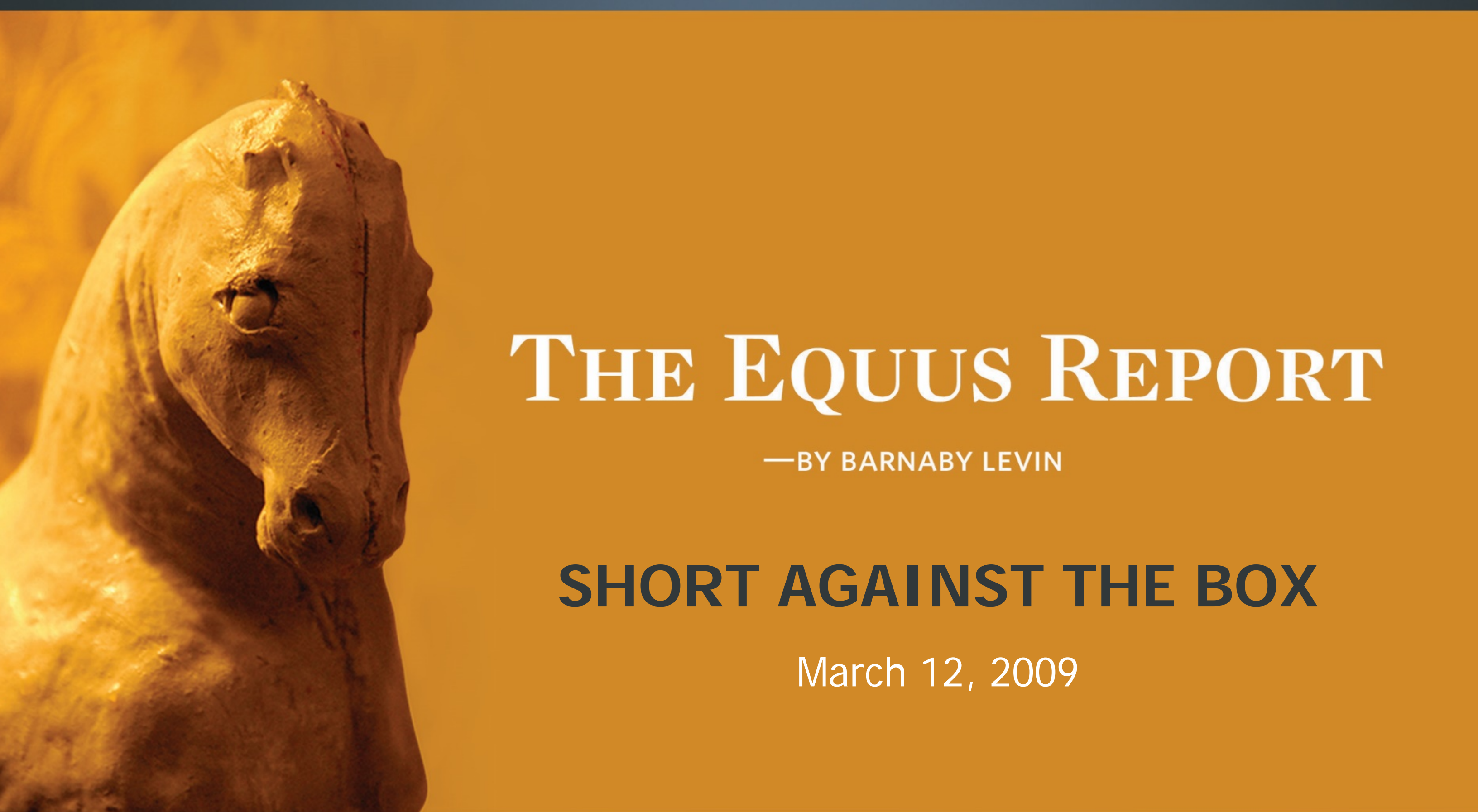
THE EQUUS REPORT
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SHORT AGAINST THE BOX
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"Short Against The Box"

The primary purpose of Asset Allocation – by establishing a reasonable degree of diversification – is to provide investors with a means to benefit during favorable conditions while remaining financially secure and comfortable during riskier times. For any given portfolio, adding up to 30 securities – the point where statistical risk becomes constant – should result in a reduction of what is known as "portfolio risk."[1]

When two assets or asset classes are negatively correlated, the idea is that their returns will offset one another and, by combining these assets in equal amounts, we can create a portfolio with substantially less volatility than either of its components alone. For example, bonds – and, to a lesser extent, international stocks – have historically moved by different degrees or in opposite directions to a large-cap domestic portfolio and, as a result, would theoretically reduce risk. Adding domestic small-cap, on the other hand, would not.[2] The latter should offer incremental returns over time, but wouldn't necessarily reduce volatility, hence risk, in the short term.

Investing in one or more diversified portfolios in a variety of non-correlating asset classes, then, should lower the risk of catastrophic loss – such as a bankruptcy or default, which could wipe out one's entire portfolio – and, by combining these two concepts (diversification and correlation), one could say that "diversifiable risk" should essentially be eliminated.

The object of this approach is to "Win by Not Losing." As illustrated in the following table, if a person has a choice of two opportunities – one with higher returns but at least one negative year versus one with lower but consistent results – he or she would likely choose consistent results:

Year	1	2	3	4	Average Annual Return
A	15%	15%	15%	-15%	6.63%
B	7%	7%	7%	7%	7.00%

**For Illustrative Purposes Only*

[1] *"Safety in Numbers," Investment Analysis & Management, Smith Barney Advisor, 2009 Asset Allocation Certification*
[2] *"Negative Correlation," Smith Barney Advisor, 2009 Asset Allocation Certification*

The point is that, even with broad diversification, a bad year can impact long-term investment performance far more than one might imagine. As we discovered in 1998 with the collapse of Long Term Capital Management – and again with the financial crisis in the fall of 2008 – it has become increasingly evident that, in times of extreme stress, virtually all non- or negatively-correlated assets become correlated.[3] Of course, excess leverage was one of the primary culprits in both of these instances. But, other than US treasuries and government-guaranteed money market funds, there really was no place to hide at the time and, while many financial planners may wax poetic over the merits of the "Efficient Frontier,"[4] the conclusion I have reached is that there are only two ways to truly defend and protect a portfolio when we enter a "perfect storm" or one of the increasingly common sell- offs that are periodically triggered by some external event that causes widespread selling across the world's equity markets. We can either sell everything, or we can hedge. And, given our interconnected global markets that now trade 24/7 and which feed on one another as each new trading day begins – as well as the increasing frequency and volatility of these triggering events – I far prefer the notion of hedging as a first line of defense.

For my clients, as we headed into 2008, the housing and unemployment pictures were already beginning to deteriorate at an accelerating pace and I wanted to protect our gains from prior years. I wasn't sure how long the economy would be at risk or, more importantly, whether or not there would be any significant degree of collateral damage to industries otherwise unrelated to the issues at hand. Raising cash, although it might provide us with a source of funds for later use, would still leave the remaining portfolio fully exposed. A more aggressive, trading orientation like the computerized buy-and-sell programs used by some hedge funds – unless done in a tax-deferred IRA – probably wouldn't be suitable for a meaningful number of people who face different tax rates for short and long-term gains; must abide by 30-day Wash Sale Rules; and don't relish constant turnover.[5] For months I intensely considered, evaluated, but ultimately had to dismiss most hedging strategies that used either options or inverse index shares as an efficient, cost-effective and properly-correlated means to adequately protect portfolios against large price declines or for any

[3] *"Evaluating Correlation Breakdowns During Periods of Market Volatility," Mico Loretan and William B. English, Board of Governors of the Federal Reserve System, International Finance Discussion Paper # 658, February 2000*
[44] *The "Efficient Frontier" is the point at which no other asset or portfolio of assets would theoretically offer a higher rate of return with the same or lower risk*
[5] *"Wash Sales 101," by Kaye Thomas, Fairmark Press Inc, May 30, 2007. When selling stock at a loss, if identical securities are bought within 30 days before or after the sale, the loss cannot be deducted until the replacement shares are later sold*

substantial period of time. There is, however, one optimal way to hedge a high-quality portfolio of core, blue chip stocks or indexes that – for the moment at least – we would prefer not to sell. That strategy is to sell short "against-the-box" securities identical to those we already own.

In the late 1990's, "Short Against The Box" was prevalently used by investors with large, concentrated positions in a single stock and was being abused by many who were carrying that hedge forward year after year. As a result, the IRS intervened, determining that – once such a hedge was engaged – it would be considered a "Constructive Sale." Unless, they said, a long list of newly-imposed restrictions was met during and after the hedging transaction, the individual would be subject to taxation as if the shares had been sold on that date. For example, the IRS insisted that the hedge must be closed on or before January 30th of the following year so that the maximum length of time it could be employed was thirteen months. They said that, for any hedged shares held less than one year, the "purchase date" had to be reset to the date shares were hedged so that the long-term capital-gain clock shares returned to their lenders, the long position couldn't be re-hedged for sixty days so the investor would be at risk again for this period of time. These and other restrictions – even when hedging a single position – made "Short Against The Box" both cumbersome and unattractive and, for many years, the strategy fell into disuse.

When I reconsidered this strategy in late 2008, however, it seemed to me that – with the benefit of modern technology and, to be sure, some very complex programming – each restriction could, indeed, be automated and addressed and that the strategy, therefore, could once again offer an unparalleled means to fully hedge each position across a multitude of holdings for multiple clients. This way, it would provide us a means – not only to lock in our portfolio value and give us the chance to then step back and calmly assess the situation as it unfolds without risk – it would present us with two distinct ways to ultimately settle the trade. We could either tender our long shares as if we had sold on the original date and price when we hedged or, if the stock does indeed decline, purchase the shares in the open market at a lower price with a ready reserve of cash.

Selling "Short Against The Box" means that, to the degree that we already own shares of a given stock, we can "short" an equal or lesser quantity that we borrow from someone else. When we sell short, we receive cash that we can then hold in reserve and we assume

the obligation, at some point in time, to return the borrowed shares. This creates three separate entries on our personal Balance Sheet: a credit for the long shares we already own free and clear; an equal debit (assuming a 100% hedge) for the liability created when we sell short; and the cash received from the latter sale. Taken together, they equal the value of our original, long-only position.

Strategically, if we like the companies whose shares we own but fear the broader market or some near-to-intermediate term event, using this method allows us to address our concern and hedge our risk so that, if the market does indeed decline, we are able to preserve the portfolio value. The idea, again, is to do this during times when we like our portfolio, but temporarily fear the market, and it provides us with an alternative to selling everything with all of its inherent tax consequences, challenges and rules for re-entry.[6] To protect against the potential for unlimited loss from a theoretically infinite rise in price that is created when we sell short, we can start by setting reasonable, good-till-cancelled stop- loss orders to retain the freedom and flexibility to keep our long shares and cover the short with cash. Conversely, because we already own the shares, we always have the right and the ability to simply cover the short position(s) by tendering our long shares in part or in full. In so doing, we will realize whatever gain or loss and value that we had on the date we hedged and we can use the cash we raised to reinvest elsewhere. The point is that, when used in this fashion, the strategy is both conservative and precise. It is "precise" because we can create mirror models for our Long and Short portfolios – incrementally, or all at once – using similar percentage allocations. The strategy is "conservative" because we are able to sell short without exposing ourselves to the potential of unlimited loss were we selling short on an uncovered basis. The mechanics – as illustrated in the attached spreadsheet – are such that, as we sell short, we accumulate a cash reserve that we would retain until the danger has passed. If the market declines and stock prices fall, we would eventually cover our short with cash now on hand; realize a short-term gain on the hedging-transaction; and, most likely, use the balance of cash to increase the number of shares of our long positions at lower prices to magnify our gain when prices ultimately recover. Throughout the process, the value of our portfolio can be protected as of the date we hedged and, during times of extreme volatility and upheaval, we are able to take a temporary "Time Out" without

[6] *There are strict rules in IRS tax code Sec. 1259 regarding "Constructive Sales" that can be triggered by such a strategy. By closing out the short position before year-end, that contingency is satisfied.*

leaving ourselves open to risk. When the danger has passed, we can pick up where we left off as if nothing had happened and with little or no additional money out of pocket![7]

Again, it is important to note that the use of this strategy can trigger a number of potential tax consequences and traps. These are detailed below in footnote form[8] and must be managed as part of any implementation to avoid what the IRS considers a "constructive sale." But I believe that I have taken all of these issues into account.

[7] *See Example on attached page*
[8] *The following discusses IRS tax code Sec. 1259 regarding "Constructive Sales" :*

Basic Rule*: If an investor owns an appreciated security and enters into a short sale of substantially identical securities, then the long position is treated as if it was sold and the gain must be recognized.*
Exception to Rule*: If the short sale is closed within 30 days after the year in which it was entered into, then the constructive sale rules will not be triggered and the long position will not be treated as sold when the short was established.*
Traps and Other Things to be Aware of:
1) The short term sale must be ***closed*** *by the* ***30th*** *day after the year it was established.*
a. A short sale is closed by making delivery. If shared are purchased to close the short sale then the purchase must settle on or before January 30. If a weekend is involved the purchase must be made by January 25 in order for it to settle by January 30. ***To be safe, have a rule to place the order no later than January 24.***
b. After the short sale is closed a new short (or other hedge, with some exceptions) may not be established within 60 days after closing the short. If the trade to close the short was entered into January 24 and settled on January 29, for example, the short would have been closed on the 29th. A new short could therefore be only entered into 61 days after that, or March 31. ***To be safe use April 2 as the date, in case you actually close the short on January 30.***
2) some additional ramifications of entering into the short position
a. If an investor dies while the short position is on, or within the 60 day period after it was closed, the investor's estate will not get a step up in basis on the long stock.
b. If the long stock was held for 1 year or less before the short position was established, its holding period is destroyed. If the stock was held for more than one year then the holding period is unaffected.
c. There may be 3 cash flows while the short position is on. The investor should be earning rebate, receiving dividends on the long position and making in-lieu of dividend payments of the short position. The rebate income is treated as ordinary income. The dividend income does not qualify for the 15% preferred tax rate, but rather is taxed at ordinary rates. The in-lieu of dividend payments is currently deductible as an ordinary expense up to the amount of rebate income earned on the transaction. The reminder must be capitalized and will either reduce gain or increase loss when the short position is closed.
3) Closing the Short
a. If the short is closed at a gain:
i. If new stock was purchased to close the short, the gain is considered a short-term capital gain.
ii. If all of the stock held by the investor was already held for over one year prior to entering into the short sale, and that stock is used to close the short sale, then the gain will be long-term capital gain.
iii. If some stock was held for more than 1 year and other stock for less than 1 year, the gain on the amount of shares held for less than one year will be treated as short-term capital gain, regardless of which stock was utilized to close the short sale. Depending on how much the stock has dropped, a decision has to be made whether to deliver the existing shares and to recognize a long-term capital gain or to deliver the new shares and recognize a short term capital gain. The amount of gain will differ.
b. If the short is closed at a loss:
i. If the long stock was held for more than 1 year prior to the establishment of the short position, then any loss on the closing will be treated as long-term capital loss.
ii. If the long stock was held for less than one year, any loss will be treated as a short-term capital loss.
iii. If some stock was held for more than 1 year and other stock for less than 1 year, then the loss on the amount of shares held for more than one year will be treated as a long-term capital loss, regardless of which stock was utilized to close the short sale.
Iv. If new stock is delivered to close the short sale at a loss, the loss may not be deducted until the original shares that were being hedged are disposed of, or there is no longer any unrealized gain in those shares.

In the meantime, let me be clear: "Short Against The Box" would only be one of several tools that we will need at our disposal. In the end, the purpose of this paper is to offer clients an opportunity to consider and discuss with me a number of more creative strategies for preserving capital in volatile markets. I invite this discussion so everyone is individually comfortable with whichever approach we ultimately adopt and, through this process, instill in them the confidence that we are prepared to deal with the new realities we will undoubtedly face over the course of the coming decade together.

The point is that we must adapt to our ever-changing global markets and to economic conditions – and we must have as robust a set of tools and alternatives as possible to preserve capital and address each event as it occurs. I have no doubt that neither my clients nor I will again be satisfied with a "long-term, buy-and-hold" approach in which we are forced to either make an extreme, black-and-white, sell-everything decision or ride the market down and back and, thereby, lose another decade as they have in Japan.

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Hedging: Short Against the box **HYPOTHETICAL**

Initial Position	# of Shares	Price/Share	Value	
Long XYZ	**100**	**$100**	**$10,000**	
Initial Hedge				
Long XYZ	100	$100	$10,000	Asset
Sell Short XYZ	-100	$100	-$10,000	Liability
Cash Credit from Short Sale			$10,000	
Net Number of Shares Long	0		$10,000	
Scenario: Stock drops 50%				
Long XYZ	100	$50	$5,000	Asset
Short XYZ	-100	$50	-$5,000	Liability
Cash Credit			$10,000	
Net Number of Shares Long	0		$10,000	
Action: Cover Short through Cash Purchase in Open Market				
Long XYZ	100	$50	$5,000	Asset
Short XYZ	-100	$50	-$5,000	Liability
Buy Back (Short) XYZ	100	$50	$5,000	Debit from Cash
Cash Balance			$5,000	
Net Number of Shares Long	100		$10,000	
Action: Add to Long Position Using Remaining Cash Balance				
Long XYZ (Original)	100	$50	$5,000	
Cash Balance			$5,000	
Buy more XYZ	100	$50	$5,000	
Debit from Cash Balance			-$5,000	
Net Number of Shares Long	**200**	$50	**$10,000**	
				% Change in Value vs. Original
Result of Alternate Outcomes				
No Action:	100	$50	$5,000	**-50%**
Hedging (After Tax):				
Long	200	$50	$10,000	
Less Tax on Short-Term Gain at 35% FED / 9.3% CA			-$2,215	
Adjusted After-Tax Value			$7,785	**-22%**
And, when Stock Recovers	200	$100	$20,000	
Less Tax on Short-Term Gain			-$2,215	
Net, Tax-Adjusted Change in Value versus Traditional Buy-and-Hold			**$17,785**	**78% GAIN**
Cash Out of Pocket			ZERO	