

L1 Capital's three rules for investing short



by [Jemima Whyte](#)

US-based money transfer giant Western Union has long been a target of short sellers betting on disruption, all too convinced the enormous 6 per cent fees it charges customers to move money around the world are unsustainable.

But there's far more to a successful short position than a logical investment thesis.

Melbourne-based L1 Capital founders Mark Landau and Rafi Lamm, who launched their long-short fund almost two years ago and have just opened it to retail investors, have a few rules, based on the view that a short position is always riskier than a long position: smaller positions for shorts than longs, avoid crowded short trades because of the potential for short squeezes, higher cost of borrowing stock and less opportunity for an information edge. And finally, never invest without seeing a catalyst for a re-rating.

In the case of Western Union, the L1 team are betting the catalyst will come this year.

"We think market expectations for their earnings in the coming year are too optimistic," says Landau, carefully choosing his words like most Australian long-short investors to avoid openly criticising the stock.

The pair are even more guarded when it comes to naming other short positions in the portfolio, only saying that in some cases, the market is underestimating the business model fragility in some second-tier financial stocks and, even more worryingly, the balance sheet strength.

As the long-only fund approaches its 10-year anniversary, the pair who founded L1 in their late 20s, are keen to reflect on their performance, noting the original fund has returned 11.1 per cent per annum since inception, compared to 4 per cent for the S&P/ASX200 Index. The long-short fund hasn't had a month where it has lost more than 1 per cent in two years.

"We worry when times are good, and worry when times are bad," says Landau as fighter jets circled around their offices at Melbourne's 101 Collins Street on Friday ahead of the weekend's Grand Prix.

"You have to stay paranoid as a fund manager to make sure the team doesn't get complacent and doesn't get arrogant in any way."

Landau says that paranoia is mitigated by "the modest size of positions and ensuring that you're not taking bets on things you don't have any edge in. We're not going to try and predict things like currency, interest rates and Chinese GDP [gross domestic product]. I think very few people around the world can."

And after a decade running their own funds, which now combined have more than \$1 billion under management, what's the biggest lesson?

Landau and Lamm say the importance of shielding the portfolio from unpredictable macro events has been continuously brought home to them, even though their main focus is firmly on picking stocks.

They describe 2014 as dominated by yield trade, 2015 as a year for growth and momentum, while 2016 was all about "resources and value reflation trade".

"The fact the portfolio produced strong returns in each those years – without being overweight those thematic – is a function of the way we construct the portfolio. Not trying to time macro factors but rather trying to reduce the impact of macro factors."

Like many, Lamm predicts 2017 is the year where markets will become even more volatile, and he is cautious on valuations.

He says that given stocks have risen in price without strong earnings growth, high multiples make the market vulnerable.

"There's a good chance volatility escalates over the coming quarters."

That said, there are plenty of stocks that the fund has confidence are a good investment. And in order for any stock to go in the portfolio, both Lamm and Landau must both want to invest – a strategy they say has strengthened their partnership, and now works to the point that one wouldn't even propose a stock that he knows the other won't consider.

Despite wanting to dodge thematic, many of their investments including Boral, Lendlease and CIMIC are linked to the infrastructure spend on the east coast of Australia, the pair say.

"Some of the analysts and fund managers haven't witnessed a tight market before so they are underestimating the potential for price increases, particularly with Boral," says Lamm.

And what about the positions that have added significant performance in the past 12 months?

Landau says global toll road developer Macquarie Atlas Roads still has "reasonable upside", mainly in the form of cheaper refinancing which he argues will allow the company to grow dividends by at least 50 per cent in the next three years. And the fund still has a position in Bluescope Steel – which it bought at about \$4 a share – on the basis it still remains cheap relative to global competitors and has the second lowest price-earnings ratio of any stock in the S&P/ASX 100. The pair believe that cost reduction and business improvement, rather than market factors, has mainly driven its earnings improvement and remain happy to hold their reduced position.

However, L1 has just sold AGL Energy because of the belief that the higher wholesale electricity prices are factored into the stock, and there is a risk of government actions which could distort energy markets.