Market neutral equity is one of the easiest hedge fund strategies to understand. However, it is also among the most difficult to manage. There are distinct risks inherent in market neutral equity strategies that must be properly managed in order to produce respectable risk-adjusted returns and eliminate risk.

**Long and short**

For every $100 of capital invested in a typical market neutral equity portfolio, approximately $100 is held in cash. Another $100 of stock is sold short, while $100 is held long. While the typical market neutral equity portfolio is ‘cash neutral,’ this by no means implies market neutrality. By definition, market neutrality means a portfolio has a forecasted beta, or correlation, with an equity market index of exactly zero. As a result, it has no systematic market risk.

Without market risk, there are no market returns. All returns from market neutral strategies come from one source—stock selection. Without positive stock selection, or alpha, a market neutral portfolio generates a risk-free rate, less fees and expenses. The manager must be able to select stocks for the long component of the portfolio so prices rise more than the stocks selected for the short component of the portfolio in ‘up’ equity markets.

**What are the risks?**

Stock selection risks consist of idiosyncratic and systematic risk. Idiosyncratic risks are generally random events that drive individual stock prices up or down. These risks can be eliminated through diversification and, accordingly, most well-managed market neutral equity portfolios hold a large number of stocks—usually more than 200.

While market neutral equity portfolios do not have market risk, they are exposed to a number of other systematic risks. All managers base the selection of stocks for the long and short components of their portfolios on the characteristics of the stocks themselves, or the underlying companies.

Presumably, the portfolio manager is buying so-called ‘good’ stocks for the long component and shorting ‘bad’ stocks for the short component of the portfolio. For example, ‘good’ stocks may be those with low price-to-earnings ratios, high return on equity, positive analyst earnings per share revisions, high expected future growth as well as good quality management. On the other hand, ‘bad’ stocks have the opposite characteristics. These are all systematic bets or risks.

It is the net impact of these exposures to the long components of the overall portfolio that is important. Net systematic stock selection risks are responsible for most of the positive and negative returns in a market neutral equity portfolio. The stock selection factors used by the manager are the sources of net systematic risks in market neutral equity portfolios. However, it is necessary to assume these risks in order to generate positive returns.

Effective market neutral managers will manage and control the systematic stock selection risks to which they are exposing the portfolio. They will also manage and control many other systematic risks that may be inherent in the long components of the overall portfolio. For example, these managers will measure and tightly control gross and net exposures to industries, sectors, volatility, stock liquidity and investment styles.

Indeed, the greatest risks that a portfolio is exposed to are those that managers are not aware of, and as a result, not managing. This can lead to significant drawdowns in market neutral portfolios as well as hedge fund strategies in general.