Active Extended Equity: Evaluating Today's Quantitative Landscape

What is Active Extended Equity?

Active Extended Equity strategies begin with the basic idea of relaxing the constraints around a long-only active portfolio or passive index by introducing a short selling component that takes advantage of both positive and negative company information. At the same time, the portfolio maintains similar market exposures as the benchmark index.

The most recognized implementation is "130/30," 130% long and 30% short exposure. However, different implementations (150/50, 170/70, etc.) exist depending on desired portfolio objectives. All of these implementations lead to a "Beta-1" positioning, where portfolio market exposure is 100% net long, similar to long-only active or passive counterparts.

While a handful of offerings come from fundamental managers, quantitative strategies coming both from well-established equity shops and hedge funds have been receiving the majority of institutional allocator attention in recent years and will be the focus of this discussion.

A Brief History

Active Extended Equity strategies were originally developed in the mid-2000s as financial engineering developments led to increasingly sophisticated equity products manufactured and offered to investors leading up to the 2008 Great Financial Crisis.

As one may imagine, most of the nascent products during this period came from ill-equipped investment managers and did not survive given limited risk management capabilities, poor short-selling acumen, and unforeseen operational challenges. This resulted in great disappointment by early investors, as well as relief from those who avoided "Active Extended Equity 1.0."

However, a handful of leading quantitative managers coming from both traditional equity and hedge fund backgrounds have since established lengthy track records that have withstood a variety of market meltdowns and run-ups, including Brexit, a global pandemic, and significant wars across the globe. Reflected by the resurgence of these offerings, investors have been taking notice of "Active Extended Equity 2.0."

Two Camps

Active Extended Equity managers come from both traditional shops and hedge funds and are usually considered separate from each other. We believe a holistic approach of viewing the full peer group makes more sense, given the structural similarities and quantitative capabilities.

After a thorough evaluation of leading providers across this space, we discovered that while highly nuanced from manager to manager, there are essentially two broad categories of offerings. We will refer to these camps as “Style Factor Harvesters” and “Idiosyncratic Alpha Generators.”

Institutional allocators that are able to evaluate and appreciate the similarities, differences, and limitations across these offerings will put themselves in a position to make more effective decisions when balancing the desire for excess returns, diversification benefits, and portfolio risk.

Key Characteristics of Active Extended Equity Approaches

Portfolio Type	Return Objectives	Active Share	Diversification Benefit*	Leverage/ Shorting	Trading Frequency/ Turnover	Fees	Investor Liquidity
Style Factor Harvesters	Similar	Similar (Increases with Leverage)	Moderate	Similar	Medium- to Long-Term	Moderate (Varying)	Typically Monthly
Idiosyncratic Alpha Generators	Similar	Similar (Increases with Leverage)	High	Similar	Medium-Term	Higher (Varying)	Typically Monthly or Quarterly
Long-Only Index Fund	*Passive*	*None*	*Low*	*None*	*Passive*	*Lowest*	*Daily*

*Relative to traditional long-only actively managed equity.

Camp #1: Style Factor Harvesters

These managers utilize common academic “style factors,” such as value, momentum, and profitability along with a mix of proprietary versions of these factors. Research has shown that these factors have historically generated persistent premiums over time, supported by economic and behavioral rationales for existence.

Models will be constructed with the goal of combining a number of these factors, while controlling for correlations amongst them in order to ensure optimal portfolio diversification. Typically housed within more traditional quantitative equity shops, offerings will be based on geographical or market cap-based public equity benchmarks.

It is important to understand that Style Factor Harvesters will be more exposed to, and correlated with, style regimes across public markets. It should come as no surprise that those tilted toward momentum and growth characteristics in recent years have typically performed better than others with more static tilts toward low valuation.

Inconsistent, late, or simply poor timing of style factor trends embedded in manager stock forecasts will lead to short-term manager underperformance. Managers who have been able to generate more reliable excess returns have shown the ability to dynamically adjust the style factor tilts within their portfolios.

Camp #2: Idiosyncratic Alpha Generators

Instead of devoting resources to studying widely established style factors and their top-down effects on individual stock prices, these hedge fund managers focus on developing independently-generated forecasting signals that are more proprietary in nature. Such proprietary factors often provide high risk-adjusted performance, but can be arbitraged away more quickly than more common style factors.

These strategies will feature a far greater number of forecasting signals in their models, and must place more emphasis on the continued innovation of new factors and the retirement of older, obsolete ones that have been arbitraged away or are constrained for capacity. This also leads to a shorter company forecast horizon and higher portfolio turnover than Style Factor Harvesters.

The underlying objective is to deliver excess returns with very low correlations to any type of common factor regime, in order to deliver consistent stock-selection alpha. This leads to the advantage of stronger diversification benefits vs. Style Factor Harvesters.

As a result, these hedge funds require a much larger group of research professionals and overall investment staff that is often more geographically spread out, given the need to constantly discover and implement new, highly proprietary quantitative techniques. When selecting Idiosyncratic Alpha Generators, evaluating their ability to quickly evolve, adapt, and innovate is just as important as evaluating historical returns.

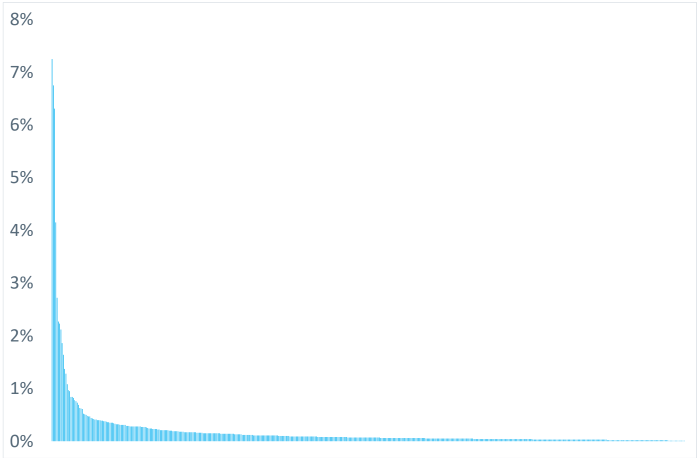
Why Active Extended Equity?

Active Extended Equity affords managers the opportunity to utilize both leverage and short positions while maintaining fully directional exposure to equity markets. The additional layer of leverage translates into additional "active share" available to overweight, underweight, and even short stocks across the universe of focus.

Increased Active Share. The concept of active share quantifies a portfolio's deviation from benchmark weights, which in turn drives the potential for excess returns. Maintaining high stock diversification, while introducing the ability to introduce short positions, creates a meaningfully higher active share relative to a long-only active portfolio, which must increase stock concentration to "keep up."

Looking at the current weights of all S&P 500 constituents and the enormous "right tail" of constituents with de-minimis index representation, it is easy see how little active share is available for any benchmark-constrained, long-only active

Index Weight of All S&P 500 Constituents



Source: S&P Global.

manager and appreciate the possibilities for excess returns that are unlocked within an Active Extended Equity implementation.

Quantitative Portfolio Construction Process

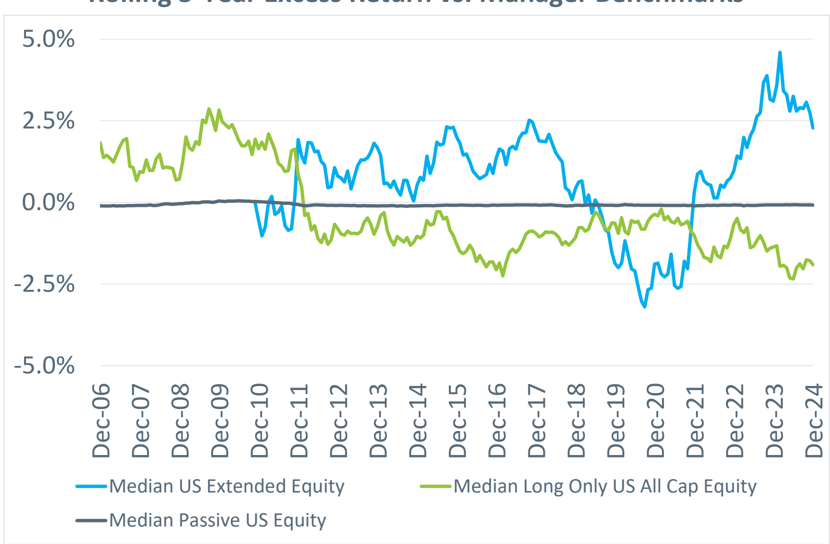
Increased Transfer of Information. The transfer of useable stock forecasts to portfolio weighting decisions is referred to in financial theory as the "Transfer Co-Efficient." When the barrier on active weighting is relaxed on long positions and negative stock information can be transferred to investable short positions, the potential for excess returns will naturally grow. In a 130/30 portfolio, one-fifth of the portfolio can be allocated to shorting companies with negative forecasts.

Encouraging Performance Characteristics. While this discussion is not intended to serve as a large performance study, there is strong evidence of persistent outperformance from Active Extended Equity managers vs. the traditional long-only active peer group. For the sake of simplicity and data integrity, we will highlight the full manager peer group of US-focused, long-only managers with the highest number of investable constituents.

Key metrics across both short- and long-term horizons suggest that Active Extended Equity managers have effectively added value in a consistent fashion and have weathered meaningful economic storms.

Although many hedge funds do not share performance data with public databases and are much more guarded with their track record data, we internally see similarly encouraging performance characteristics across both shorter and longer timeframes.

Rolling 3-Year Excess Return vs. Manager Benchmarks



Source: eVestment. Data is presented net of fees.

Performance vs. Long-Only Active Managers

Peer Group Median	Active Share	# of Holdings	10-Year Excess Return	10-Year Tracking Error	10-Year Information Ratio	10-Year Sharpe Ratio	10-Year Beta
US Extended Equity	95%	254	1.35	5.97	0.31	0.75	0.95
US All Cap Equity	80%	48	-1.39	5.01	-0.29	0.52	1.00
US Large Cap Core Equity	71%	64	-1.30	3.68	-0.36	0.66	0.97

As of December 31, 2024. Data is presented net of fees. Sharpe Ratio is relative to the FTSE 3-Month US T-Bill Index. Other statistics are relative to product-specific benchmark indices.
Source: eVestment.

Additional Considerations

Fees. While fee structures vary widely across both peer groups of managers, Style Factor Harvesters will typically charge fees that are more in line with other traditional active managers. It can be expected that Idiosyncratic Alpha Generators, which are typically housed within large quantitative hedge funds, will be more expensive. Fees are typically assessed on generated alpha, not total returns.

Investor Liquidity. Given that daily liquidity likely creates a mismatch with single-stock shorting programs, we consider monthly and quarterly liquidity to be appropriate terms for both peer groups. It is most likely that hedge fund firms will offer these products as LP (limited partnership) structures.

Leverage/Short Selling. Higher levels of leverage and short selling can temporarily exaggerate active management trends. Amongst common implementations, these issues will be least prevalent in a 130/30 portfolio and more prevalent in a 150/50 or 170/70 portfolio. Inflection points within market trends can present as difficult conditions for extended equity products, while low interest rates create structural headwinds for shorting.

Risk Management. As we have learned from "Active Extended Equity 1.0," the full spectrum of asset managers offering these products across both retail and more institutional channels will vary in risk management capabilities. Operational complexity, regulatory regime changes, and counterparty relationships evolve constantly. Effectively managing these dynamics is especially important for managers with short selling programs. Investors must carefully evaluate and compare the overall robustness of risk management resources and processes under the hood of both Style Factor Harvesters and Idiosyncratic Alpha Generators.

Conclusion

Active Extended Equity strategies offer institutional allocators a compelling alternative to passive equity allocations or traditional active long-only managers. These offerings have constructively evolved since the first wave of nascent offerings prior to the 2008 Great Financial Crisis and are being provided by some of today's strongest players in quantitative equities investing.

Both the Style Factor Harvester and Idiosyncratic Alpha Generator groups offer a variety of solutions targeting different geographies and market caps. While we have discussed some key similarities and differences of each group, investors must evaluate their own excess return objectives, diversification needs, and tolerance for higher fees.

By considering these strategies as a complement to other long-only active and passive investments across a larger equity composite, a more optimal portfolio could potentially be achieved by institutional allocators.

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