

*This article is excerpted from a letter by MOI Global instructor Daniel Gladis, portfolio manager of Vltava Fund, based in the Czech Republic.*

Approximately eight years ago, in 2011, my colleagues at Vltava Fund and I sat down and debated the following topic: If we were to manage the Fund for another 30 years, how in the future could we bring additional value for the Fund's shareholders above and beyond what would be possible by means of the investment strategy we are currently pursuing? Of the various possibilities raised, just one option remained in the end: taking short positions. We decided to commence doing so to a very limited extent and after approximately seven years to evaluate if we really could add value in this manner and whether or not we would continue with it into the future.

Our investment activity is not static but rather develops over time. We continuously strive to evaluate our results and to analyse successful and unsuccessful transactions or approaches. One could say we continuously force ourselves to question whether or not we are correct in what we are doing. It can be very dangerous when an investor stops questioning his or her own approach. We also strive constantly to learn new things.

Among these strivings is our pursuit of the plan to take short positions in individual stocks. Not only is practical experience the best school, it also provides immediate and abundant feedback. Our short positions in individual stocks were therefore a very real, albeit miniscule, part of our overall portfolio.

We have discussed short selling with you several times at our Shareholders' Meetings, and now, seven years after the aforementioned initial idea, comes the time to evaluate the success of this additional strategy.

Our entire investment philosophy is based on a simple idea. What we pay (price) must be much lower than what we obtain in return (value). We say (and the history of the markets confirms it) that price and value are two different categories. For transient periods the two may differ significantly, but, over the long term, price has a strong tendency to follow the development of value. When we say that many stocks can be found that are priced substantially below their values, then, analogously, there must also be a number of stocks to be found whose market prices are substantially above their fundamental values.

Short selling endeavours to take advantage of those situations when price can be expected to follow value downward. The mechanics of these transactions are pretty simple. An investor borrows shares from his or her broker, sells them on the market, and holds the cash thus obtained. In future, he or she then buys the shares back using the cash acquired earlier and returns the shares to the broker. The profit or loss from this transaction (not including transaction costs) depends upon the development of share prices between the time of selling the stocks short and buying them back. In fact, this is just a mirror image of buying the usual long positions.

It follows from the preceding paragraph that one does not need additional capital for short selling. Therefore, if a fund's entire capital is invested in long positions and it makes money over the long term, and if several short positions can be added to this, then the profit from the latter may bring additional return, even at a lower net market exposure (which is defined as the difference between the sizes of all long and short positions).

Theoretically yes. The practical implementation, however, is not quite so simple. In looking back at the past 10 years, which is the period since the switch to our current investment strategy, we can see that the success rate of our long positions is approximately 9:1. This means we make money on almost nine out of ten stocks that we buy. The success rate of our short positions is not that high. In addition, short positions require a disproportionate commitment of time and energy. Our average long position accounts for approximately 5% of the portfolio. When we pick well, profit may easily be 100-200%, which is 5-10% percent of the overall portfolio.

The individual short positions, however, must be much smaller. In our case, this was approximately 1% of the portfolio and there were only a few of these positions at any one time. A 50% return on a short position, which can be considered a very good result, therefore, means only one-half of 1 percentage point return for the overall portfolio. In addition, looking after short positions is more demanding than is managing long positions. It all begins with analysis of the company itself. Whereas on the long side we focus on companies with no crucial accounting, financial, or managerial problems, on the short side we seek out precisely such companies as do face these sorts of problems. Their analysis is much more time-consuming. Monitoring the active position and dynamic risk management also are much more demanding in the case of short positions.

All of this has led us to the conclusion that it is better to focus our efforts fully on the long side of our portfolio and not to open any new short positions in individual stocks. In accordance with market developments, we will close out the last short position we are still holding and instead will devote our full effort to the long side of the portfolio. One can make money in short positions, and they may be used to help in managing the portfolio's risk profile. Their benefit to us, however, seems to be inadequate vis-à-vis the effort and time they would require if they were to form a larger part of the portfolio.

This conclusion may seem self-evident, but our decision-making was more complex than this. The following are some of the arguments we took into account:

1. Individual short positions cannot be considered independently. Each constitutes a part of the overall portfolio, changing its characteristics and risk profile. Particularly in periods of more substantial market decline our short positions had very advantageous effects. They usually fell more than did the overall market, and thus they were a brake on the decline of the overall portfolio.

2. Seven years of seeking out and analysing potential short positions was an excellent learning exercise for us that perhaps elevated our own analyses to a higher level. I believe that we can make good use of this knowledge in selecting long positions. When a person goes looking for something he or she does not want, this helps one to better recognise what

it is that he or she really does want. We came to realise something that I call the short-selling paradox: Even though most investors would be better off not attempting to sell short, most investors would nevertheless benefit from trying to find stocks to short.

3. Short positions help increase the market's efficiency and improve its price formation function. Although a number of investors consider short selling to be some sort of wager on failure or an excessively negativistic approach to investing, we do not see it that way at all. In selling a stock short, an investor expresses not what he or she wishes would happen but what he or she thinks will happen. By the way, investors have lost much more money by praising overvalued stocks than by identifying overpriced ones. The market needs investors who sell short, and there should be many more of them.