JOSEPH SHIER *Managing director, Maple Financial Alternative Investments.*

SIZING UP STABLE RETURNS

Do market neutral strategies work in the current environment?

The low interest rate environment of the past few years has put tremendous pressure on pension funds: the present value of liabilities has increased, while current and future expected yields on fixed income instruments have decreased. Concerns over the performance of the so-called traditional investment classes have given rise to a greater interest in alternatives. One such alternative—market neutral strategies—continues to provide stable returns, but has itself been affected by low volatility in the equity markets as well as by low interest rates. Given these factors, does market neutral continue to have a place in the asset mix? This question gives rise to the broader one of the place of "alternatives" in an investment portfolio.

Defining Alternative Investments

The word alternative means "instead of"—it poses a choice and implies one can take it or leave it. This meaning is highlighted when contrasted with the term "traditional" as it is used to refer to equities and bonds. Traditional implies security and comfort, tested over a long period of time. Yet it wasn't that long ago that equities weren't considered appropriate for pension funds. Equities come with market exposure and volatility, both of which affect funding requirements. The bull market that began in 1982 and saw a cumulative gain of the Dow of almost 1,000% was preceded by 17 years in which the Dow actually lost 3.5%; for the first half of 1982, the Dow traded below the level it had reached 17 years earlier in 1965.

Beta is what one gets from the equity markets: it is a commodity and can therefore be purchased cheaply. Due to the specialized knowledge involved, market neutral strategies cost more, and for the past two years have been fighting a difficult environment. Still, the strategies have earned spreads over short-term rates and undoubtedly serve to reduce a portfolio's volatility. Is an allocation to these strategies worthwhile? If so, what should one's allocation be? Perhaps these questions should be turned around and directed not at market neutral strategies but at higher volatility assets: should portfolio managers take on extra risk when those risks generate diminishing returns on a risk-adjusted basis?

Extending the Efficient Frontier

Portfolio theory calls on managers to look for assets that provide diversification and improve the efficient frontier either by improving return or reducing volatility. Each efficient frontier will have one point with the best risk-return profile. Moving further out on the curve to generate the higher returns needed to meet a pension fund's return assumptions means taking on more risk for each additional dollar of return. But there is a more efficient way to generate the returns needed: combine the most efficient portfolio with the borrowing rate available. The investor will then earn greater returns for each dollar of risk remaining on the efficient frontier.

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Overlay structures allow pension funds to use the borrowing rate in this way. The overlay allows the portfolio manager to focus on creating better—that is, more efficient—portfolios and then, by adjusting the level of overlay, take the risk appropriate for the fund. Market neutral strategies have delivered absolute returns across market cycles and are therefore particularly appropriate to be overlaid on the existing bond and equity exposures within the pension fund's "traditional" investment portfolio. The end result should be greater returns with reduced risk. ■