

Intelligent short selling:
providing clients with
another approach to
investing

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The long-only constraint can be a costly shackle on investment managers because it limits outperformance potential. Overweighting winning stocks and underweighting losers obviously results in alpha. However, the potential returns (positive and negative) from this approach pale in comparison to the potential returns (positive and negative) possible from combining long investing with shorting.

Typically, investment research produces insights into companies that are poised to both outperform and underperform. Therefore, when allowed to short sell prospective underperforming stocks (as well as owning prospective outperforming companies), managers have at their disposal extra opportunities to add value for clients.

The world has changed and so...

Events stemming from the 2008 capital markets' firestorm and the persistence of volatility since that time suggest that we are now in a new and less predictable investment age. While it is risky to declare the end of one era and the beginning of another, it is difficult to imagine a return any time soon to the broadly investor-friendly conditions of the 1980s, 1990s and even much of the 2000s.

We are living and investing in an age of deleveraging. This is an unwelcome but natural aftermath of a multi-year global credit boom, a credit bubble and, of course, the 2008 worldwide bust. The deleveraging process following credit/debt shocks can take years to play out as households, companies and governments gradually abandon extravagance and rediscover saving.

It implies shorter economic cycles, potentially lower economic growth and more frequent bouts of volatility. The upshot is that investment approaches that worked well in the past may be less effective in future.

...adaptation becomes imperative

Rather than fearing volatility, however, investors can intelligently embrace and even profit from it. If stock market upswings followed abruptly by downswings become the norm, long-only investing – that is, owning shares in the expectation that their value will go up – may be inadequate. In fast-moving share markets, today's gains can be washed away by tomorrow's losses.

Long-short investing – through vehicles such as the BlackRock Australian Equity Opportunities Fund – is one way of adapting to the kind of altered investment environment that many market participants anticipate.

The shackles of long-only investing – holding stocks that outperform the broad market and underweighting laggards – restrict portfolios' upside potential (but also limit portfolios' downside risk). At any point in the investment cycle, though, there are always companies that are likely to underperform.

For example, a company could tip into an underperformance phase because it has become overvalued. This can happen when investors extrapolate from strong past performance and assume that the future will be the same. Superior profit-generating companies can also go into a slower cycle as profits head back towards levels that are more normal.

Investment strategies restricted to long-only investing, in effect, give up the chance to obtain maximum benefit from research insights into companies that are primed to slide. For the long-only investor, the best result achievable in such situations is a zero weighting in potential underperformers.

This is a waste of investment knowledge, which has the potential to generate better portfolio returns. Long-short investing enables the investor to more effectively act on both positive as well as negative views.

Please note however that there are risks associated with short selling. In particular, a short sale creates the potential for an unlimited loss as the price of the underlying security could theoretically increase without limit, therefore increasing the cost of buying those securities to cover the short position.

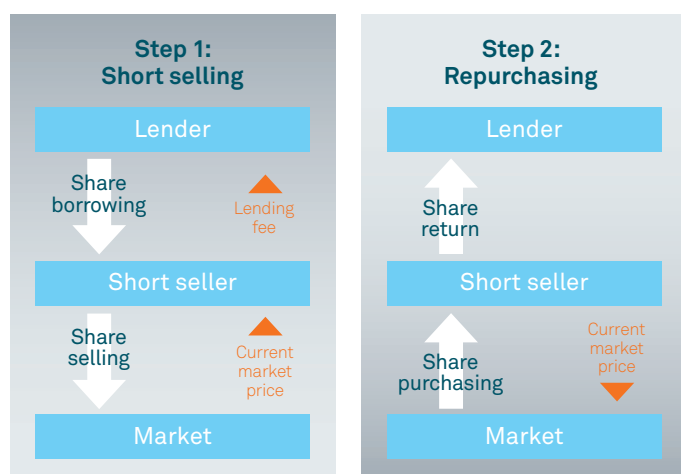
For further information about the risks of short-selling, please refer to the 'What are the significant risks?' section of the BlackRock Australian Equity Opportunities Fund PDS.

Mechanics of short selling

The concept of short selling shares is neither new nor unusual, having been around since the early days of share markets. Most stock markets and countries have rules and laws that regulate short selling.

A short seller borrows a company's shares (from an investment bank or broker, for example) and then sells them, with the intention of buying them back at a cheaper price. Thereafter, the short-seller returns the loaned shares back to the lender and books profits from the transaction, as the figure below shows.

Mechanics of short selling



Source: BlackRock

A hypothetical example of the short selling process works something like this:

An investment manager may have been tracking a retailer, Company A, through 2010 and is struck by its impressive earnings and share price performance. At the same time, though, the investment manager becomes convinced that due to consumer caution, household spending will diminish in 2011. They conclude that Company A's earnings growth and share price will taper off.

To act on this belief, the investment manager decides that he or she wants to short sell Company A's shares in September 2010. However, the manager does not own any of Company A's shares. This is overcome by borrowing the shares from a Company A shareholder who lends them for a fee; say 1% p.a. (in the same way banks charge borrowers). The manager then sells the shares.

The proceeds from selling Company A shares in September 2010 at \$22.00 per share (for example) are placed on deposit at money market rates, of 5% p.a. for illustrative purposes. Interest income accrues to the manager, the short seller.

Any dividends declared on the borrowed Company A shares accrue to the lender. Over the year to September 2011, the dividends declared are 48c and 29c per share.

The manager buys back the shares in September 2011 at \$15.00 per share, and returns them to the stock lender to close the transaction.

In summary, the manager makes \$7.00 on the trade, receives $5\% \times \$22.00 = \1.10 in interest, pays \$0.77 in dividends, and pays $1\% \times \$22.00 = \0.22 in borrowing fees. Thus, the profit on the hypothetical trade is $\$7.00 + \$1.10 - \$0.77 - \$0.22 = \$7.11$.

On the other hand, if the share price went up, the manager would lose money. Say that in September 2011 Company A announces a dramatic improvement in sales and a positive outlook for 2012. The share price rises to \$25.00, and the manager, believing the share price will continue to rise, buys back the shares and loses \$3.00 on the trade. The profit on the hypothetical trade would then turn into a loss of $(\$3.00) + \$1.10 - \$0.77 - \$0.22 = (\$2.89)$.

Deep relationships and excellent supervision are key

Strong risk management processes are integral to successful short selling. Long-short strategies require rigorous oversight, risk controls and investment skills in implementing and closing out short positions.

The technology, information systems and relationships with institutional market participants, such as investment banks, that are required to implement a long/short strategy are considerable and generally not accessible to retail investors.

Before deciding whether to invest in a long-short investment strategy, investors should speak to a financial or other professional adviser to ensure that they fully understand the risks associated with such strategies, including the risks associated with short selling.



Further information

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