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Market-neutral strategy generates positive returns

Investors looking for fixed income alternatives

Sensitivity to market volatility and concerns about rising interest rates have many investors turning to alternative strategies as a way to get downside protection.

Data provider Hedge Fund Research says total assets in the global hedge fund industry have increased to $2.63 trillion. Meanwhile, the HFRI® Fund Weighted Composite Index posted a gain of 9.2 percent, the best calendar year performance since 2010.

According to a Deutsche Bank Alternative Investment Survey, approximately 61% of global hedge fund assets under management come from institutional investors such as pension funds and endowments. Likewise, the net percentage of pension funds growing their hedge fund allocations has doubled year on year from 30% to 60%.

Interest in hedge funds is not a new phenomenon. Morgan Stanley notes that the primary reasons for the shift to hedge funds are for diversification to decrease volatility (56%) and improve the overall risk/return of the portfolio (18%).

A hedging approach that has gained considerable interest is the market neutral strategy, which aims to achieve absolute returns regardless of what happens to interest rates, the markets, or the economy. Given the uncorrelated nature of market neutral strategies, many investors have been turning to them as a supplement for fixed income holdings.

Market neutral managers typically invest equal dollars in long and short positions. The long positions represent the managers' best ideas or the positions which they deem most attractive. The short positions will be investments that the managers deem unattractive and which are trading at over-inflated prices likely to depreciate.

Money is made when the long positions outperform the short positions. Returns consist of the spread between the long and short holdings plus interest earned from cash positions. Consider a hypothetical $100 investment in various markets. If the markets are rising and the long positions are up $15 and shorts are up $10, the profit is $5. Likewise if the markets are declining, with the long positions down -$18 and the shorts down -$25, the profit is $7.

Success with a market neutral strategy depends on the manager's ability to identify short opportunities. AllianceBernstein analyzed the Russell 1000 Index over the past 37 years to illustrate the advantage of shorting. Excepting the 50 largest stocks in the index, they found that avoiding the worst-performing 20% stocks would have contributed less than 10 basis points to the relative quarterly performance of a long-only manager. However, shorting those same stocks

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would have added 66 basis points to relative performance.

When used as a diversifier, market neutral strategies have the potential to act as a portfolio stabilizer and source of consistent returns. AllianceBernstein found that the market-neutral index delivered 6.94% annualized returns since 1990, compared with 8.60% for the S&P 500 Index and 7.11% for the Barclays Capital US Aggregate Bond Index. They also noted that the market neutral index was less volatile and produced a better risk/reward ratio.

Since much of the success with market neutral strategies depends upon the skill of the manager, due diligence is critical. One of Canada's largest hedge fund managers, Picton Mahoney Asset Management, recommends that investors go through the Due Diligence Questionnaire provided by The Alternative Investment Management Association.

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