MEKETA

Extended equity strategies

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Extended equity strategies, also known as "active extension," "beta-one," or 130/30 strategies, are designed to allow portfolio managers to more fully capitalize on both their bullish and bearish stock convictions. The primary appeal is that by combining long and short positions, they offer skilled managers greater latitude for generating excess returns, all while maintaining a net 100% long exposure and targeting a beta to the market of 1.0. That is, they are intended to keep up with the market over the long term while offering greater alpha potential than traditional long-only strategies.

This paper aims to familiarize institutional investors with extended equity strategies. It addresses how these strategies were developed, why they may be of interest to institutional investors, their risk and return characteristics in comparison to long-only strategies, as well as several key implementation issues. In addition, we provide clear quantitative and qualitative examples so that institutional investors may better understand the underlying mechanics of these strategies.

Key takeaways

- Extended equity strategies aim to enhance portfolio efficiency and alpha potential by relaxing the long-only constraint of traditional equity approaches. The combination of long and short positions retains 100% net market exposure while enabling managers to more fully express both negative and positive outlooks on securities.
- While extended equity portfolios typically exhibit similar volatility compared to long-only portfolios, the inclusion of short positions can introduce additional risks, such as short squeezes and asymmetric loss potential.
- The data on relative performance is inconclusive. The median 130/30 strategy in the US has not performed meaningfully differently than the median long-only equity strategy. Further, the data is susceptible to survivor bias and a smaller sample size.
- The strategy's success is highly manager dependent, and most strategies rely on a quantitative framework.
- Implementation costs can be substantial, involving higher fees, short borrowing costs, operational reliance on prime brokers, and increased transaction costs compared to those of a long-only portfolio.

Background

The extended equity approach assumes that a typical active equity portfolio manager is hampered by their ability to hold only long positions (i.e., they cannot sell stocks short). Active portfolio construction typically centers on screening a particular universe of stocks (e.g., US large cap) and picking the best securities for the portfolio. Whatever their analytical approach, the portfolio manager will seek to select stocks that they believe will outperform the market over the expected holding period. It is natural to assume that during this analytical screening process, the portfolio manager may also come across stocks that they expect to underperform the market. That is, the portfolio manager not only has ideas about which stocks may be winners, but by logical extension, the same analytical process is likely to tell them which stocks are likely to be losers as well. If this portfolio manager could short the stocks they are pessimistic about, they might be able to add value to the portfolio. An extended equity strategy is designed to allow the portfolio manager to do just that, without modifying the portfolio's net exposure to the equity market.

For example, suppose that a long-only portfolio manager is benchmarked to the Russell 1000 Index. The largest 200 stocks in this index comprise over 75% of the index's total capitalization, and the remaining 800 stocks each account for a fraction of a percent of the remainder.[1] If the investment manager has a positive opinion on the 201st stock, they can buy a large quantity of it and take advantage of their conviction, as the managed portfolio weight in this stock will dwarf the index weight. However, if the portfolio manager has a negative opinion on the 201st stock, the most they can do is weight the stock at zero inside the portfolio. In other words, their only option is to exclude the stock from the portfolio; they cannot stretch the boundary of potential performance because of the shorting constraint that they face.

Since the stock is too small for the portfolio to benefit significantly from their conviction that the stock is about to underperform, there is no effective way for the manager to reflect their outlook in a way that meaningfully contributes to a portfolio's performance. However, if we remove the short constraint and allow the portfolio manager to short this stock, then they can effectively achieve a negative weighting that captures their investment beliefs better than merely reducing that stock's weighting in the portfolio to zero. Thus, in theory, the 130/30 manager can put their opinions of individual securities (both bullish and bearish) to work in generating excess returns for the portfolio more effectively than can a long-only manager.

[1] Source: FactSet, as of August 31, 2025.

Extended equity construction

The most common version of the extended equity strategy is a 130/30 portfolio.[2] The numbers "130" and "30" indicate that a manager has a 130% weighting in long positions and a 30% weighting in short positions within the same portfolio. The result is a 100% net long portfolio, and a 160% gross exposure.

[2] Because 130/30 has been the most common implementation of extended equity strategies, we focus on it through this paper. Note that there are many variants on these weights, with a targeted net long position of 100%.

To illustrate the mechanics, suppose that a manager purchases $100,000 worth of stock for the portfolio that they expect to outperform relative to the market. They then short $30,000 worth of stock that they expect to underperform and subsequently use the proceeds to buy $30,000 more of the expected outperforming stocks. The result is a gross exposure of $160,000 ($130,000 long plus $30,000 short) to the market with a net of $100,000 actually invested. Thus, the use of proceeds from short positions is an important component of the 130/30 portfolio construction; managers must not only correctly identify stocks likely to underperform but also redeploy the capital into long securities with strong upside potential.

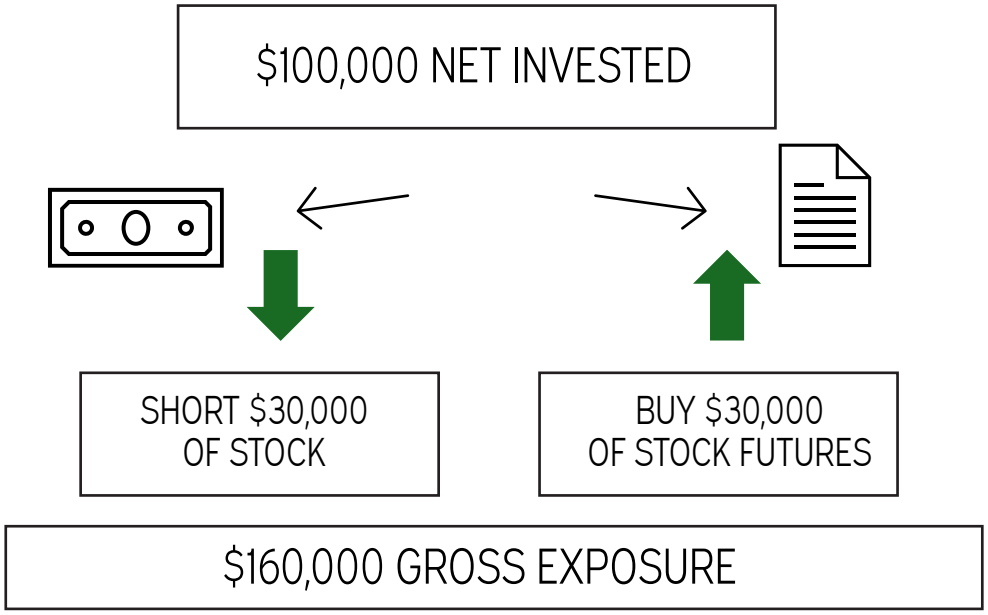

FIGURE 1
Long / Short Equity Position

Source: Meketa Investment Group, 2025.

Extended equity portfolios are targeted to have a beta of 1.0 and are therefore also known as "beta one" strategies. Beta measures the volatility of an investment relative to the market. A beta above 1.0 suggests higher volatility than the market, while a beta below 1.0 indicates lower volatility. The beta-one portfolio is structured such that the net beta is targeted to be the same beta value as the index to which the strategy is benchmarked. With the same systematic risk as the market, the goal is then to produce a return greater than the market (i.e., positive alpha) without taking on added market risk. Contrast this with a passive index fund, which, by definition, has a beta of 1.0 but an expected alpha of zero.

History

The concept of the 130/30 portfolio and its "extension strategy" variants (e.g., 120/20 and 140/40 portfolios) is not new. Academic research has touted the benefits of pairing longs and shorts in a single portfolio ever since the advent of Modern Portfolio Theory. Markowitz's original work, expanded upon by Sharpe, Lintner, and others, resulted in the Capital Asset Pricing Model (CAPM).[3] "Efficiency" in this framework calls for the unlimited ability to sell short and employ full use of the proceeds. Jacobs and Levy, as well as Brush and others, began writing articles on long-short investing in the 1990s, largely to explain the risk and return properties of market-neutral portfolios that had been managed since the 1980s.[4] However, it was not until the work of Clarke, de Silva, Thorley, and Sapra was published and widely understood that extended equity strategies began to gain serious traction as a separate entity from other long-short combinations such as a market-neutral hedge fund.[5] The foundation was laid that justified this particular combination of longs and shorts as being the optimal (in a theoretical and mathematical sense) structure for expressing manager skill.

The global bear market of 2000 to 2002 caused much concern for institutional investors. As is often the case following bear markets, financial innovation surged and investors turned to alternative sources of return such as private equity and hedge funds. It was against this backdrop of market conditions that interest in alternative investment strategies, including extended equity, came to the forefront.

Extended equity strategies gained popularity in the mid-2000s, peaking in late 2008. However, just as many of these products were incepting, the Global Financial Crisis (GFC) occurred, causing great losses across risk assets. While a typical equity fund may have a 96% long exposure with 4% cash, which provides a slight cushion in downward markets, extended equity funds aim to be 100% net long and generally do not have that protection from cash. Many portfolios lost significant value and experienced below average returns, causing newly emerged products to close in their first few years. After the GFC, the strategy was abandoned by some investors, as the number of funds reporting returns plummeted (see Figure 2). This rapid descent appeared to level off in 2011 before declining again in the latter half of the decade.

3 Sharpe, W. F. "Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk," The Journal of Finance, September 1964, pp. 425-442. Lintner, John. "The Effect of Short Selling and Margin Requirements in Perfect Capital Markets," The Journal of Financial and Quantitative Analysis, December 1971, pp. 1173-1195.

4 Jacobs, Bruce I. and Kenneth N. Levy. "20 Myths about Enhanced Active 120-20 Strategies," Financial Analysts Journal, July/August 2007, pp. 19-26. Brush, John S. "Comparisons and Combinations of Long and Long/Short Strategies," Financial Analysts Journal, May/June 1997, pp. 81-89.

5 Clarke, Roger G., de Silva, Harindra, Sapra, Steven, and Steven Thorley. "Long/Short Extensions: How Much is Enough?" SSRN Working Paper. July 2007.

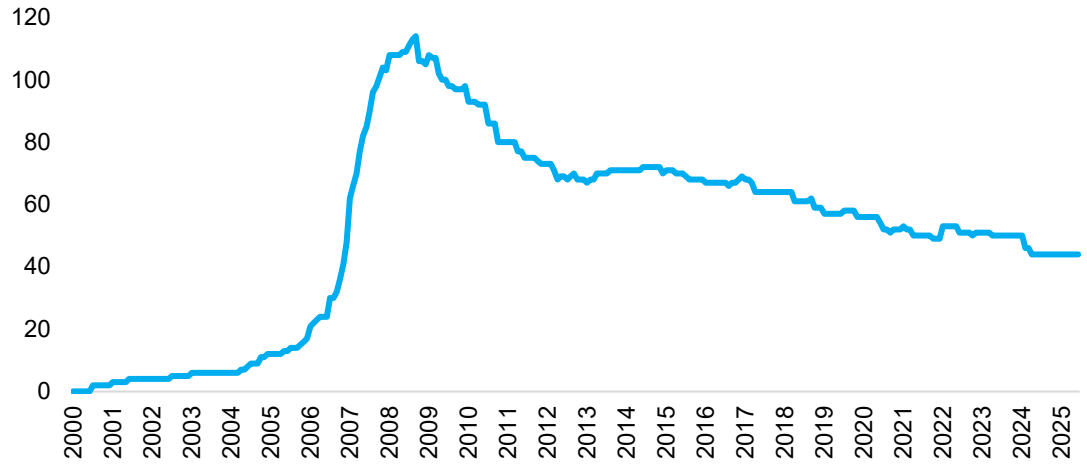

FIGURE 2
Number of US Extended Equity Funds that Reported Monthly Returns

Source: eVestment Alliance, as of June 30, 2025. Indices used: eVestment US Extended Equity Universe. Default reporting method used.

Analytical process

Quantitative techniques naturally lend themselves to a more comprehensive coverage of the investable universe for extended equity strategies because automatic rules can be set up. Thus, the majority of extended equity managers utilize quantitative analysis as opposed to fundamental analysis.[6] Ranking systems vary among managers but range from the simple (earnings or cash flow multiples) to the complex (multifactor regression models to determine stock price sensitivity). The main idea behind quantitative variants is straightforward. Once the model or the screening criteria are established, the decision threshold automatically ranks and designates securities for purchase and sale without the perceived handicap of emotion or judgment. This enables the quantitative manager to scour through a much larger investable universe than a fundamental manager reasonably could.

[6] As of July 2025, the majority of eVestment US extended equity products (both active and inactive) reported a quantitative primary investment strategy. The vast majority, over 80%, reported either a quantitative or combined approach.

However, there are a few extended equity managers that claim to primarily use fundamental techniques.[7] One potential drawback with this approach is that fundamental analysis is generally more time consuming per individual investment than a quantitative approach. If comprehensive analysis of each of the stocks within the Russell 1000 is going to take place on a security-by-security basis, then it could be resource exhausting (or impossible) to thoroughly analyze each name in the investable universe. This is not normally a problem for a long-only fundamental portfolio where the fundamental analysis can be conducted and updated as needed.

[7] As of July 2025, less than 20% of eVestment US extended equity products (both active and inactive) reported a fundamental primary investment strategy.

However, in a portfolio where there is short selling involved, this can be problematic because the shorted names will typically have a higher turnover than the long side of the strategy. Constant fundamental updating in the short book in such a way is so daunting that most fundamental competitors tend to be the larger investment managers that have access to enormous analytical manpower and institutional-quality resources. Alternatively, rather than selecting individual stocks to short, the manager may short a "basket" of stocks (e.g., via an ETF) based on the broad market or sector of the market.

Selling short

The inclusion of short selling, reflected in the 30% short allocation of a 130/30 portfolio, distinguishes extended equity strategies from traditional long-only equity approaches. Short selling is the process of selling shares of a security without owning them, planning to buy them back at a future date in the expectation that their price will have fallen. It is "buy low, sell high," but with the order reversed. The concept of short selling may be particularly appealing to an extended equity manager, who has an opinion not only on which stocks will go up in price, but also which ones will decline.

Shorting can provide diversification benefits to a portfolio as well. Just as on the long side, a portfolio of short positions decreases in risk with increased diversification. Further, a portfolio of short positions becomes less risky when combined with a portfolio of long positions, as this reduces some of the market risk. In addition, managers can use shorts to hedge against unwanted exposures so that their long positions are more targeted (e.g., focused on one particular product line at a company).

To engage in short selling, an investor must establish an account with a prime broker, who arranges to borrow the security to be shorted. For illiquid securities, short selling poses a particular problem, as it may be difficult to borrow the needed quantity. Moreover, if the lender recalls the security, the broker may not be able to find a replacement, thus forcing the investor to cover their short position at what may be an inopportune time.

The cost of borrowing stock can vary greatly based on supply and demand. The cost of borrowing for less widely traded illiquid securities may be hundreds of basis points higher than the cost for widely traded stock. The short seller incurs this cost as a "haircut" on the "short rebate," a payment received from the interest earned on the short sale proceeds. The prime broker typically takes custody of the long positions as collateral for the short positions.

On its own, short selling can be very risky. When an investor takes a long position in a security, the amount they can lose is limited to the amount they invested in the security, as the price of the security cannot fall below zero. However, when short selling, the amount an investor can lose is unlimited, as the underlying security may increase in value infinitely. A sharp, unexpected increase in the price of a shorted security may trigger what is known as short covering, where a manager must buy back shares of the shorted security to mitigate further losses.

An amplified version of this is the phenomenon known as a "short squeeze." In a short squeeze, price increases in the shorted stock spur a systematic purchasing of the stock to cover the short positions before the losses get worse. This purchasing can occur manually but frequently occurs because stop-loss orders have automatically been placed on the shorted stock. If there is enough demand for the stock at a time when short interest is also very high, the situation snowballs as buy orders begin to inundate the market, further driving the stock price up and worsening the magnitude of losses for short sellers.

Historical performance

For purposes of evaluating the extended equity universe and its performance characteristics, we use eVestment's Extended US Equity universe as a proxy. This universe encompasses 130/30 funds as well as funds that employ similar long-short extension techniques (i.e., products that maintain 100% net portfolio exposure with specified short positions).[8] This allows for a balance between using a dataset representative of the universe while still having enough funds for the analysis to be meaningful. For comparison purposes, we also use eVestment's US Large Cap Core Equity universe filtered for long-only funds as well as the S&P 500 Index.

[8] Our analysis focused on the US as eVestment had far fewer global than US funds in its universe.

Risk and Return

Over the past 10 years, the median US extended equity's net annualized return was 12.7%, slightly higher than the median US long only equity's 12.3% and lower than the S&P 500's 13.0%.[9] All three have followed very similar trends over the long term (see Figure 3 below). The median for extended equity has tended to deviate more often and by a larger amount.

[9] Source: eVestment Alliance and InvMetrics, as of June 30, 2025. Indices used: eVestment US Extended Equity Universe and eVestment US Large Cap Core Equity universe filtered for Long Only funds, S&P 500 Index. Performance is net of fees.

US extended equity's outperformance should be noted with the caveat of survivorship bias. Funds that report longer-term returns are by definition those that have survived the full period. Managers who experienced underperformance are more likely than the rest to have closed their funds, and those returns have been excluded from the data. Moreover, with the substantially smaller number of extended equity products analyzed (relative to long-only), the influence of outliers becomes more pronounced.[10] That is, if a single fund performed either poorly or substantially well, it has a larger effect on the median returns for extended equity funds then it would for the larger universe of long-only funds.

[10] There were 28 funds that reported performance over the full 10-year period for US extended equity and 281 funds for US long-only equity.

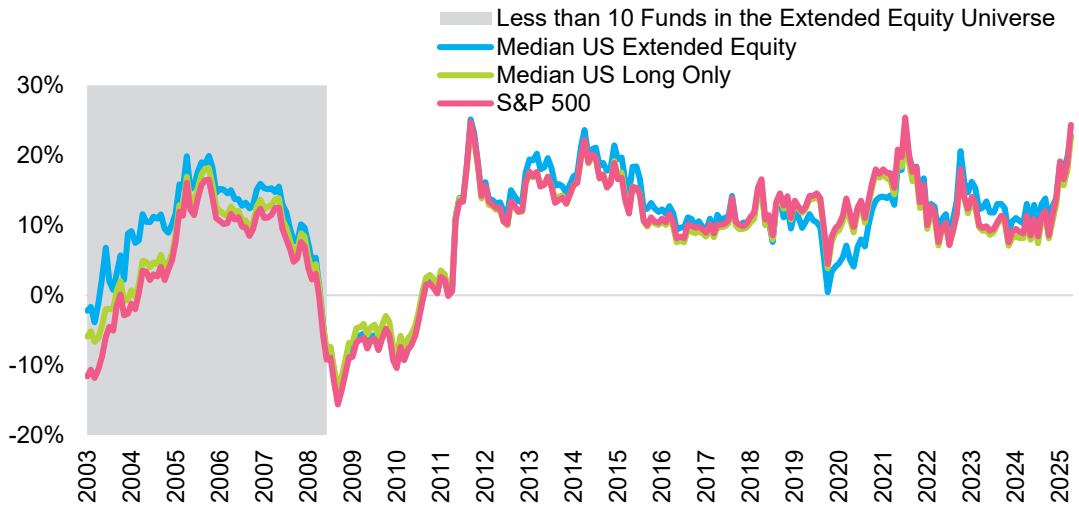

FIGURE 3
Rolling 3-Year Annualized Returns, Net

Source: eVestment Alliance and InvMetrics, as of September 30, 2025. Indices used: eVestment US Extended Equity Universe and eVestment US Large Cap Core Equity universe filtered for Long-Only funds, S&P 500 Index. Performance presented in this chart is net of fees.

Due to the very similar trends of these return streams, it may instead paint a clearer picture to analyze relative outperformance. Figure 4 shows how the median US extended equity strategy slightly outperformed during the relatively low volatility period of 2011 to 2018 but largely underperformed during the COVID-19 pandemic and then appeared to rebound from late 2022 to early 2025.

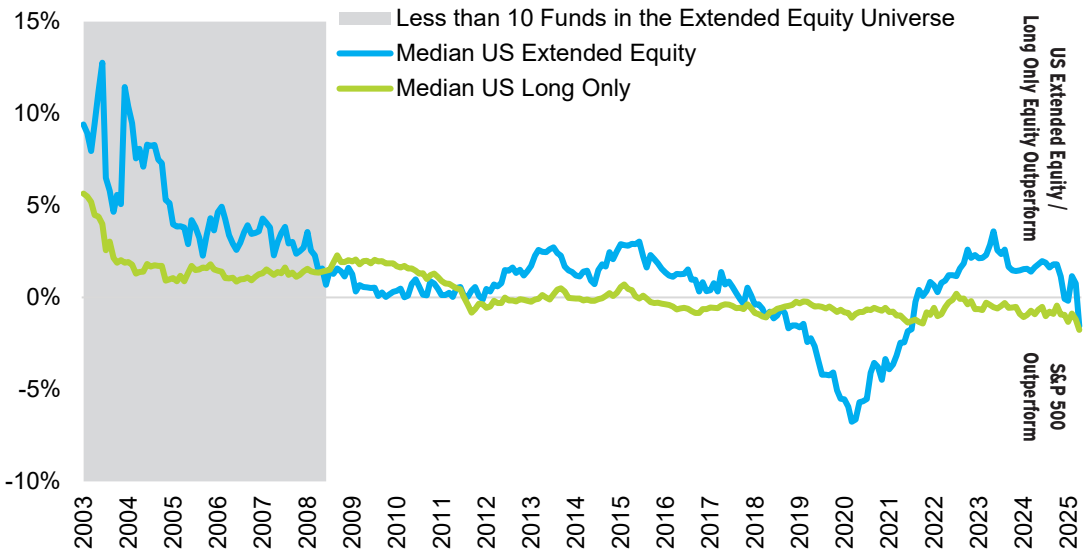

FIGURE 4
Rolling 3-Year Annualized Outperformance, Net

Source: eVestment Alliance and InvMetrics, as of September 30, 2025. Indices used: eVestment US Extended Equity Universe and eVestment US Large Cap Core Equity universe filtered for Long Only funds, S&P 500 Index. Performance presented in this chart is net of fees.

Interquartile spreads can be interpreted as how much potential value lies in selecting superior active managers (or, conversely, how much potential value an underperforming manager can detract). Figure 5 depicts how US extended equity has had a consistently higher interquartile spread than US long only equity, implying that it has more potential for managers to add (or detract) value. Note that some of this higher spread may be attributed to the significantly lower number of funds in the US extended equity universe.[11]

[11] The average number of funds shown in Figure 5 (beginning when there were at least 10 funds with data) was 47 for US extended equity and 396 for US long only equity.

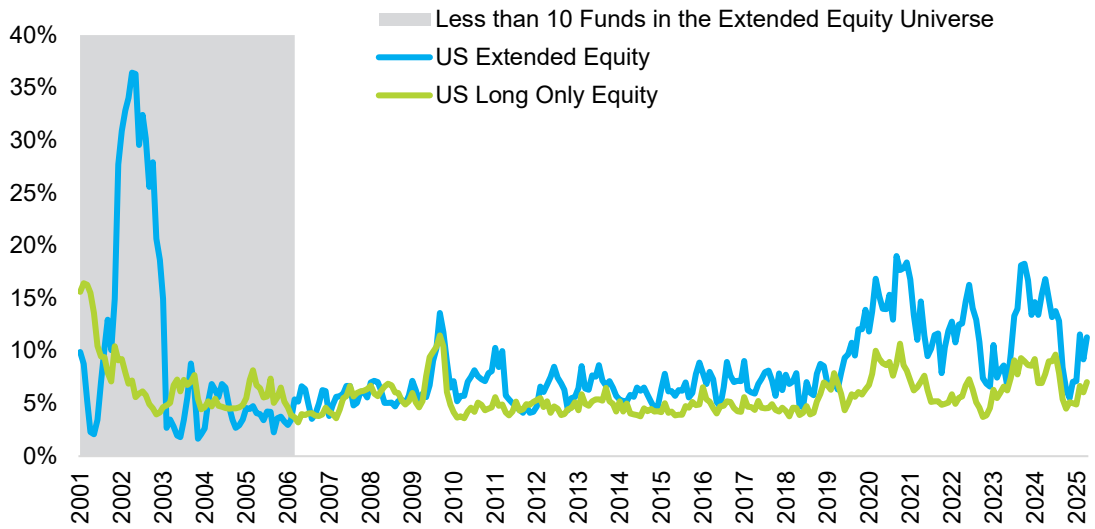

FIGURE 5
Rolling 1-Year Interquartile Spread

Source: eVestment Alliance and InvMetrics, as of September 30, 2025. Indices used: eVestment US Extended Equity Universe and eVestment US Large Cap Core Equity universe filtered for Long Only funds. Performance presented in this chart is net of fees.

The median US extended equity universe exhibited a trailing 10-year annualized volatility of 16.0%, slightly higher than the median of 15.6% for US long-only and the S&P 500's 15.5%.[12] Like their returns, all three have followed very similar volatility trends.

[12] Source: eVestment Alliance and InvMetrics, as of June 30, 2025. Indices used: eVestment US Extended Equity Universe and eVestment US Large Cap Core Equity universe filtered for Long Only funds, S&P 500 Index. Performance is net of fees.

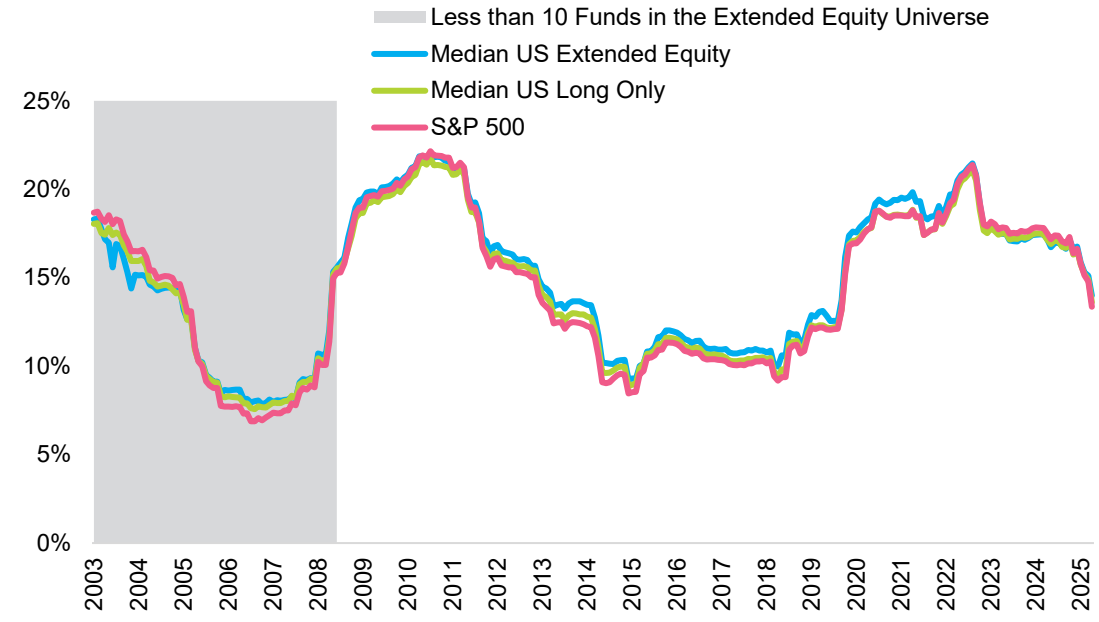

FIGURE 6
Rolling 3-Year Annualized Standard Deviation, Net

Source: eVestment Alliance and InvMetrics, as of September 30, 2025. Indices used: eVestment US Extended Equity Universe and eVestment US Large Cap Core Equity universe filtered for Long Only funds, S&P 500 Index. Performance presented in this chart is net of fees.

Beta

One goal of a "beta-one" strategy is to achieve a return higher than the benchmark while taking substantively similar market risk as the benchmark. By definition, the risk as measured by beta for any equity index is 1.0 (hence the "beta-one" name). Therefore, unlike an active long only strategy, which may seek beta exposures that differ from the market to achieve excess returns, extended equity managers strive to use the blended long-short strategy to target the same risk as the market. As a result of the limited supply of small-cap and lower mid-cap securities available (due to the higher costs to borrow and short), larger-cap indices such as the S&P 500, which is used in the chart below, are considered more accurate to use as benchmarks.

Over the past 10 years, the US extended equity universe exhibited a median beta of 0.94, slightly lower than the median for US long-only equity's 0.98.[13] Despite the two having very similar overall betas to the US equity market, the median US extended equity's beta has been more volatile (see Figure 7). This is likely due to the nature of extended equity funds, as the inclusion of short selling creates nonlinear sensitivities, with gains or losses on short positions swinging the portfolio's beta more dramatically. Extension equity strategies also tend to take more active bets, leading to greater exposure to changing factor correlations and idiosyncratic risks. By contrast, long-only funds tend to maintain more stable, benchmark-aligned exposures, resulting in smoother betas. It is worth noting that the higher volatility of extended equity's beta may be the result of its relatively lower number of funds per period.[14]

[13] Source: eVestment Alliance and InvMetrics, as of June 30, 2025. Indices used: eVestment US Extended Equity Universe, eVestment US Large Cap Core Equity universe filtered for Long-Only funds, S&P 500 Index. Beta is measured against the S&P 500 index.

[14] The average number of funds shown in Figure 7 (beginning when there were at least 10 funds with data) was 47 for US extended equity and 396 for US long only equity.

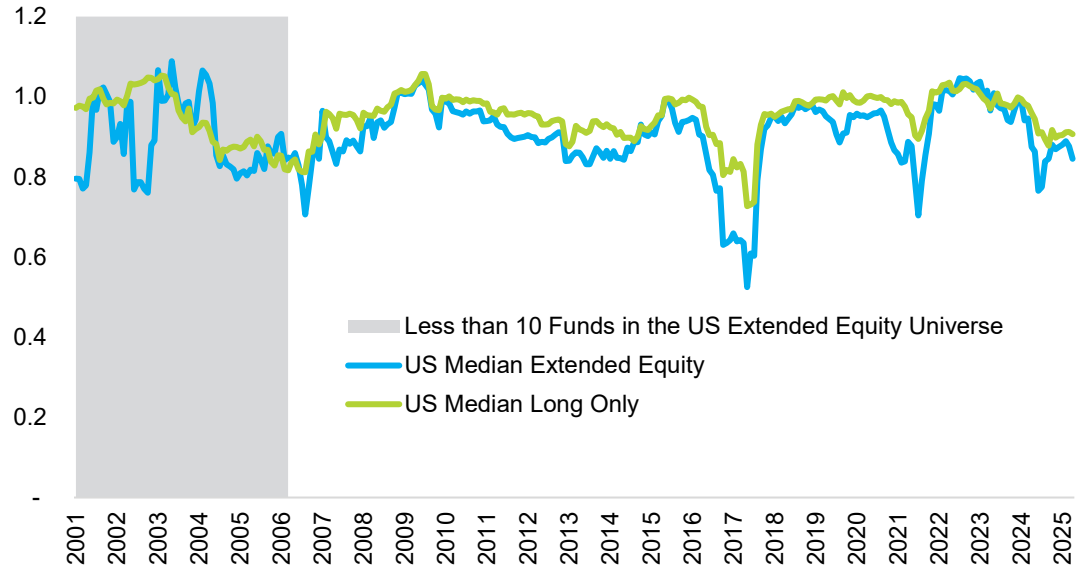

FIGURE 7
Rolling 1-Year Beta, Net

Source: eVestment Alliance and InvMetrics, as of September 30, 2025. Indices used: eVestment US Extended Equity Universe, eVestment US Large Cap Core Equity universe filtered for Long Only funds, S&P 500 Index. Performance presented in this chart is net of fees. Beta is measured against the S&P 500 index.

Potential for Amplified Returns

In theory, extended equity strategies' use of both short and long positions results in inherently more risk. A manager could be wrong on both their long and short positions (i.e., long positions fall and short positions rise), thus losing money on both sides. Alternatively, they could be right on both sides (i.e., long positions rise and short positions fall). In either case, an extended equity strategy would amplify the magnitude of the gains or losses (see Figure 8).

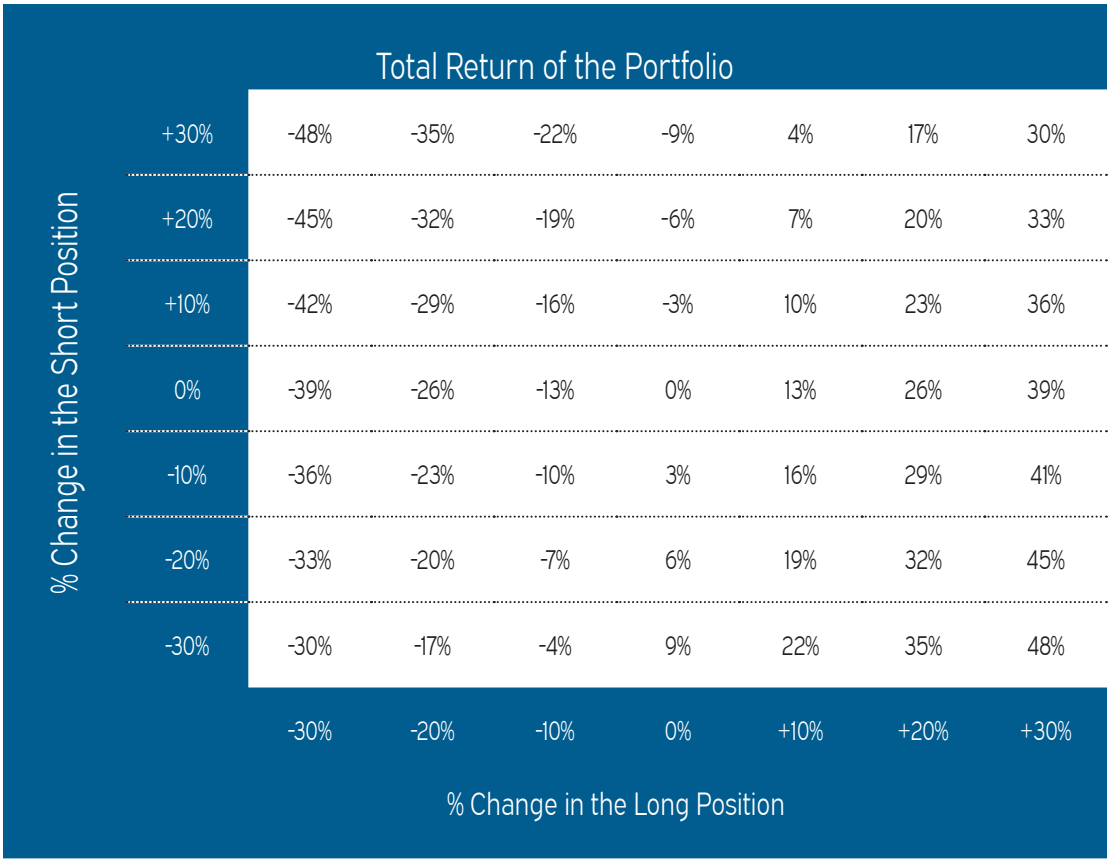

FIGURE 8
Hypothetical 130/30 Portfolio Returns, Gross

Source: Meketa Investment Group, 2025. We ignore associated costs for simplicity.

Role of strategy

Where extended equity strategies should fit within an investor's portfolio is not a simple determination. Some believe that the strategy can be included in a portfolio's conventional equity allocation.[15] After all, most of the strategy's expected return (and risk) will be derived from the public equity market, and as was noted earlier, they tend to have an average beta to the equity market of roughly 1.0. However, some institutional investors might include it in an "alternative" asset class category given its use of leverage and short selling.

[15] Source: Andrew Alford, "Demystifying the Newest Equity Long-Short Strategies: Making the Unconventional Conventional," Perspectives: Insights on Today's Investment Issues (Goldman Sachs Asset Management, October 2006).

Implementation issues

Extended equity products naturally have a plethora of implementation issues that managers must face.

Benchmarks

Finding the most appropriate benchmark for extended equity strategies has been a debated topic. Benchmarks ought to be transparent, investable, and replicable. Investors have generally benchmarked their extended equity managers to traditional long-only indices, such as the S&P 500 or the Russell 1000 indices, though there are some specific extended equity indexes.[16]

[16] Examples of 130/30 specific indexes include the UBS 130/30 Large Cap Index and a suite of 130/30 indexes from Standard & Poor's. These 130/30 index methodologies and construction methods differ, with some using popular factors.

Fees and Other Costs

Extended equity strategies are typically actively managed and tend to have higher fees relative to traditional long-only strategies. Moreover, the fee structure of extended equity funds can vary, with some charging just a management fee (like many long-only funds) while others charge both a management and performance-based fee. The median product fee on a $100 million mandate was 75 basis points for US extended equity funds that charge just a management fee, higher than US long-only funds' median fee of 50 basis points.[17] For US extended equity funds with performance-based fee structures, the management fee may range from 0.20% to 1.0%, and the performance fee may include a 10% to 20% cut of any excess returns (above the benchmark). However, this fee structure is less common and hence has more limited data for which to base these ranges on.[18] Also note that these are "rack rate" fees, and investors may be able to negotiate lower fees.

Not only are extended equity portfolios' fees above those of long-only portfolios, but the trading costs tend to be higher, as well. For example, a strategy with gross exposure of 160% of assets (130% long plus 30% short) translates into higher transaction costs due to the increased number of positions to enter, rebalance, and maintain. As a practical matter, 130/30 strategies could easily have transaction costs 1.6 times higher than traditional long-only portfolios, on average. In addition, extended equity strategies are more sensitive to timing issues, particularly on the short side, where the borrowed stocks may have to be replaced by a pre-specified time. Consequently, the holding period for securities in extended equity portfolios may be shorter than in traditional long-only portfolios, leading to more frequent trading and hence greater transaction costs. Higher fees and transaction costs obviously present a higher hurdle for the portfolio manager to overcome.

Extended equity funds also include the additional cost of managing the short positions. This includes the inherent cost of borrowing stock to short, as well as the opportunity cost if a prime broker requires collateral to be held from the proceeds of short selling the security. The premise of an extended equity strategy is that long positions are purchased with the proceeds from the shorts. When a prime broker requires collateral, this can make it difficult for a portfolio manager to implement a true extended equity strategy.

Skeptics might see extended equity strategies as a way for previously long-only portfolio managers to manage a product for which they can charge higher fees while they receive on the job training in shorting stocks. Some portfolio managers of extended equity strategies have been criticized for merely shorting index/industry ETFs, while actively managing only the long side of the strategy. Arguably, such a manager adds minimal value over a long-only strategy and is unlikely to deserve the higher fees charged by this strategy.

[17] Source: eVestment Alliance, as of August 26, 2025. Indices used: eVestment US Extended Equity Universe, eVestment US Large Cap Core Equity universe filtered for Long Only funds. Backdated fee data is unavailable. US extended equity fee data is limited with only ~144 funds reporting product fees while US long only had ~937 funds. Fees are for all product types (separate account, mutual fund, commingled fund).

[18] Source: eVestment Alliance, as of August 26, 2025. Indices used: eVestment US Extended Equity Universe. Backdated fee data is unavailable. Data for these figures is very limited with only ~20 US extended equity funds reporting management/ incentive fees.

Use of Prime Brokers

Extended equity strategies involve an extra layer of complexity in that the investment manager needs to use a prime broker to carry out their short sale operations. Nearly all the large investment banks provide prime brokerage services. For the short side of the book, prime brokers perform the critical function of securing the stocks for shorting. In addition, the prime broker deals with cash management, clearing, and custody. The prime broker may also provide analysis of the short market and inform the investment manager of supply and demand factors, as well as provide intelligence on opportunities that may arise for short trades. Without the prime broker providing these functions, the extended equity strategy would not be possible.

Because of the prime broker's importance to the extended equity strategy's execution, it is imperative that an investment manager have an established relationship with one if the strategy is to be successful. In fact, it has become standard since the GFC for a manager to have multiple prime brokers in order to mitigate operational risk. Managers who have just entered the extended equity arena may have extensive operational issues in establishing a relationship with a prime broker, including systems compatibility and unfamiliarity with the complex details of maintaining this relationship. This is particularly relevant for institutional investors considering investing in a commingled extended equity account, where an established prime broker relationship may mean a more efficient product. However, should an institutional investor be large and sophisticated enough to want a separately managed account, that investor will have their choice of which prime broker(s) to use. In many cases, though, the extra costs associated with forcing the investment manager to use a new prime broker instead of their established prime broker relationship may exceed any perceived benefits.

Summary

The extended equity portfolio structure has a mixture of support and resistance. While a highly skilled active manager can theoretically add greater value within an extended equity framework than a long-only portfolio, investors have not collectively replaced long-only portfolios, perhaps because actual experience has not lived up to the expectations for the average extended equity manager. However, this strategy can be seen as a different, and perhaps more efficient, way to obtain equity market exposure.

If an institutional investor is seeking exposure to strategies of a non-traditional nature, then extended equity strategies represent a logical step in the pursuit of returns above what a long-only portfolio can deliver. For institutional investors with existing hedge fund exposure (particularly long-short), there may be no discomfort with hiring an extended equity manager in principle, though they may need to adjust both their beta and alpha expectations relative to long-short strategies.

The market for extended equity funds has grown since falling during the financial crisis. As with any other strategy, both winners and losers have and will continue to emerge as manager skill in this space is tested by the market. The higher fees charged and costs incurred represent a significant hurdle that may be difficult for many managers to overcome. The smaller sample size of available data compared to long-only portfolios also makes it difficult to reach definitive conclusions. If an institutional investor does decide to proceed with the inclusion of an extended equity strategy, they should look at the products on a manger-to-manager basis. As this strategy requires a high amount of skill and active management, proper manager selection is of utmost importance to add value using extended equity strategies.

Appendix

Why the 130/30 Structure?

Clarke, de Silva, and Thorley outline how two major factors, signal quality and the transfer coefficient ("TC"), contribute to excess returns.[19] Signal quality describes how well the manager can forecast the returns of securities in the portfolio, and is therefore a measure of manager skill. TC is a measure of how effectively a manager can translate that skill into actual security weights to capitalize on their forecasting ability. An investment manager with a high signal quality (information ratio) but a low TC because of portfolio constraints is like an architect who has drafted the blueprints for his masterpiece but lacks funding to actually buy the materials and see construction through completely. As should be expected, the removal of the long-only constraint can theoretically enable the manager to transfer their knowledge into a more efficient portfolio construction and increase their TC. If TC is increased, then the information ratio is increased, in other words, higher active returns per unit of active risk.

There have been numerous academic and practitioner studies showing the benefits of loosening the shorting constraint of a manager on the resultant TC of the portfolio. Clarke, de Silva, and Sapra show that the marginal increase in the TC begins to diminish as the 125/25 to 150/50 range is reached.[20] Alford shows that the increase in expected alpha at a given tracking error begins to diminish with increases in the amount of shorting in the portfolio past a 130/30 structure.[21]

The dominant consensus is that while increasing the amount of shorting beyond 130/30 could potentially add value, most of the benefits of shorting are captured in the 130/30 configuration and any additional shorting would entail marginal risks and costs that exceed the marginal benefits of the additional constraint loosening.

In reality, 130/30 managers may stray from a pure 130/30 long-short allocation as the landscape of opportunity changes. Many managers begin with a 130/30 allocation as a starting point and then deviate based on a variety of factors. A 130/30 manager may drift between structures if they perceive the potential to add value or to align with client preferences. An institutional investor should check the details of the product's investment policy to see how much leeway the manager has in changing the tactical long-short allocation.

[19] Source: Roger G. Clarke, Harindra de Silva, and Steven Thorley, "Portfolio Constraints and the Fundamental Law of Active Management," Financial Analysts Journal, September/October 2002, 48–66.

[20] Source: Roger G. Clarke, Harindra de Silva, and Steven Sapra, "Toward More Information-Efficient Portfolios," The Journal of Portfolio Management, Fall 2004, 54–63.

[21] Source: Andrew Alford, "Demystifying the Newest Equity Long-Short Strategies: Making the Unconventional Conventional," Perspectives: Insights on Today's Investment Issues (Goldman Sachs Asset Management, October 2006).

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