



Gaining Traction by Shifting Into Neutral

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Introduction

Equity market neutral (EMN) is a classic alternative investment strategy. Like its sibling, long-short equity, and several other arbitrage strategies, it aims to deliver solid returns with muted volatility and low correlations to traditional asset classes. And by stripping out “beta” (i.e., market sensitive) exposure, EMN returns tend to come from skill, versus market effects. As skill tends to be more enduring than luck, such strategies have a fighting chance to make ideal long-term contributors to a sound portfolio.

There has never been an issue with the promise of such strategies. Those features should appeal to institutional and individual investors alike. However, the actual execution of neutral strategies sometimes disappoints. Thus, it is only through detailed analysis that we can evaluate whether a particular EMN vehicle can fulfill its promise. Let’s dive into some of the basics of the strategy, address its key risks, and ask whether now is a good time for allocators to upsize their EMN exposure.

To preview, our thesis is simple: EMN strategies face a series of risks distinct from directional market risk, some of them hidden. Allocators who can get comfortable with the return drivers and specific risks of a particular market neutral program should find such an investment highly accretive to their portfolios. We believe that’s especially the case in 2014, given the current interest rate, fixed income, and equity environments.

What is Equity Market Neutral?

The premise of “market neutral” investing begs an interesting question about the very foundations of investing. It is generally understood that there is a positive relationship between risk and return. The more risk one takes, the more likely it is they can achieve higher returns (or larger losses); conversely, when one takes little to no risk, the chance of sizable gains is slim to none. If there’s any law of gravity in investing, this is it.

By virtue of the moniker, classic EMN strategies are (or should be) neutral to the market. They take no or little market risk. Then how does the strategy generate returns?

The answer lies in the choice of market, the investment process, and the structure of the portfolio. This is the interesting gateway into the world of market neutral strategies, of which there are hundreds of particular expressions, none identical to the others.

Our first point of contrast is to directional strategies – those that take “long” exposure to a chosen market, whether it is U.S. large cap stocks, small cap emerging market stocks, or anything in between. As is well understood, the typical “long only” strategy is fully invested and largely captures the beta of that chosen market. For instance, the beta of the average actively managed large-cap U.S. equity fund to the S&P 500 is 0.99, meaning that nearly all of the returns in those funds are explained by the returns of the index.

Long-short equity funds deviate from this approach by taking both long and short exposure to their target market, and by relaxing the constraint on being fully invested. As a subset of this approach, EMN goes a step further by looking to minimize systematic market exposure, often with the goal of zero beta exposure. Figure 1 presents a high-level schematic for how varied these exposures may be. In each instance, the fund manager starts with \$100 of equity capital and then builds a portfolio to desired specifications.

Figure 1: A Basic Snapshot of Long-Short Equity & Equity Market Neutral Portfolios

	Mutual Fund	Long-Short Equity - 1	Long-Short Equity - 2	Equity Market Neutral - 1	Equity Market Neutral - 2	Equity Market Neutral -3
Long	100	90	180	200	350	90
Short	0	50	110	200	340	105
Net	100	40	70	0	10	-15
Gross	100	140	290	400	690	195

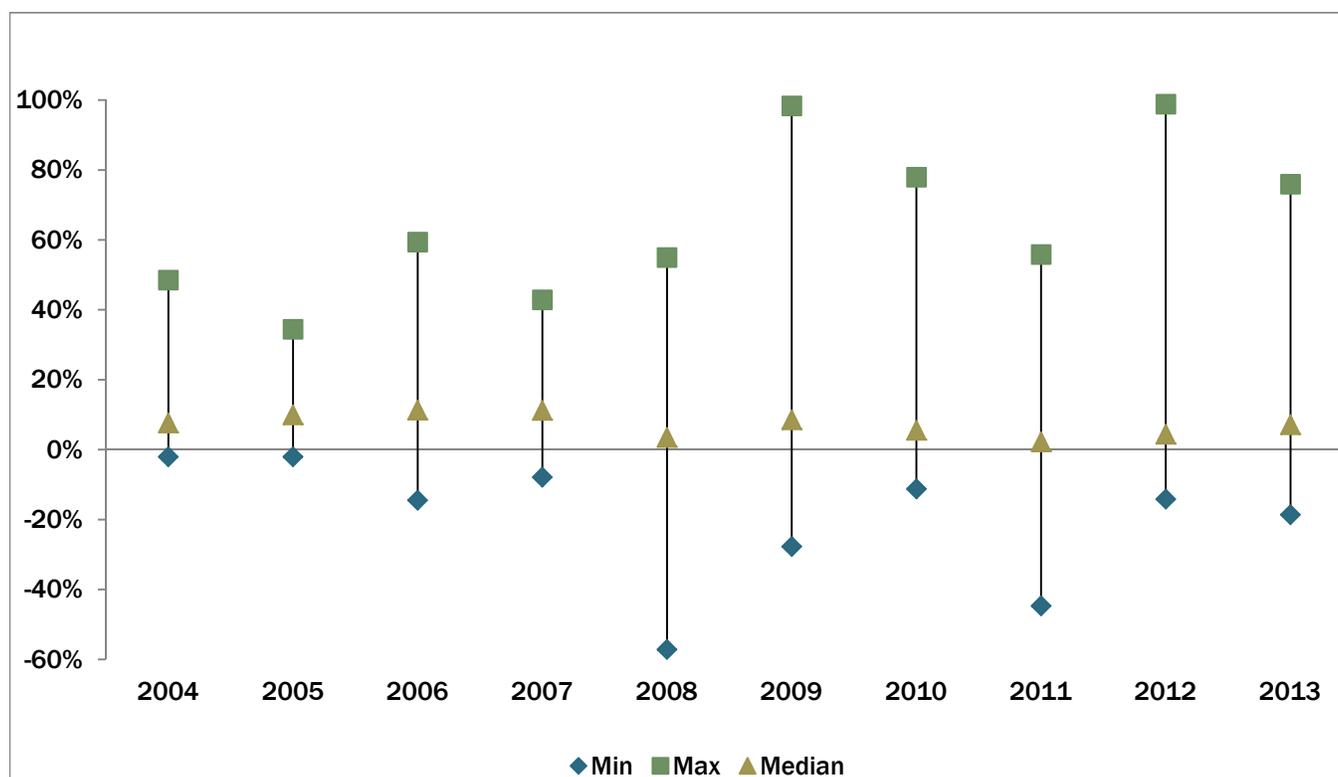
Among the EMN strategies, even though we don’t know what markets they invest in or the determinants of stock selection, we can see immediately that their portfolio structures differ markedly, in terms of both net market exposure (roughly, but not identical to “beta”) and gross market exposure (or leverage).

EMN strategies tend to pursue relative value strategies, meaning that they take advantage of comparative market inefficiencies. In long-short equity generally, portfolio managers seek to own good companies trading at cheap valuations and short, weak companies trading at expensive valuations. But they also might find differences in other factors, such as sectors or geographies. In EMN specifically, funds will roughly be equally long and short segments of a market they find to be

attractive and unattractive, respectively, thus mitigating the impact of the market's overall direction. As a result, they tend to have much lower correlations than directional strategies.

This sounds pretty straightforward. However, even a brief glance at the historical record for EMN funds shows that the returns of the peer group's constituents differ markedly.

Figure 2: Calendar Year Returns Dispersion Among Equity Market Neutral Funds



Source: HFR

Figure 2 presents a snapshot of the strategy's return distribution over the past decade. The range of calendar year performance among funds that call themselves "neutral" is vast. While the median fund's return tended to range between 0% and 15%, the outliers in either direction have been extreme.

Also, keep in mind that fund's self-reporting to the hedge fund databases, meaning they can choose the category in which they'd like to be included. For example, HFR's Equity Market Neutral category

includes a surprisingly large number of Asia-focused funds. Given the difficulty of shorting stocks in that region, it is unlikely that they are truly market neutral.

This dispersion profile reflects the fact that insightful due diligence is required to understand a fund's underlying focus, process, and portfolio. Let's now turn to an overview of the risks that EMN funds might be taking to generate returns.

The Risks of Equity Market Neutral

While all funds look to add value through skill, they inevitably take risks that are both unavoidable and consequential. That's true of any strategy, including EMN. Let's walk through five common risks that cover the waterfront of where and how these funds can make or lose money.

Directionality. As noted earlier, funds take varying degrees of directional market exposure. While a strategy called "market neutral" clearly implies no net dollar or beta exposure, the fact is that even EMN funds range widely in the net market exposure they take. Some run with truly no beta exposure, while many others will run slightly net long, say 10% to 20% net long. That might not sound like much of a difference, but think about that exposure in a year like 2013, when the S&P 500 spiked 32%. So a fund with 20% net long exposure would have added about 6.4% in returns just from "beta." That's an enormous head start over those funds who run truly neutral and have no beta tailwind. Conversely, in a down market, truly neutral funds are poised to significantly outperform.

Leverage. The biggest trade-off for EMN funds is that absent market directionality, they turn to leverage to achieve desirable return targets. EMN funds tend to exploit relatively small inefficiencies. The inherent rate of return in those securities is small, thus leverage is necessary. What is the right amount of leverage for EMN? There is no right answer. It depends largely on the inherent volatility of the underlying securities. A market neutral strategy focused on large-cap U.S. stocks could stand (and would be likely to receive from banks) much more leverage than, say, one that focused on smaller-cap emerging market issues.

Illiquidity. Related to leverage risk, illiquidity speaks to the ease with which a fund manager can trade the portfolio's positions. This is relevant to EMN strategies in two ways. First, smaller-cap and international markets tend to be less liquid than large cap U.S. markets, which might render challenging the ability to maintaining a portfolio's neutrality. Second, shorting stocks is more technically complicated than owning them long. Stocks that are less-liquid can be categorized as "hard to borrow," meaning that inventory for them can be limited and, even when available, quite expensive. In some cases, it's simply impossible to build a sizable short portfolio in one's target market.

Concentration. Position sizing matters greatly in determining the risks of one's equity hedge fund. Take an extreme (absurd!) example of an EMN fund that held just two stocks. With \$100 of client

capital, the fund went long \$100 of ABC and short \$100 of XYZ. Technically, this fund would be “market neutral” ($100-100=0$), but the risks of the portfolio are quite obvious. But even in less extreme scenarios, one can still have markedly different portfolio structures. Some EMN funds have literally 1000’s of stocks; others have dozens. Assessing stock-specific risks, as distinct from deeper factor-based risks will be driven in large part by position diversification.

Basis risk. Because EMN is a relative value strategy, the potential for the long and short portfolios to dislocate from one another should be a serious risk consideration. When the long and short books are highly correlated in general, then that can create an opportunity for savvy stock picking without much “noise” from extraneous factors. When those correlations break down, however, the portfolio can lose significantly despite appearing “neutral.”

Take, for example, those who use an index fund to source some or even all of their short exposure. Imagine then a scenario in which a long book of mostly mid-cap stocks is hedged by a short S&P 500 futures or ETF position. That might work sometimes, but returns for large- and mid-caps sometimes diverge; thus the portfolio implicitly bets on the relative performance of those two market segments, not individual stocks. Another example comes from 2007, when some hedge funds were long commodity stocks and short financials. That was a savvy bet at the time, considering emerging market economies were soaring (and thus aggressively buying oil, copper and other commodities) while developed market banks struggled. But these were two uncorrelated bets – hardly neutral. If emerging market stocks declined and banks recovered, then investors’ losses would have been magnified.

Why EMN? Why Now?

While it is critical to be transparent about the risks inherent in an EMN strategy, it’s also true that when well executed, it can make a strong addition to investors’ portfolios.

The returns for most EMN strategies should be understood in a “cash plus” framework. Because the typical EMN fund looks to capture a spread between its long and short books, the size of that spread multiplied by the amount of leverage (assuming no net market exposure) is the roughly correct way to approximate the expected return target. Thus, a fund that aims to generate 250 basis points of alpha per year and uses 3 turns of leverage should expect roughly 7.5% returns over the risk free rate. Note that because the fund will have a sizable cash balance due its short sales proceeds, that balance will earn the risk-free rate (such as LIBOR or 30-day T-bills). As a result, the attractiveness of EMN has a certain evergreen quality, at least for firms with a demonstrated ability to find and capitalize on market inefficiencies.

Further, according to the most foundational rule of modern portfolio theory, lower-correlated investments will push a portfolio further out on the efficient frontier. In Figure 3, we set out some basic asset allocation scenarios, mixing stocks and high grade long-term corporate bonds. In every

instance of adding a modest allocation to a market neutral strategy, the portfolio earns slightly higher returns with materially lower volatility. It is important to note that this Equity Market Neutral category index, by some quirks of its construction, has a relatively high correlation to the main asset classes (~ 0.5). Given that many market neutral strategies we are familiar with have very low (even sometimes negative) correlations, the revealed diversification benefits prove even better.

Figure 3: Calendar Year Returns Dispersion Among Equity Market Neutral Funds

	# Months	Geometric Mean (%)	Standard Deviation (%)	% of Standard Deviation
Cat: Equity Market Neutral	240	9.08	5.06	
IA SBBI S&P 500 TR USD	240	9.54	16.79	
80% Equity / 20% Mkt Neutral	240	9.61	13.92	82.91%
IA SBBI US LT Corp TR USD	240	8.02	10.12	
80% Fixed / 20% Hedge	240	8.31	8.32	82.21%
60 % Equity / 40% Fixed Income	240	9.32	11.06	
50% Equity / 30% Fixed / 20% Mkt Neutral	240	9.36	9.62	86.98%
50% Equity / 50% Fixed Income	240	9.18	10.06	
40% Equity / 40% Fixed / 20% Mkt Neutral	240	9.22	8.58	85.29%
40% Equity / 60% Fixed Income	240	9.01	9.35	
30% Equity / 50% Fixed/ 20% Mkt Neutral	240	9.04	7.87	84.17%

Source: Ibbotson Associates, Chicago Equity Partners

In addition to the strategy's evergreen qualities, there are also situational reasons to own an EMN strategy in 2014 and beyond. First, it is a good complement for portfolios that have grown overloaded with equity beta after a strong five-year bull market. The challenge, of course, is finding other sources of attractive returns that are also liquid but have little correlation to equities.

Second, there is the fixed income market. Without belaboring a well-understood point, the current low yield environment is a major concern for those seeking a conservative source of total return – a concern that is compounded by the potential for rising interest rates and the anticipated impact on bond prices. Those searching for higher yields in 2014, might have to stretch further out on the risk curve than is appropriate. As a result, we think there is a compelling case for EMN as a fixed income replacement strategy. One fair warning, though: in conducting due diligence on any particular expression of EMN, it is critical to evaluate the portfolio's credit and duration sensitivity. If a manager cannot prove that its strategy is not impacted by the movement of credit spreads and interest rates, then the attractiveness of EMN as a fixed income replacement strategy evaporates.

Summary Points

- ▶ Equity Market Neutral strategies can prove highly accretive to investor portfolios due to several attractive features: solid returns in the high-single or low double-digit range, low volatility, and limited correlation with traditional equity or bond markets.
- ▶ There are several risks inherent to any EMN strategy. There is no such thing as getting “something for nothing” in investing, so it is critical that due diligence identify the nature and extent of those risks, which will also drive a clear understand of a particular strategy’s source of returns.
- ▶ EMN is an especially attractive strategy in 2014. After an extended bull market in equities, EMN strategies allow investors to roll out of their equity “beta” exposure without sacrificing returns. Additionally, in a low yield environment vulnerable to interest rate spikes, EMN can offer a compelling fixed income substitute that can achieve the goals of high yield investors without taking on exposure to duration or higher-risk credits.