130/30 Strategies: Myths and Realities

*Presenters*

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130/30 in the Market

- Currently estimated at $65 billion of assets under management\(^1\)
- Institutional investors, mainly public & private pension plans, represent most of the market
- Global demand with interest from UK, Australia and Netherlands
- Creation of 130/30 fund of funds offering
- 130/30 strategies offered in traditional structures:
  - Collective Trust, Institutional Separate Accounts, 1940 Act, Limited Partnerships
- Expansion of product offering from initial focus on US Core Equity to offering across market capitalization, style and geography

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What are 130/30 Strategies?

<table>
<thead>
<tr>
<th>Myths</th>
<th>Realities</th>
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<tbody>
<tr>
<td>▪ An alpha transport (derivatives or overlays)</td>
<td>▪ 130% long equity exposure and 30% short</td>
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<tr>
<td>▪ An absolute return strategy (market neutral)</td>
<td>▪ Market exposure relative to the stated benchmark (beta equal to 1)</td>
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<td>▪ Inherently riskier than a long-only strategy</td>
<td>▪ Employs modest amounts of leverage</td>
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<td></td>
<td>▪ Higher alpha for the same level of risk compared to a long-only strategy</td>
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<td>▪ As transparent as a long-only strategy</td>
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## What are the Risks Associated with 130/30 Strategies?

<table>
<thead>
<tr>
<th>Perceived Risks</th>
<th>Myths</th>
<th>Realities</th>
</tr>
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<tbody>
<tr>
<td>Tracking Error</td>
<td>Higher for 130/30 strategies</td>
<td>Can be customized for same tracking error targets as long-only</td>
</tr>
<tr>
<td>Leverage</td>
<td>Incremental leverage leads to incremental risk</td>
<td>Levered strategies can target the same tracking error as unlevered strategies</td>
</tr>
<tr>
<td>Shorting</td>
<td>130/30 strategies are riskier due to shorting component</td>
<td>Shorting risk can be mitigated through diversification and portfolio construction</td>
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130/30 strategies are not necessarily riskier than long-only

Please refer to the Glossary of Terms for definitions of Tracking Error and Shorting.
Do 130/30 Strategies Offer Higher Return/Alpha Potential than Long-Only?

Decomposing the Russell 1000 Index

Group I
Index Weight: 33.27%

Group II
Index Weight: 33.34%

Group III
Index Weight: 33.39%

28 Stocks
Average Stock Weight: 1.19%

128 Stocks
Average Stock Weight: 0.26%

830 Stocks
Average Stock Weight: 0.04%

Source: New York Life Investment Management LLC, April 2007
The figure above segments the Russell 1000 Index into three groups by market capitalization, each with approximately the same total weight by market capitalization. Please refer to the Glossary of Terms for index definition.
Do 130/30 Strategies Offer Higher Return/Alpha Potential than Long-Only?

Russell 1000 Index Weight
As of 3/30/2007

130/30 managers are able to capitalize on their best ideas, whether positive or negative.
Do 130/30 Strategies Offer Higher Return/Alpha Potential than Long-Only?

US Large-Cap Core Forecasted Alphas

Lost opportunity to capitalize on negative alphas due to long-only constraints

Source: New York Life Investment Management LLC, April 2007
The example above shows how long-only mandates may limit the alpha potential that can be realized from exploiting underperforming stocks in an equity portfolio.
Will Higher Leverage and Shorting Strategies Generate Higher Information Ratios?

Opportunity set will change with benchmark

Source: New York Life Investment Management LLC, April 2007

There can be no assurance that the targeted tracking error stated above can be achieved. Please see appendix for further information.
For a Given Tracking Error, how do 130/30 Strategies Increase Alpha?

The Transfer Coefficient measures how much of the information generated by the model is reflected in the portfolio. By allowing shorting, you increase the Transfer Coefficient.

Source: New York Life Investment Management LLC, April 2007
Can 130/30 Strategies be Applied to any Equity Market?

- Cap-weighted benchmarks will lend themselves better to 130/30 strategies
  - i.e. R1000 versus DJIA
- Shorting is more cost-efficient in large-cap markets since there are more stocks available to borrow at lower rates
- Costs associated with shorting in small-caps are higher but there is greater alpha potential
- All of the above apply in international markets provided shorting is allowed
How do 130/30 Strategies Fit in an Overall Asset Allocation?

- Benchmarked to equities
- Beta 1 portfolios

Assumptions vs. Expectations

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<table>
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<tbody>
<tr>
<td>Expected 5-year return of 60/40 portfolios&lt;sup&gt;1&lt;/sup&gt;</td>
<td>5.70%</td>
</tr>
<tr>
<td>Long-term return assumptions&lt;sup&gt;2&lt;/sup&gt;</td>
<td>8.47%</td>
</tr>
<tr>
<td><strong>Difference</strong></td>
<td><strong>(2.77%)</strong></td>
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</table>

1. Forecast return of a portfolio composed of 60% US equities returning 8.0% and 40% US fixed-income instruments returning 4.5% for the 5-year period ending December 31, 2010. Source: Congressional Budget Office (The Budget & Economic Outlook: 2004-2013).
2. JPMorgan (“Global Gambits,” 2006), Bloomberg Average long-term return assumptions of 100 largest corporate defined benefit plans as of fiscal year ended 2005.
Who is Best Suited to Manage 130/30 Strategies?

**Long-Only Manager**
- A natural extension of a quantitative long-only manager’s capability
- Experience managing active portfolios versus equity benchmarks
- No shorting experience

**Hedge Fund Manager**
- Experience with shorting and leverage
- Managing relative to equity benchmarks requires a shift in perspective from absolute to active
- Requires broader universe coverage
- Willingness to increase transparency
Why Quantitative Managers?

- Existing model provides alphas for the entire universe
- 130/30 is a change in constraints of existing long-only portfolio construction
- Quantitative processes lend themselves to more credible back-testing
Question & Answer Session
Glossary of Terms

**Alpha:** Alpha is a risk-adjusted measure of the so-called “excess return” on an investment. It is a common measure of assessing an active manager’s performance as it is the return in excess of a benchmark index or “risk-free” investment.

**Beta:** A quantitative measure of the volatility of a given investment, relative to the market, such as the S&P 500. A beta above 1 indicates that the investment is more volatile than the market. A beta below 1 indicates the investment is less volatile than the market.

**Information ratios:** The Information Ratio concept is one measure of volatility-adjusted return and is used in the analysis of performance investment strategy. Specifically, the information ratio is defined as excess return divided by tracking error. Excess return is the amount of performance over or under a given benchmark index. See definition of tracking error below.

**Leverage:** The use of credit or borrowed funds to potentially increase the rate of return from an investment, as in buying securities on margin.

**Long-only:** An investment strategy that seeks to produce investment returns based on the potential for a security to increase in value over time. In a long-only portfolio, the portfolio manager can only underweight a stock by its weight in the index.

**Short selling:** Borrowing a security from a broker and selling it, with the understanding that it must later be bought back (hopefully for a lower price) and returned to the broker. Short selling (or “selling short”) is a technique used by investors who try to profit from the falling price of a stock. If a short sale is successful, the profit is the difference between the price at which the stock was sold and the cost to buy it back, less transaction costs. However, if the price of the shares increase, the potential losses are virtually unlimited, which makes selling short more risky than traditional long-only investing.

**Tracking error:** The standard deviation of excess returns (the difference between a portfolio’s returns and the returns of the benchmark) over time. Tracking error is sometimes called active risk. Low tracking errors indicate that a portfolio is closely following its benchmark; high tracking errors indicate the opposite.

**Russell 1000 Index:** Designed to measure the performance of the top 1,000 companies from a universe of the 3,000 largest stocks in the US. This index is capitalization-weighted and includes only common stocks belonging to corporations domiciled in the US and its territories and traded on the NYSE, NASDAQ®, or AMEX. The Russell 1000 Index is adjusted once per year, in June, to reflect changes in rankings and shares outstanding. It is not possible to invest directly in an index.
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It is anticipated that the strategy will generally hold long positions equal to 130% of net assets and short positions equal to 30% of net assets. However, long positions may range from 120% to 140% of net assets and short positions from 20% to 40% of net assets.

The NYLIM US Large-Cap core 130/30 Strategy involves risk of loss of capital. There can be no assurance that the strategy’s objective will be achieved.