Riding the volatility

Equity Market Neutral strategies may enable investors to maintain equity exposure while navigating changes in market cycles

By Donald Rice

TODAY'S investors are finding it difficult to navigate the current low-yield environment. The pace of the US Federal Reserve's tightening of interest rates coupled with volatility in energy prices and equity markets have resulted in individual investors wondering how to best position their equity portfolios. Why not emulate some of the strategies followed by the heavyweights, namely institutional investors such as endowments and pension funds?

Credit Suisse Capital Services recently surveyed 369 institutional investors globally, in an effort to gain insights into their investment approach this year. According to the survey, these sophisticated investors have chosen to allocate to hedge funds with 87 per cent intending to maintain or increase their allocations this year.

Furthermore, in an indication of how they intend to manage volatile markets in 2016, Equity Market Neutral (EMN) strategies appear to top the list of preferred strategies to follow. This would indicate that institutional investors are anticipating yet another year of market volatility and are therefore looking for hedge fund strategies with low market exposure and high alpha potential.

But what exactly should one understand by the notion of EMN? This is a strategy that takes both long and short positions in securities while seeking to minimise exposure to the systemic risk of the market (that is, a beta of zero is desired) with the aim of being uncorrelated to market movements and delivering pure alpha.

These funds aim to exploit investment opportunities presented by a specific group of stocks, while maintaining a neutral exposure to broad groups of stocks such as a sector, industry, market capitalisation, country, or region. The strategy's market neutrality essentially seeks to eliminate concerns related to investment market timing.

Let's take a closer look into these strategies to see how average investors can invest alongside professionals. The two main ways to implement the EMN strategies is through statistical arbitrage and/or factor-based quantitative approaches.

Statistical arbitrage is a model-based investment process, which aims to build long and short portfolios whose current relative value is different from a theoretically or quantitatively predicted value. Because of the large turnover of stocks being traded, sometimes in the thousands and the fairly small size of the individual effects one is trying to capture, the strategy is often implemented in a highly automated fashion. It usually utilises Pair Trading and Mean-reverting strategies.

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The Pair Trading strategy may be implemented through matching a long position with a short position in a stock within the same sector. This creates a sector neutral position and just isolates the dispersion between the two stocks.

Mean-reverting strategies, on the other hand, are based on the assumption that stock prices are mean-reverting. Hence, if the stock price deviates from its historical average, it's expected to move back (revert) to the mean over time. Accordingly, stocks that are outperforming (hence expected to decrease in value over time) should be sold short, while underperforming stocks (those expected to increase in value over time) should be bought.

The factor-based quantitative approach relies on multi-factor models, which can be used to explain performance, by comparing two or more factors to analyse relationships between variables and the security's resulting performance. Multi-factor models can be divided into three categories: macroeconomic (comparison to factors such as employment, inflation and interest); fundamental (relationship between a security's return and its underlying financials); and statistical models (comparing the returns of different securities based on the statistical performance of each security individually).

EMN strategies usually have high barriers to entry. When selecting a fund to invest in, among other factors, it is important to consider the quality of the investment team (usually, these comprise "quants", individuals with PhDs and post-doctorate degrees with strong technical backgrounds from top universities), the depth of their research and development capabilities (that is, to build/improve on their models), as well as the breadth of the firm's infrastructure platform.

These strategies are not without a certain level of risk. Transaction costs can be quite significant given the number of trades required to execute each strategy. Short positions need to be liquid and it is possible that the number of shorting opportunities is limited. Violent market reversal or sector rotation moments may also harm the strategy (due to leverage).

In addition, an investment in the fund involves numerous risks including (among others), general market risks relating to the underlying portfolios, interest rate risks, inflation risks, liquidity risks, emerging market risks, and legal and regulatory risks.

Furthermore, one can't have a discussion on EMN strategies without reflecting on the lessons learned from August 2007. EMN strategies experienced a significant dislocation in early August 2007 and many of the quantitative funds suffered unprecedented losses over a short three-day window.

For those funds that stayed the course and relied on their models, they recovered around 50 per cent of their losses a few days later. Others, who liquidated their positions during the unwind, suffered heavy losses. This dislocation led to many managers subsequently recalibrating their models to prevent getting caught in a future negative deleveraging spiral such as the one that occurred during the financial crisis.

While keeping in mind the risks that the strategy presents, investors should consider the numerous benefits it offers. For example, returns are often independent and uncorrelated with equity markets. The strategy can also potentially produce low-volatility positive returns regardless of the economic cycles. It can also benefit from higher market volatility which results in higher market dispersion and a broader opportunity set.

Given the current market cycle and the outlook for 2016, an allocation to a well-diversified EMN fund can potentially play an important role within investors' allocation and may enable them to maintain equity exposure, while navigating changes in market cycles. W

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