

The Long and Short of Market-Neutral Investing

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Market neutral strategies have been around for roughly two decades. But the more volatile conditions of recent years have increased interest among consulting firms, investment banks and money managers in how this relatively lower-risk investing method can be used to generate competitive returns.

The attraction of market neutral investing

As the name implies, market neutral strategies work by neutralizing as many risk factors as possible, including beta, currencies, market caps, sectors, regions and investing styles. For example, in a well-constructed market neutral fund, if you're long one dollar, you'll be short one dollar, leaving no dollars exposed to the market. With all factors neutralized, the only issue that should remain is whether the portfolio manager is good at picking stocks, both long and short.

Market neutral strategies also have the advantage of being very liquid, with no need for bank loans, credit default swaps, distressed debt, or high yield. Nor is there a need for much leverage.

As the exhibit below indicates, the correlation characteristics of market neutral strategies are appealing, not only compared to traditional long-only equities and fixed income, private equity and real estate, but also to non-traditional approaches, such as other hedge fund strategies.

Exhibit 1) Low Correlations to Traditional & Alternatives Asset Classes

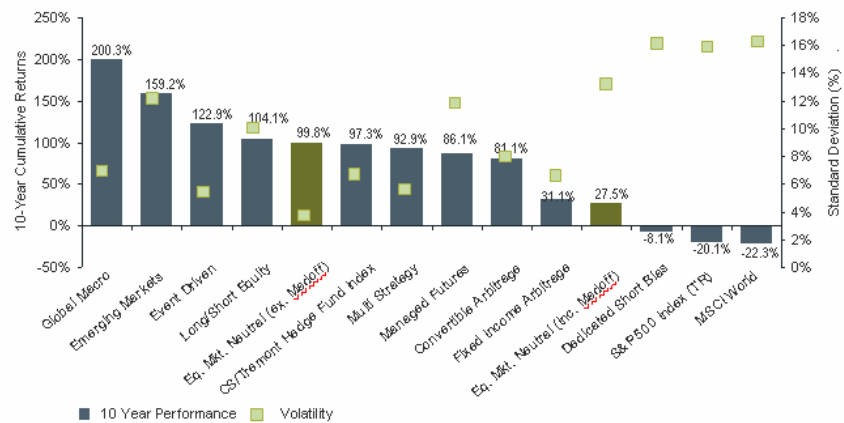


As seen in the graph below, market neutral strategies can also provide solid risk-adjusted returns. In the past decade, they have provided returns similar to most hedge fund strategies, but without the high volatility associated with hedge funds. This same return pattern is evident over longer periods.

Exhibit 2)

Market neutral strategies may provide stability relative to other Hedge Fund strategies

10-YEAR PERFORMANCE AND VOLATILITY FOR STRATEGIES IN THE CREDIT SUITE/TREMONT HEDGE FUND INDEX AND EQUITY MARKETS



Source: Credit Suisse/Tremont Hedge Fund Index, Bloomberg. Excludes the US\$3.7B in closed November 2008 and \$2.2B in July 1999-June 2009 (USD)

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Quantitative or fundamental?

There are two basic ways to pursue a market neutral strategy. The quantitative method, used by the majority of investors, looks at historic information, including earnings, valuation, share buy-back activities, and insider trading activities to try to predict the best companies to buy and to short in a portfolio. The second, or fundamental approach, looks at more fundamental research that might or might not be captured by quantitative tools. This approach tends to be more forward looking.

In general, quantitatively based market neutral strategies have not fared as well as fundamentally based strategies since 2007. In part, this may be because quantitative managers have tended to use the same algorithms and models, in effect chasing the same cheap growth opportunities and overcrowding the marketplace. Managers would be better advised to tweak their models and look in different areas for growth.

Putting market neutral into practice

Despite this caveat, market neutral strategies produce results that compare favourably with traditional asset classes. Using various index data, market neutral strategies have, over the past four years, shown low to negative correlations with several traditional hedge fund strategies, including the convertible arbitrage, short-biased and event-driven strategies found in many clients' portfolios. Similarly, market neutral compares favourably in terms of risk-adjusted returns or Sharpe ratios over longer periods.

Given these advantages, our clients use market neutral strategies in a variety of ways. More than 40% of them include market neutral strategies in their equity portfolios as a risk mitigation tool, for example. Whatever the application, they know market neutral strategies provide a liquid, low-leverage approach that can generate solid return potential with potentially lower risk.