Relaxed Constraint

Relaxed-Constraint Portfolios

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We discuss how active equity managers can raise expected returns of their portfolios by relaxing the long-only constraint. Active managers' main task is to identify good stocks with high expected returns and bad stocks with low expected returns, but managers can only partially take advantage of these insights in a long-only portfolio. Allowing managers to short the bad stocks gives them more "elbow room" to express their negative views and in turn the ability to take larger positions in the favored stocks, giving rise to better overall performance. Based on simulations and historical evidence we confirm that this effect has allowed so-called 120/20 and 130/30 strategies to meaningfully improve returns. We show that the investment community has largely turned away from these strategies, but our findings suggest that they may want to take a renewed look.

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