasonable-price (known as GARP), while many portfolio managers are style agnostic.

- **Value** funds seek margins of safety by focusing on perceived undervalued stocks—such as those with low price-to-earnings or price-to-book ratios—on the long side and expensive stocks on the short side.
- **Growth** funds target companies with strong earnings or revenue growth potential, often in growth-oriented sectors, such as information technology, biotechnology, and consumer discretionary.
- **Quality** funds emphasise financially sound companies with strong balance sheets, high returns on equity, competitive advantages ("moats"), and consistent earnings, while shorting companies with the opposite characteristics.
- **GARP** funds blend growth and value investment styles by targeting growing companies that are not believed to be excessively overvalued.

Although less commonly used for classification, investment style is another important feature of many equity long/short funds.

Some funds, particularly value-oriented funds, target smaller capitalisation ("cap") stocks, which are often neglected by investors and therefore offer greater potential for mispricing. However, small cap-focused funds tend to be more capacity-constrained, due to the liquidity and short borrow limitations of small caps. While value funds were widespread in the 1990s and 2000s, they are far less common nowadays; the value factor has underperformed since the Global Financial Crisis ("GFC") in 2008, particularly during the low interest rate

environment of the 2010s. As such, equity long/short funds today are more likely to exhibit growth and/or quality biases.

Certain institutions and investment managers are associated with particular investment styles, so familiarity with key players in the investment landscape can offer insight into a portfolio manager's style based on where he or she was trained. For example, Columbia Business School is closely associated with value investing and has produced many successful value investors, most famously Warren Buffett. Spinoffs from Julian Robertson's Tiger Management, known as 'Tiger Cubs', are often associated with growth investing. Multi-strategy platforms with large equity businesses—which have gained prominence in recent years and spawned many spinoffs—also possess stylistic nuances.

Dollar turnover—defined as the value of trades for a period divided by average gross exposure—can also provide useful insight into a portfolio manager's investment style. Higher turnover typically indicates a greater willingness to trade around positions, although it may also be reflective of net positioning, as lower net funds usually require more active risk management, due to greater use of shorting and leverage.

- Turnover of two to five times per year is considered average for equity long/short funds, indicative of mid net, style agnostic funds.
- Turnover of half to two times per year (not much higher than the turnover of most long-only funds) is considered below average and typically associated with value funds, which are usually mid net and have longer investment horizons.
- Turnover of greater than five times per year is considered above average. Turnover of around ten times per year is typical for portfolio managers at the large market neutral equity platforms of multi-strategy funds, where active trading is often encouraged and risk management is prioritised. The most highly active funds can have turnover exceeding 20 times per year.

Dollar turnover—defined as the value of trades for a period divided by average gross exposure—can also provide useful insight into a portfolio manager's investment style.

A word of caution—many equity long/short portfolio managers do not routinely track the turnover of their funds and can be poor at estimating turnover accurately. As such, annual financial statements can be a useful source of more reliable turnover information.

TYPICAL PORTFOLIO CHARACTERISTICS OF THE NET EXPOSURE CATEGORIES FOR EQUITY LONG/SHORT FUNDS

Sub-strategy	Net exposure	Gross exposure	Volatility	Beta	Turnover	Liquidity	Leverage
Market neutral	0%	200% to 400%	Low	Low	High	High	High
Low net	10% to 30%	150% to 300%	Med	Low to med	Med to high	High	Med to high
Mid net	30% to 60%	120% to 200%	Med to high	Med	Med	Med to high	Med
Long-biased	< 60%	100% to 150%	High	High	Low	Low to med	Low

SHORTING—A RAREFIED SKILL

Shorting is a more challenging enterprise than investing long. While longs have limited downside (the most an investor can lose is the value of the capital invested) and unlimited upside, shorts—being the inverse of longs—have limited upside (the most an investor can make in the event that the asset becomes worthless is 100%) and unlimited downside. Similarly, while the portfolio position sizes of underperforming longs decrease, position sizes for underperforming shorts increase.

As such, short positions are vulnerable to a phenomenon known as a ‘short squeeze’, a situation whereby an asset experiences a rapid increase in price (whether the result of some fundamental or technical development), forcing short sellers to purchase stock in order to risk-manage the position, which in turn drives the price up even more. The parabolic move higher in GameStop in January 2021—a heavily-shortened stock which gained popularity among retail investors and caused meaningful losses for many equity long/short funds—is a cautionary tale of the dangers of shorting. Given these hazards, portfolio managers tend to size shorts more conservatively than longs.

As such, short positions are vulnerable to a phenomenon known as a ‘short squeeze’, a situation whereby an asset experiences a rapid increase in price

Shorts often fall in one of the following three categories:

- **Structural:** Shorts based on perceived enduring weaknesses or headwinds faced by a company or an entire industry. An example at the company level is a firm offering an inferior product compared to more innovative or efficient competitors. An example at the industry level are traditional brick-and-mortar retailers struggling against the rise of e-commerce.
- **Valuation:** Shorts targeting often high-quality or fundamentally sound companies that are perceived to be overvalued. For example, a profitable, well-managed software company trading at extreme valuation multiples, such as 50 to 100 times earnings, far above industry norms. Valuation shorts can be especially dangerous, as valuation anomalies can persist for extended periods. As the legendary economist John Maynard Keynes famously observed: “Markets can stay irrational longer than you can remain solvent.”
- **Accounting:** Shorts based on financial irregularities or misstatements, or outright suspicions of fraud in a company’s financial statements or reporting.

Shorting is a rarefied skill and often a key differentiator for the most successful funds.

EXPANDING THE TOOLKIT

While the backbone of most equity long/short funds is listed single stock longs and shorts, some portfolio managers utilise a wider set of assets and strategies. Equity options may be used to express tactical views or shape risk/return, while equity swaps may be used to minimise taxes, such as stamp duty, in certain markets. Opportunistically, portfolio managers may add corporate credit at opportune points in the business cycle. For example, many value managers had meaningful allocations to credit in the aftermath of the GFC, as credit offered equity-like upside with reduced risk. A few funds are willing to venture even further down the liquidity curve and invest in private equity. In such cases, however, managers will typically limit private exposure to a single digit percentage of fund assets or structure their offering to allow investors to avoid or reduce exposure to these illiquid assets.

The vast majority of equity long/short funds comprise of a single portfolio manager. However, co-portfolio manager funds also exist and multi-portfolio manager platforms—comprising of several portfolio managers managing autonomous portfolios within a usually market neutral construct—are increasingly popular. Portfolio managers are usually supported by a team of analysts, who conduct much of the day-to-day fundamental research on equities. The number of analysts typically ranges from one to several depending on the size of the fund. Larger funds typically require (and can afford) more analysts, given the need for a greater number of portfolio positions to satisfy the larger asset base without compromising on concentration and liquidity standards.

As with other hedge fund strategies, there is some overlap between equity long/short and other strategies. Funds, often value funds, seeking to trade around corporate catalysts—such as mergers and acquisitions, restructurings, and bankruptcies—overlap with event driven funds, while growth or thematic-oriented funds that incorporate top-down data in their processes can overlap with macro funds. Market neutral funds, especially those with multiple independent portfolio managers, resemble the equity platforms at multi-strategy funds. From a portfolio structuring perspective, these funds also resemble quantitative equity funds, given the low net and high gross exposure portfolios. However, the thesis of trades (fundamental versus technical),

portfolio turnover, and concentration may differ meaningfully between fundamental and quantitative equity market neutral funds.

MANAGER ARCHITECTURE: SINGLE PORTFOLIO MANAGER (“PM”) FUNDS VERSUS MULTI-PM PLATFORMS

Organisational architecture—single portfolio manager versus multi-PM platform—has profound implications for risk management, turnover, and cost.

Single PM funds are built around one lead investor, typically a seasoned sector or style specialist with strong conviction and long-standing corporate access. Capital is concentrated behind that expertise: while risk budgets, net exposure bands, and stop-loss rules are generally in place, they usually remain flexible, allowing the manager to run higher concentration and tolerate mark-to-market volatility when fundamental views diverge from price. Trading frequency tends to be moderate; borrow costs are managed stock-by-stock; and prime broker relationships are usually limited to one or two firms. The appeal for investors lies in the transparency of who is driving returns. Risks include key person dependency, limited scalability, and capacity constraints as assets increase. Many single PM setups are sector focused, which can introduce return cyclicality as stock dispersion and the opportunity set expand and contract over time.

Multi-PM platforms adopt a federated structure, comprising anywhere from a handful to over a hundred independent “pods”, each with its own portfolio manager and analysts, running tightly hedged books under a firm-wide risk framework. This architecture enforces constraints across gross and net exposures, sector and factor concentration, and drawdown triggers. The larger platforms may employ central treasury desks to optimise financing, securing reduced haircut terms across multiple prime brokers (typically three to five plus) and in-house crossing networks to facilitate internal flow execution without market impact. The result is far higher leverage (gross exposure of typically 400 to 600%), higher turnover levels, and lower realised portfolio volatility. Shared data science, compliance, and technology allow pods to scale quickly. Such PM teams are typically compensated via formulaic payout schemes tied to individual performance. Fee structures vary: while some platforms follow the traditional management and performance fee model, the industry trend has moved towards a pass-through fee model, whereby investors assume the “netting risk” of underperforming PMs, resulting in typically higher total expense ratios.

Choosing between the two blueprints depends on allocator priorities. Single PM funds offer concentrated, human-driven alpha and simpler fees, but carry heavier key person risk. Multi-PM platforms provide alpha via diversification, institutional robustness, and financing efficiencies, though investors typically tolerate higher overall fees, frequent pod turnover, and the possibility that prescribed risk budgets can cap upside in strong markets. Understanding these trade-offs is essential when constructing a balanced equity long/short allocation.

TYPICAL ATTRIBUTES OF SINGLE PM VERSUS MULTI-PM PLATFORM EQUITY LONG/SHORT FUNDS

Dimension	Single PM fund	Multi-PM platform
Gross/net exposure limits	PM-specific; flexible	Hard caps and stop-out rules
Turnover	0.5 to ten times per year	Five to 20 times per year
Financiers/prime brokers	One to two	Five to ten
Financing terms	Standard haircuts	Lower haircuts and better borrow lists
Research model	PM-led, bespoke analysts	Independent or collaborative pm pods; access to central research and data-science hub
Internal trade crossing	Low	High (reduces costs and market footprint)
Cost structure	Traditional 1.5 to 2% management fee and 15 to 20% performance fee	Typically pass-through of operating expenses and pm incentive fees plus a performance fee
Key person risk	High	Low (pod rotation)
Capacity scaling	Constrained by PM style and liquidity	Large; capital re-allocated dynamically

FINANCING CONSIDERATIONS IN EQUITY LONG/SHORT STRATEGIES

An important, yet often underappreciated, dimension of equity long/short investing is portfolio financing, which can meaningfully impact returns, risk, and operational flexibility, particularly on the short side. Short positions require borrowing stock, typically via a hedge fund's prime broker network, which introduces variability in both borrow availability and associated financing costs. *Hard-to-borrow* shares—often small-cap stocks, crowded shorts, or securities with high retail ownership—may carry high annualised borrow costs (“specials” can easily exceed 10% p.a. and can spike to greater than 50% in a squeeze situation), representing a material drag on performance.

Since the beginning of the 2022 monetary tightening cycle, rising policy rates have increased the yield paid on cash from short proceeds. While prime brokers often retain a spread of 25 to 75 basis points, the rebate now materially exceeds the near-zero levels observed from 2010 to 2021. For liquid, easy-to-borrow equities, this shift has turned what was historically a financing cost into a meaningful yield, partially or even fully offsetting stock turnover fees. This change in the funding environment has been especially favourable for market neutral and low net funds, given their large short books. Conversely, long-biased funds, which use shorts less intensively, are less exposed—positively or negatively—to such financing considerations.

However, financing risks remain a key concern. Hard-to-borrow names and episodic deleveraging events—such as those seen during the fourth quarter of 2018 and the first quarter of 2020—can result in rising margin requirements, reduced borrow availability, and portfolio-level financing stress. In extreme cases, this can necessitate forced de-risking or liquidation of positions, potentially at suboptimal prices. As such, robust financing management is a critical differentiator for operationally sophisticated long/short equity funds. Best-in-class managers typically diversify across multiple prime brokers, use collateral efficiently, and monitor borrow costs in real time. These practices are particularly important in crowded, factor-sensitive, or high turnover strategies, where alpha erosion from poor financing discipline is a material risk.

An important, yet often underappreciated, dimension of equity long/short investing is portfolio financing, which can meaningfully impact returns

FINANCING TERMS FOR EQUITY LONG/SHORT FUNDS

Term	Description
Borrow cost	Annualised fee to borrow stock; varies by stock, size of borrow, and market demand.
Hard-to-borrow	Shares with limited borrow supply or high demand; may carry borrow costs greater than 10% or become unborrowable.
Cash rebate	Interest earned on short sale proceeds; currently elevated due to higher policy rates.
Broker spread	Prime brokers retain a rebate spread (typically 25 to 75 basis points) between policy and fund rebate rates.
Gross leverage	Overall, long plus short exposure as a proportion of fund assets; higher leverage increases exposure to financing dynamics.
Net exposure	Long minus short exposure; low net funds tend to have higher cash balances from short sales.
Utilisation	Percentage of permitted leverage utilised; high levels restrict flexibility in stress events.
Margin requirements	Capital required to support positions; often increases during periods of volatility or stress.
Prime broker diversification	The use of multiple prime brokers reduces concentration risk and improves access to stock borrow.

RISK MANAGEMENT

Attitudes towards risk management also varies among equity long/short funds. Beyond target net exposure—which defines the extent to which a portfolio manager may be willing to assume market risk, often the dominant risk for equity long/short funds—and associated target gross exposure, key risk management considerations include liquidity, concentration, stop losses, factor exposures, and crowding.

- Liquidity:** A widely accepted measure of equity portfolio liquidity is the estimated time to liquidate a holding, calculated as a proportion of recent average daily trading volume (“ADV”). Many funds assess liquidity by modelling the ability to sell no more than 20% of a stock’s ADV over the preceding 60 trading days; however, estimations based on 10% or 5% of ADV are more conservative, thereby providing a greater margin of safety, especially in stressed market conditions. A fund’s portfolio liquidity should be closely aligned with the liquidity terms offered to investors. For example, if a fund offers monthly liquidity with 30 days’ notice, but only 60% of its portfolio could reasonably be liquidated within a 30-day window, the fund would be mismatched from a liquidity perspective and exposed to the risk of failing to meet redemption requests during periods of heavy outflows. Investors should carefully review and challenge the liquidity modelling and assumptions used by managers, ensuring that redemption terms are appropriate given the true liquidity profile of the underlying holdings.
 - Side pockets: Deliberate structures versus remedy for illiquidity:** Side pockets are a structuring tool used by some hedge funds to house investments that are inherently illiquid or become so during the life of the fund. When used proactively, side pockets allow a portfolio manager to diversify into less liquid opportunities—such as small-cap recovery shares, pre-IPO convertibles, or private investments in public equity (PIPEs)—by offering longer lockups than the main fund. Best practice includes full transparency for investors, independent valuation where external quotes are unavailable, and clear pre-defined triggers for realising the position. However, side pockets are also a late-stage remedy when previously liquid investments suddenly become

illiquid, be it through trading suspensions, catastrophic stock-specific events, or a collapse in market depth. In such cases, the creation of a side pocket often signals an investment that has gone awry: assets are segregated to avoid unfairly diluting continuing investors or forcing fire sales, but this typically comes with delayed return of capital for investors. Managers who make regular use of side pockets must justify such illiquidity and demonstrate that these exposures are prudently sized relative to the liquid core of the portfolio. Investors should be alert to any side-pocket activity that arises reactively, as such events are often symptomatic of deeper portfolio stress or failures in pre-emptive risk management.

- **Concentration:** As Harry Markowitz, the Nobel Prize-winning economist known for his work on modern portfolio theory, said: “Diversification is the only ‘free lunch’ in investing.” More diversified portfolios tend to be lower risk, though may require larger investment teams to sustain the greater number of positions. Long position sizes of c. 10% of net asset value (“NAV”) and shorts of c. 5% of NAV are generally considered large.
- **Stop loss policies:** Stop losses are rules that require portfolio managers to reduce risk—at the individual position, theme, or portfolio levels—in the event of a drawdown. For example, a portfolio manager may commit to reducing the fund’s gross exposure by a third in the event of the fund sustaining a 5% drawdown. Stop loss policies are common among lower-net funds, as the higher short and gross exposures associated with such funds necessitates more proactive risk management. By contrast, stop losses are less common among higher net funds, which often emphasise fundamental stock selection in managing risk. In any event, investors should understand how a portfolio manager typically behaves during a drawdown and historic examples of drawdowns are important for demonstrating experience of challenging market conditions and building resilience.
- **Factor exposures:** Similarly, while less relevant for higher net funds (market exposure tends to be the dominant factor for equity portfolios so a portfolio manager willing to assume meaningful market risk is less likely to be concerned with factor exposures, which tend to be secondary), lower net funds have become increasingly sophisticated at mitigating factor exposures, such as growth, value, and momentum, in recent years.
- **Crowding:** Crowding relates to commonly-held positions among equity long/short funds. Equity portfolio managers often have similar training and value similar attributes in stocks leading them to hold similar longs and shorts. While these holdings may be fundamentally sound (hedge funds tend to attract the most successful investors), the growth of the hedge fund industry, the use of leverage, and short squeezes can result in periods of hedge fund deleveraging. As such, some funds track portfolio positioning among equity hedge funds—using prime brokerage data or regulatory filing data, such as 13F quarterly reports—and seek to limit exposure to crowded positions within portfolios.

COMMON EQUITY FACTORS

Factor	Description
Value	Stocks that appear undervalued based on financial metrics, such as price-to-book or price-to-earnings ratios.
Growth	Companies with strong historical or expected earnings growth. Such stocks tend to reinvest profits into expansion and often trade at higher valuation multiples.
Momentum	Stocks that have had strong recent performance.
Quality	Companies with strong balance sheets, consistent earnings, high profitability, and good corporate governance. Such stocks are often seen as more resilient during downturns.
Low volatility	Stocks with lower price fluctuations. Such stocks typically provide more stable returns and are considered defensive in turbulent markets.
Size	Companies with smaller market capitalisations, which historically have outperformed larger cap stocks due to higher growth potential and risk premiums.
Sector	Stocks within the same industry, such as information technology, health care, and energy. Sector exposure influences returns based on macroeconomic trends and business cycles.
Region	Companies within the same country or broader geographic region. Regional exposure influences returns based on local economic conditions, currencies, and political risks.
Dividend yield	Stocks with high dividend payments relative to stock price. Such stocks often appeal to income-focused investors and can signal financial stability.
Earnings revisions	Companies with recent upward analyst earnings estimate revisions. Positive revisions often precede price increases due to improving business fundamentals.

What to look for in equity long/short funds

Given the large number of the equity long/short funds, what factors should investors consider when choosing between funds?

- **Pedigree and training:** Prior investment experience of the portfolio manager and broader investment team is key. Where did the portfolio manager work previously and in what capacity? Simply knowing the portfolio manager's "school" provides a good indication of his or her likely investment style.
- **Reputation and references:** What do former colleagues and peers say? In the hedge fund world, reputation travels fast. Solid referencing is vital—do not shy away from checking what insiders think of the portfolio manager's skills and integrity.
- **Performance:** Ultimately, does the manager have a successful history of running money? Look for a demonstrable track record of alpha generation that has stood up through market cycles.

Choosing the right fund requires looking beyond glossy presentations and performance charts—scrutinize the people, their training, and the intangibles that drive sustained outperformance.

FORENSIC PERFORMANCE ANALYSIS

Quantitative analysis of track records, both for the current fund and any prior mandates, can be extremely helpful. While strong absolute returns are desired, the manner in which returns were generated provides a clue as to whether the portfolio manager may possess a repeatable process for returns to be sustained. One needs to peel back the layers.

- **Alpha or beta?**
 - Returns should be analysed for the presence of alpha, on both the long and short sides of the portfolio preferably.
 - Non-market neutral funds can be expected to exhibit beta commensurate with the level of net exposure targeted. However, regardless of the level of market exposure, a material layer of alpha should be in evidence.
 - More refined factor analysis, based on weekly or daily return data if available, can uncover factors, such as growth, value, momentum, or a particular sector or country, which have led returns and therefore highlight vulnerabilities should these factors reverse.
- **Volatility and shock resistance:**
 - The volatility of returns and drawdowns should also be considered. High absolute returns can be tarnished by high volatility and meaningful drawdowns.
 - How did the fund or portfolio manager perform during challenging periods for equities, such as the GFC in 2008, the European sovereign debt crisis in 2011, the pandemic during the first quarter of 2020, and the rising interest rate environment of 2022?
 - In addition, how did the fund perform during periods of factor rotation and equity long/short deleveraging, such as the first quarters of 2014 and 2016 and the fourth quarter of 2018. In such episodes, directional equities may perform fine, while equity long/short funds (a parallel market in some respects), particularly lower net funds, can be meaningfully challenged, as both longs and shorts suffer.
 - Did the manager sidestep these market 'landmines' or step on them with both feet?

Once a fund has been selected for investment, ongoing, active monitoring is key. If a fund was appealing when managing \$500 million, is it still attractive at \$5 billion? Monitoring key metrics such as the number of portfolio positions, market cap exposure, and liquidity, as well as the size of the analyst team and continuous dialogue with funds, can provide useful clues as to how portfolios evolve as assets increase. A conservative attitude towards asset growth, a broadly stable investment team, and incremental, as opposed to sudden large scale, change is generally preferred.

ART, SCIENCE, AND FIT

Investing is more art than science and the beauty of the craft is that there are multiple different paths to success. As Jack Schwager, author of the acclaimed *Market Wizards* book series, has noted, success often lies in adopting a strategy suited to one's personality. As such, constructing a portfolio of equity long/short funds with a variety of investment styles, as well as varied across geographies, is important to harness the rich diversity within the space.

Investing is more art than science and the beauty of the craft is that there are multiple different paths to success.

Performance in different market regimes

Given that stock-specific fundamentals typically form the basis of most trades, equity long/short funds tend to perform better in environments when fundamentals are the primary determinant of stock performance. By contrast, markets in which fundamentals take a back seat to macro factors—such as economic indicators, monetary and fiscal policy, and geopolitics—tend to be more challenging for equity long/short funds. Relatedly, funds, particularly lower-net funds, usually favour higher dispersion between the performance of equities, though struggle when stock dispersion is low.

- Market shocks, characterised by a sudden and significant market sell-off, tend to be particularly challenging for equity long/short funds, because most funds are managed with some net market exposure and such episodes are characterised by fundamentals becoming largely irrelevant and stocks moving in tandem, i.e. with high correlation/low dispersion.

The strategy also typically benefits from a healthy level of equity market volatility (though, as noted, not crisis level of volatility), which can increase the frequency of tradable opportunities. By contrast, environments characterised by low volatility, can be challenging for the strategy.

Risk/return profile

While difficult to generalise, given the variety of investment styles, equity long/short is generally considered to be on the riskier side of hedge fund strategies—equity beta sneaks into most funds, so headline risk is anticipated to be higher than credit, macro, or statistical arbitrage funds.

Higher net funds typically target higher returns, such as low-to-mid double digit percentage annualised gains over a full market cycle. However, the quality of returns for such funds can be poor, with greater dependence on the performance of equities resulting in higher equity beta, higher volatility, and lower alpha. On average, beta tends to track net exposures reasonably closely. However, there are exceptions, with beta meaningfully lower than expected in the case of some of the highest calibre funds.

By contrast, lower net funds typically target lower returns, such as high single digit percentage annualised gains. However, the quality of returns for such funds tends to be high, with alpha representing the vast majority, if not all, of returns generated and volatility and equity beta relatively low.

TYPICAL TARGET RETURN AND BETA/ALPHA MIX FOR THE NET EXPOSURE CATEGORIES OF EQUITY LONG/SHORT FUNDS

Net exposure sub-strategies	Percent annualised return target	Beta/alpha mix	Features
Mid/variable net (30% to 60%)	Low double digits	Both meaningful contributors	Potentially more lucrative topline but bumpier performance, with higher volatility and more severe drawdowns when the equity markets stall. A handful of elite funds are able to pair high net exposure with acceptable beta and high alpha.
Low net (10% to 30%)	High single digits to low double digits	Alpha rich, beta lean	Smoother P&L. Alpha drives most of returns; beta and volatility are more muted.
Market neutral (-10% to 10%)	High single digits	Pure alpha hunt	Minimal market drag; success is more dependent on stock selection and portfolio management skill. Typically, also has low factor exposures.

Most common equity long/short strategies

As noted, there are many ways to categorise equity long/short funds. The approach that Aurum has employed within its Hedge Fund Data Engine is grouping funds by sector or regional focus, while separating global or US market neutral funds into a distinct category, Fundamental Equity Market Neutral (“MN”). The seven sub-strategies within Aurum’s Hedge Fund Data Engine’s equity long/short category are as follows:

- Sector;
- Global long/short;
- US long/short;
- European long/short;
- Asia Pacific long/short;
- Other long/short;
- Fundamental equity MN.

Other long/short comprises of mostly non-Asia Pacific emerging markets-focused funds, with a handful of short-biased funds in the mix.

Sector and global long/short are the largest sub-strategies, each representing a little more than a quarter of assets within the strategy. US long/short is the next largest sub-strategy, representing c. 15% of assets, followed by European long/short and Asia Pacific long/short, both representing c. 10% of assets. Other long/short and fundamental equity MN are the smallest sub-strategies, both representing c. 5% of assets. While fundamental equity MN is a relatively small strategy on a standalone basis, it is a core strategy within most multi-strategy funds.

While the general comments in the previous sections are applicable to all equity long/short sub-strategies, some—notably sector, European long/short, and Asia Pacific long/short—possess particular nuance, which is discussed in the sections that follow.

SECTOR

Sector specialisation is common among equity long/short portfolio managers, with Sector the largest sub-strategy group within Aurum's Hedge Fund Data Engine. **Information technology, consumer discretionary, and health care** are popular sectors of focus. These sectors are among the largest and known for higher single stock performance dispersion (i.e. more 'winners' and 'losers'), offering alpha potential on both the long and short sides of portfolios.

- **Biotechnology** is considered a sub-specialism within health care due to the highly specialised pharmacology and regulatory knowledge required to bet on drug approval outcomes. Biotechnology portfolio managers often have a background in medicine or pharmacology or employ analysts with such domain expertise. Risk profiles of biotechnology funds can be elevated, as trades often involve taking a view on binary outcomes—the success or otherwise of drug development. As such, some biotechnology funds use options to limit downside in the event that drug development or regulatory decisions do not work out as expected.

Financials and industrials are also common sectors of focus among funds. These sectors are more macro-dependent (financials are sensitive to interest rates, while industrials to economic growth and commodity prices) and so exhibit less dispersion than other sectors (stocks often move in tandem). Nevertheless, they are among the largest sectors (together with information technology, consumer discretionary, and health care, they form what is colloquially known as the 'big five' sectors) and so garner interest.

Most sector funds invest in the US and, to a lesser extent, globally, so the sub-strategy grouping can largely be considered a specialisation within US and global equity long/short investing. There are, however, a group of sector funds that focus on Europe and, to an even lesser extent, Asia Pacific.

EUROPEAN LONG/SHORT

European long/short equity funds typically focus on investing in developed market European equities. The main stock exchanges in Europe are based in London, Paris, Amsterdam, Frankfurt, Zurich, Stockholm, Milan, and Madrid. Like the US, Europe enjoys reasonably developed capital markets, with a large number of listed equities, plentiful borrow availability for shorting, and mature options markets. However, compared to the US, European equity markets are significantly smaller and less liquid.

As such, while many US equity long/short funds focus on a particular sector, European equity long/short funds typically invest across sectors and across the various jurisdictions in Europe. The utilities sector is an exception, attracting specialists based on opportunities related to a fragmented regulatory regime for utilities in Europe and the push for renewables.

The lack of liquidity relative to the US make European equities more volatile, particularly in times of market stress. As a result, risk frameworks for European equity long/short funds tend to be looser, such as wider stop loss limits. However, the smaller market provides opportunities, with a meaningful proportion of listed equities in Europe lacking sell-side analyst coverage. An often complex political and regulatory framework is another source of opportunity for specialists in the region.

The make-up of equities in Europe also differs from the US. The large technology and, to a lesser extent, biotechnology sectors in the US, give the US a growth bias. By contrast, Europe has more of a value and cyclical bias, featuring relatively few technology companies, though many companies in "old world" sectors, such as industrials, financials, and consumer discretionary. As such, while growth investors may be attracted to the US, Europe often attracts value investors.

ASIA PACIFIC LONG/SHORT

Asia Pacific equity long/short funds focus on investing in Asia Pacific equities. The main developed market within Asia Pacific is Japan, with most other economies in the region considered emerging. As such, the Japanese and non-Japan/Emerging Asia Pacific equity markets possess reasonably distinct characteristics, leading to most Asia Pacific equity funds focusing on either one or the other.

Japan Long/Short

In terms of equities, Japan shares many similarities with Europe:

- Reasonably mature capital markets, with a large number of listed equities (similar to the number of listed equities in the US) and a developed borrow market for shorting.
- Compared to the US, however, the Japanese market is significantly smaller (the average market cap is several times smaller than the US), less liquid, and more volatile.

- Lack of analyst coverage for a meaningful proportion of equities creates opportunities for active investors.
- A value and cyclical bias, with industrials, financials, and consumer discretionary the largest sectors and less exposure to technology than the US.

There are, however, several features distinct to Japan. After a very strong decade in the 1980s, Japanese equities experienced a prolonged bear market during the 1990s and 2000s. While the bursting of the historic late eighties Japanese assets bubble was the primary cause for the underperformance in the subsequent two decades (through both deflation and investor scarring from the bust), certain structural factors were also at play. Japan's cultural commitment to stakeholder capitalism, though well-intentioned, fostered widespread cross shareholding among corporations. This practice diluted shareholder rights and reduced free float, contributing to the low liquidity observed in many stocks.

In recent years, however, beginning with the efforts of Prime Minister Shinzo Abe in 2013, Japanese policymakers have introduced various initiatives to reduce the amount of cross shareholding and improve corporate governance, while also stepping up quantitative easing efforts to combat deflation. These policy shifts have sparked renewed investor interest in Japan and improved the performance of Japanese equities.

Another attraction of Japan, particularly for more opportunistic, trading-oriented investors, are more timely reporting requirements for large investors, which provide a rich source of transaction data. While large investors in the US are only required to disclose holdings quarterly with a six week lag (13F filings), reporting in Japan is dynamic and more timely, with investors owning greater than 5% of outstanding shares required to disclose any changes in holdings on a T+5 days basis, and investors short greater than 0.5% of free float required to disclose any changes on a T+2 days basis.

Non-Japan or emerging Asia Pacific equity long/short

Emerging Asia Pacific equity long/short funds focus on investing in non-Japan Asia Pacific equities. China—including both mainland China and Hong Kong—and, to a lesser extent, India are the main markets within the category. Smaller, though also significant, markets include Taiwan, South Korea, Australia, and the countries in Southeast Asia, such as Singapore, Malaysia, Indonesia, Thailand, and Vietnam. Given meaningful differences between the markets in the region, country-specific expertise is required, so many funds choose to focus on just one or two primary markets.

Whereas the largest and most prominent Emerging Asia funds were previously based in the US, in recent years, locally-based funds have become the dominant player in the region, mostly located in Hong Kong or Singapore. Although funds typically focus on local equities, portfolio managers may also express their views through developed market companies that derive a significant share of their revenue from emerging Asia Pacific.

Emerging Asia Pacific, as well as emerging markets more broadly, is a further step along the risk curve, after Japan, Europe, and the US. Emerging economies are meaningfully smaller than developed counterparts, resulting in capital markets that are significantly less liquid and less developed in terms of the availability of shorts and derivative products. The challenge of shorting in emerging markets means that most emerging market equity long/short funds are mid net or long-biased. Reduced liquidity increases the volatility of stocks, particularly in times of market stress, and limits the capacity of emerging markets-focused funds.

Emerging markets are prone to cycles of over-exuberance and over-pessimism, as well as increased political and geopolitical instability (for example, Russia invading Ukraine and the risk of China invading Taiwan). Emerging market assets also tend to be overly punished in global risk-off periods, as international investor de-risking can cause liquidity to become significantly impaired. As such, in addition to deep knowledge of local markets, a good understanding of the global landscape is important. Successful managers have typically seen multiple investment cycles and, through prudent risk-taking, demonstrated the ability to capture upside opportunities while containing downside risks.

The combination of higher net exposures and more volatile underlying markets means that emerging market equity long/short funds can be reasonably volatile. As such, the risk frameworks for emerging market-focused funds tend to be looser than developed market counterparts, such as wider (or even the absence of) stop loss limits.

With the greater risk, however, comes greater opportunity.

- Emerging markets typically have higher economic growth than developed markets and select sectors and themes can offer particularly attractive growth potential. For example, the theme of the rise of e-commerce in China was a very successful investment opportunity during the 2010s.
- Emerging market equities are less crowded, with many stocks lacking sell-side analyst coverage.

- Market participants tend to be less sophisticated in emerging markets, with high retail participation leading to greater pricing inefficiencies and alpha opportunities. In China, for example, retail investors are estimated to account for approximately three quarters of trading volumes.
- Emerging markets present a broad opportunity set, particularly considering that emerging markets are often at different points in the economic cycle. As such, generalists can rotate exposures into favourable markets and investing across regions offers diversification benefits.
- In addition, different thematic opportunities tend to present in different emerging markets. For example, in China, technology nationalisation, healthcare, renewables, and e-commerce have dominated the opportunity set in recent years. Non-banking financials has been a good way to play the rising middle class in India, while Taiwan and South Korea are known for their central roles in global technology supply chains. In Australia, investors often focus on commodities and consumer demand linked to China, while, in Southeast Asia, thematic trends have mirrored those in China and India, but at a smaller scale.
- Elevated volatility can also present trading opportunities. Emerging markets tend to be less economically diversified than developed market peers and more sensitive to macro influences, whether internal—such as domestic policy—or external—such as commodity prices and the actions of the US Federal Reserve. As such, emerging market economic cycles are typically shorter and more pronounced, giving rise to a higher frequency of tradable opportunities and larger market moves.

OTHER LONG/SHORT

As noted, the Other Long/Short sub-strategy group consists largely of non-Asia Pacific emerging market funds. The main markets within the non-Asia Pacific emerging markets category are Latin America (mainly Brazil and Mexico), Eastern Europe (Russia and Poland), the Middle East (Turkey, Saudi Arabia, the UAE, and Israel), and Africa (South Africa). Along with China and India, Brazil and Russia form the four original members of the prominent BRICS organisation of emerging economies, with South Africa joining as the fifth member and other members having joined more recently. Given meaningful diversity between the various markets, regional and country-specific expertise is required, so many funds focus on just one or two primary markets. The Emerging Asia Pacific section above discusses the broad characteristics of emerging market equities and emerging market-focused equity long/short funds.

Bottom line

In the 75 years since A.W. Jones coined the term “hedge fund”, equity long/short has evolved from a single experiment to a global ecosystem of sector savants, market neutral stock selectors, and multi-PM factories. The breadth is both its strength and its trap. Returns can be pure alpha or thinly-disguised beta; risk can be moderated by the use of leverage or amplified by crowding; fees can be justified or egregious. One’s edge as an allocator is recognising which flavour of equity long/short you’re buying, what it really costs, and how it behaves when the tide turns.

Equity long/short has evolved from a single experiment to a global ecosystem of sector savants

AURUM

Aurum Fund Management Ltd.

Aurum House
35 Richmond Road
Hamilton HM08
Bermuda
Telephone: +1 441 292 6952

Website: www.aurum.com
Email: ir@aurumfunds.com

Aurum Funds Limited

80 Charlotte Street
London
W1T 4QS
Telephone: +44 (0)20 7589 1130

Waystone Investment Management (IE) Limited

4th Floor, Shelbourne Road,
Ballsbridge
Dublin D04 A4E0, Ireland

Aurum Fund Management Ltd. is
licensed by the Bermuda
Monetary Authority

Aurum Funds Limited is
authorised and regulated by the
Financial Conduct Authority in
the UK

DISCLAIMER

The information contained in this Paper (the "Paper") is issued and approved by Aurum Funds Limited of 80 Charlotte Street, London W1T 4QS, United Kingdom. Aurum Funds Limited, which is authorised and regulated in the UK by the Financial Conduct Authority, is wholly owned by Aurum Fund Management Ltd. of Bermuda ("Aurum").

This Paper does not constitute an offer to sell or a solicitation of an offer to buy or endorsement of any interest in any fund or hedge fund strategy.

This Paper is for informational purposes only and not to be relied upon as investment, legal, tax, or financial advice. Whilst the information contained in this Paper (including any expression of opinion or forecast) has been obtained from, or is based on, sources believed by Aurum to be reliable, it is not guaranteed as to its accuracy or completeness. This Paper is current only at the date it was first published and may no longer be true or complete when viewed by the reader. This Paper is provided without obligation on the part of Aurum and its associated companies and on the understanding that any persons who acting upon it or changes their investment position in reliance on it does so entirely at their own risk. In no event will Aurum or any of its associated companies be liable to any person for any direct, indirect, special or consequential damages arising out of any use or reliance on this Paper, even if Aurum is expressly advised of the possibility or likelihood of such damages.

References to Aurum Hedge Fund Data Engine refer to Aurum's proprietary Hedge Fund Data Engine database maintained by Aurum Research Limited ("ARL") containing data on around 3,100 active hedge funds representing around \$3.2 trillion of assets as at June 2025. Information in the database is derived from multiple sources including Aurum's own research, regulatory filings, public registers and other database providers. Performance in the charts using Aurum Hedge Fund Data Engine data are asset weighted unless otherwise stated.

Data from the Aurum Hedge Fund Data Engine is provided on the following basis: (1) Aurum Hedge Fund Data Engine data is provided for informational purposes only; (2) information and data included in the Aurum Hedge Fund Data Engine are obtained from various third party sources including Aurum's own research, regulatory filings, public registers and other data providers and are provided on an "as is" basis; (3) Aurum does not perform any audit or verify the information provided by third parties; (4) Aurum is not responsible for and does not warrant the correctness, accuracy, or reliability of the data in the Aurum Hedge Fund Data Engine; (5) any constituents and data points in the Aurum Hedge Fund Data Engine may be removed at any time; (6) the completeness of the data may vary in the Aurum Hedge Fund Data Engine; (7) Aurum does not warrant that the data in the Aurum Hedge Fund Data Engine will be free from any errors, omissions or inaccuracies; (8) the information in the Aurum Hedge Fund Data Engine does not constitute an offer or a recommendation to buy or sell any security or financial product or vehicle whatsoever or any type of tax or investment advice or recommendation; (9) past performance is no indication of future results; and (10) Aurum reserves the right to change its Aurum Hedge Fund Data Engine methodology at any time and may elect to suppress or change underlying data should it be considered optimal for representation and/or accuracy.