Fact Sheet: Shorts

Investor Benefits

- Allows the manager to profit when a security or market is declining.
- Statistics that include short positions provide a more robust picture of exposure and risk.

Most conventional investment portfolios take long positions in securities. Long positions involve buying the security first and then selling it later, with the anticipation that the security price will rise over time. A number of portfolios also use short positions, which are a bearish tactic that benefits when prices decline.

How to Short

To establish a short stock position, the portfolio manager borrows shares of stock from another party, sells the shares and receives cash. The manager is then obligated to buy the stock and return the shares at some point in the future. If the price falls after the short sale, the manager can profit from selling high and buying low. However, if the price of the security rises after the short sale, the manager will experience losses.

The ability to short allows a portfolio manager to take action based on a pessimistic view of a security or a market, and this may enhance returns. It is a broader mandate than a long-only portfolio, where a manager can only reduce or eliminate a long position if the outlook is negative.

Short positions have their own unique risks. In a long position, the most the portfolio can lose is the initial investment, and it is easier to hold onto the security if it takes a short-term dip. However, when a short position moves in an unfavorable way, the losses are theoretically unlimited. The broker will demand more collateral and the manager might have to close out that short position at an inopportune time to limit any further losses.

Short Strategies

There are a number of different investment strategies involving shorts. A simple example is a conventional long portfolio that reserves the right to take small short positions, say 5% of the portfolio, if a particular stock or sector looks overvalued.

A more complicated strategy is a long-short fund. These funds take long positions in stocks with attractive prospects and reasonable prices, and they take short positions in unattractive or overvalued stocks. The portfolio's overall exposure to stocks may be net long or net short, depending on the size of the long and short positions.

Market-neutral funds are a special type of long-short portfolio, where the long and short positions are approximately equal in size and similar in sector and regional exposures. The performance of these funds is driven more by stock-picking skill, rather than broad market movements. If the broad market rallies, the profit on the long positions will be offset by losses on the short positions, and vice versa for market declines. These funds aim to profit when the long stock investments do well relative to the short stocks.

The last shorting strategy is a bear-market fund, which takes short positions in stocks or bonds and long positions in cash. These funds profit when securities or markets decline. Investors might use these funds if they have a particularly pessimistic view of the economy.

Short Derivatives

Managers can also short derivatives. Derivatives are financial contracts that are based on (derived from) the performance of a specific underlying asset. In some cases, it may be easier to take a position in the derivative than the underlying asset. For example, it is difficult to short individual bonds, so managers typically use derivatives if they are bearish on bonds. Or, if a manager wanted to short an entire market, he might short a derivative based on an index, rather than shorting many individual stocks.

Morningstar models derivative holdings with a combination of the underlying asset and cash. For long contracts, the portfolio has long exposure to the underlying asset and short exposure to cash. For short contracts, the portfolio obtains short exposure to the underlying asset and long exposure to cash.

What It Means for Investors

Morningstar's portfolio statistics help investors look "under the hood" of a portfolio. These statistics summarize what the managers are buying and how they are positioning the portfolio. When short positions and derivatives are captured in these portfolio statistics, investors get a more robust description of the fund's exposure and risk.

Methodology

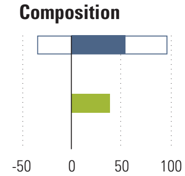
Morningstar calculates portfolio statistics on the short positions in each fund and displays long, short, and net statistics as appropriate. Short positions produce negative exposure to the security that is being shorted. This means that when the security rises in value, the short position will fall in value and vice versa. Individual short positions are displayed with negative percent weights in a complete holdings list, and the short asset allocation for a fund will also be negative. These enhanced statistics allow investors to evaluate the long and short sides of a portfolio separately and to estimate the fund's overall net exposure.

When and Where

Morningstar began incorporating short positions into detailed portfolio statistics (for current and historical portfolios) at the end of August 2007. These statistics are available in all Morningstar products.

Examples

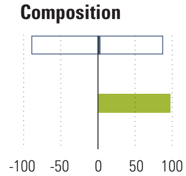
Composition



	Long %	Short%	Net %
Stocks	96	-35	61
Bonds	0	0	0
Cash	39	0	39
Other	0	0	0
Total	**135**	**-35**	**100**

This is the asset allocation for a long-short fund with a net long exposure to stocks. Cash is relatively high because it contains the proceeds from the short sale and the collateral for the broker for these short positions.

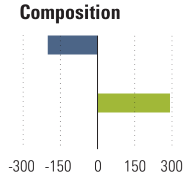
Composition



	Long %	Short%	Net %
Stocks	92	-91	1
Bonds	0	0	0
Cash	99	0	99
Other	0	0	0
Total	**191**	**-91**	**100**

A typical market-neutral fund balances its allocations to long and short stocks. The remaining assets are in cash.

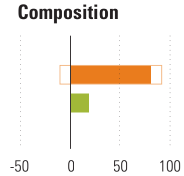
Composition



	Long %	Short%	Net %
Stocks	0	-195	-195
Bonds	0	0	0
Cash	295	0	295
Other	0	0	0
Total	**295**	**-195**	**100**

This bear-market fund offers double the inverse exposure to a stock index. This means that it aims to offer twice the return of the index in the opposite direction. So, if the index falls by 5% one day, this fund aims to earn +10%.

Composition



	Long %	Short%	Net %
Stocks	0	0	0
Bonds	92	-10	82
Cash	18	0	18
Other	0	0	0
Total	**110**	**-10**	**100**

This fund invests in bonds and buys credit default swaps for some bond issuers to protect against default. These derivatives are modeled as short bond exposure and long cash exposure.