A shining light

With the increased focus on capital preservation in an increasingly volatile world post the GFC, ***David Rosenbloom*** makes a case for market neutral investing.

Volatile markets and currencies, plummeting gold prices, concerns over China, uncertainty over commodities, Reserve Bank policy, the end of the mining boom, a slowing Australian economy – the anxiety builds.

With the GFC still being fresh in our minds, heightened uncertainty and concurrent volatility in markets has refocused investors and advisers alike on capital preservation. Together with the resultant quest for yield in a global environment of extended low interest rates, the spotlight has been turned back on absolute return strategies, with the least risky of these strategies, market neutral investing, leading the charge.

Of course, investors don't necessarily mind volatility, provided it's volatile in their favour. However, the psyche has changed in the last decade with first wealth destruction resulting from the GFC followed by an increasingly volatile 'recovery' leading to a re-emphasis on the real risks associated with investors' portfolios.

I remember only too well a post GFC meeting with a chief executive officer of a major Australian super fund who wistfully looked to the ceiling and said: "If we failed our members, it was on product design."

What he was referring to was that the fund essentially had one product, irrespective of where the member was in his/her investment life, and that product was heavily skewed to Australian equities. At best, the result was that a member about to retire was about to do so with a lot less than thought just a few months before. At worst, retirement was postponed, perhaps indefinitely!

While the phenomena is global, the impacts have been profoundly felt here in Australia: the rotation from equities to other asset classes, increased flows out of Australia into offshore markets, and the unrelenting search for yield regardless, in some cases, of any real analysis of the underlying risk. You don't need to look any further than the flood of hybrid issues and unsecured notes flowing from Australian corporates, the majority of which have found themselves into the hands of retail investors.

So it should be no real surprise that another consequence of the thirst for yield coupled with volatile investment markets has been the re-emergence of absolute return funds as investors,

still sore from the pain of the GFC, worry about capital preservation (not to mention the insomnia resulting from the volatility). Relative returns attract attention in rising markets, but investors are increasingly of the view that beating the market on the way down doesn't do much to ease the discomfort in their collective hip pockets. And you don't have to take my word for it. In the 2012 report[1], *The Mainstreaming of Alternative Investments: Fuelling the Next Wave of Growth in Asset Management*, McKinsey points out the following:

"Global alternative investments across retail and institutional segments doubled AUM between 2005 and 2011, to $6.5 trillion despite a very public flame-out during the crisis. This represents a compounded annual growth rate of 14 per cent over the period, far outstripping the growth of traditional asset classes... Alternatives are not simply growing; they are becoming part of the investment management mainstream. Three trends are responsible for this development: increasing adoption by retail investors; a shift in investor benchmarks from relative to absolute return; and the convergence of traditional and alternative asset classes, investment managers and products."

Market Neutral Investing

Since Markowitz's seminal paper in 1952 that ushered in the era of Modern Portfolio Theory and the Capital Asset Pricing Model, we have all learned of the benefits of portfolio diversification and the notion of risk relative to the market. Having completed my MBA where Markowitz was the Chair of the Finance Department, I too was well schooled in these theories (unfortunately, I never actually sighted him, much less had a conversation). However, I could never escape the fact that reducing/eliminating stock specific risk through diversification leaves us, well, with 100 per cent market risk! The fact is the Australian index with dividends reinvested has yet to make it back to the highs set nearly six years ago.

How long is long term?

Investors, from the most sophisticated practitioners to lay retail investors, have long held onto the notion of long term investing based, of course, on the belief that markets always go up over the long term. In relation to equities, at least, this has been true. However, such academic reality ignores how people invest in the real world.

As planners, you are most aware of the fact that when first heading off into working life, savings, if any, are small and risk tolerance is, and should be, high. Time is on the investor's side and any major sell-off seen as an opportunity, so-called dollar cost averaging. Yet sell-offs, such as the nearly 47 per cent peak to trough decline in the S&P/ASX 200 Accumulation Index commencing in December 2007, had real negative impacts on the lives of real people. It has, in fact, taken nearly six years for the index to again approach these levels (see Chart 1).

Of course, the 'pain factor' meant that many investors, especially those most impacted (e.g. those nearing retirement), sold out somewhere near the bottom. To put this in more perspective, consider the following in Chart 2:

As can be seen, there is quite a bit of volatility in the results, but if I could guarantee investors 9 per cent compound over 20 years, I think I'd be retired in Tahiti! The reality is, people don't invest this way, they invest progressively and, in fact, save a much larger proportion as they near retirement. To make the point, take the following example (Chart 3) of investing $2,500 per year for 20 years in the All Ordinaries Index, one starting in 1981 the other in 1982:

As can be seen, due to the 'tech wreck' that occurred in 2002, the investor who 'finished' a year earlier would have ended up with a portfolio worth nearly 18 per cent more than the investor who started a year later, despite the same compound annual growth rate. Of course, the impact would be much greater if, as usually occurs, a greater proportion of savings is accrued later in the saver's working life. This again highlights you can't spend an average!

What is 'market neutral'?

The definition of market neutral is simple: the manager seeks to make money from both increasing and decreasing prices in markets irrespective of the overall market movement. This is achieved by being long and short roughly equal (risk adjusted) amounts in the market(s) in which one invests. For the purposes of this article, we will focus on equity markets.

In the examples above, returns are primarily sourced from the performance of the long positions relative to the short positions, aptly described as spread returns as compared to the long only manager who simply tries to beat the market whether it's going up or down.

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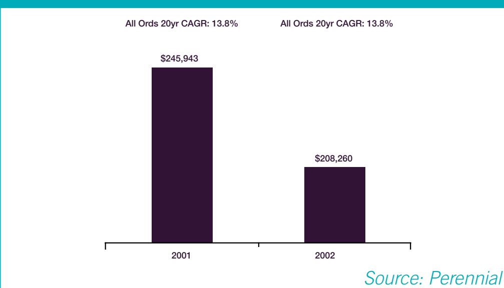
Chart 1: S&P/ASX 200 Accumulation Index

Source: IRESS.

Chart 2: 20 Year Returns of the All Ordinaries Index (dividends reinvested)

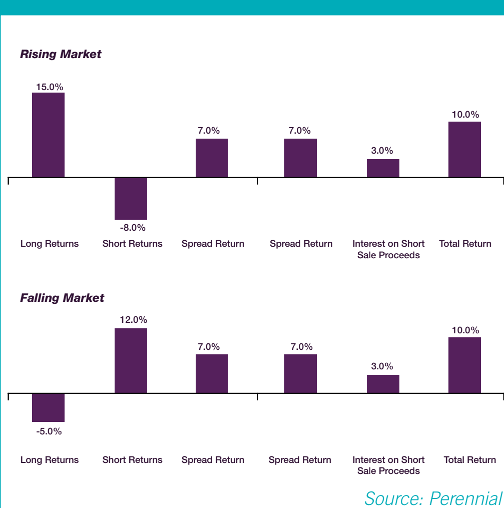
Source: Perennial

Chart 3: Value of $2,500 invested per year for 20 years in the All Ords Index: Year end 2001 versus 2002



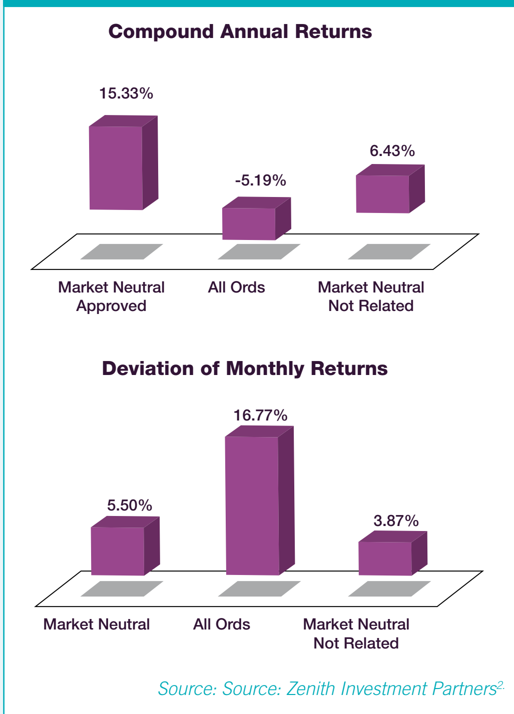
Source: Perennial

Chart 4: Market Neutral Sources of Returns (indicative)



Source: Perennial

Chart 5: Australian Market Neutral Funds versus the Market (2006 – 2011)

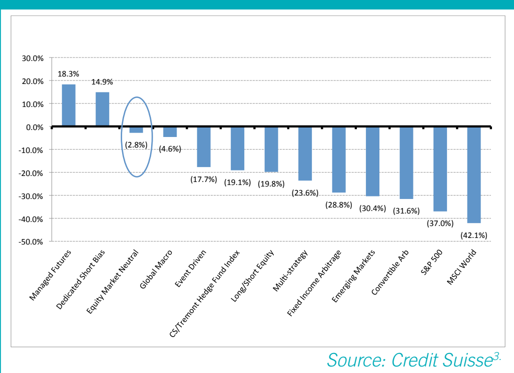


Source: Source: Zenith Investment Partners[2]

Chart 6: 10 Year Performance and Volatility of Hedge Fund Strategies: July 1999 – June 2009

Source: Credit Suisse[3]

Chart 7: 2008 Returns for Strategies in Credit Suisse/Tremont Index and Equity Markets



Source: Credit Suisse[3]

In a rising market, the manager's profits on the long positions more than offset the losses on the short positions, assuming all stocks rise. Similarly, in a declining market, profits on short positions offset the losses on the long positions. In addition, the shorting activity raises cash for the manager, providing it with interest income, though the costs of borrowing the stock and other fees partially offset the return.

Importantly, unlike many hedge fund products, most market neutral funds seek to be low risk and provide steady returns; these are not 'swing for the fences' products.

Thus, the investment case for market neutral funds is an enviable profile of risk adjusted returns, including the following attributes:

- Elimination of market timing concerns surrounding investment decision.
- Lower volatility (risk) than underlying markets.
- Capital preservation: absolute rather than relative return focus.
- Portfolio diversification: little or no correlation to underlying markets and other funds.

As the name implies, market neutral managers seek to profit irrespective of the direction of the market. The investor need only worry about whether to invest or not, with the 'when' concern effectively eliminated.

To illustrate the return and risk attributes, the following provides the return profiles and risk as measured by the standard deviation of returns for the universe of Australian equity market neutral funds covered by researcher Zenith Investment Partners (Zenith)[2]. Admittedly, the data series included the market sell-off of 2008, but I make no apologies, as it serves to highlight the benefits of market neutral funds with a real life example (Chart 5).

'Approved' funds pertain to those rated as investible by Zenith, while 'Not Rated' relates to funds researched but not rated. Interestingly, even those not approved provided investors with positive returns, while both cohorts were less risky than the underlying stock market.

Implicit in the charts above is the second major feature of market neutral funds: capital preservation. While the return profile above is flattering due to the timeframe, including one of the largest sell-offs in the Australian market ever, it is notable that by the end data point, the All Ords had yet to recover. As seen in the previous graph, this still is the case.

This is, of course, a very small sample size comprising one asset class in one geography. However, the vast majority of research reveals the same types of outcomes. In its 2009 report, *Equity Market Neutral: Diversifier Across Market Cycles*, Credit Suisse[3] reveals the following results derived from its hedge fund database that

comprises the Credit-Suisse/Tremont Hedge Fund Index (Chart 6):

The results are clear: market neutral funds have provided excellent returns, with risk well below that of the market and other strategies.

More importantly, the strategy proved itself under the most trying of conditions – the market meltdown of 2008. In a year where the market's prime volatility index, the Chicago Board Options Exchange VIX Index, reached its all-time intra-day high, the basket of market neutral funds reported only modest losses relative to both the majority of other strategies and, of course, the underlying markets themselves.

Further evidence of the lower volatility is provided below, again sourced from Credit Suisse[3], and again highlight the lower volatility and capital preservation attributes of equity market neutral. It also points out another major attribute of these funds: equity market neutral likely underperforms in raging bull markets (Charts 8 and 9).

Investing in 'hedge' funds has negative connotations in many quarters over the years, given many high-profile failures. However, the data presented here shows the many positive attributes of properly run strategies. This is especially true of market neutral funds which, at their core, are true hedge funds: they are by definition fully hedged.

The fact is that the major issue faced by investors in hedge funds over time is that of transparency. Simply put, is the manager doing what they say they are doing?

Time and again, the failures have revealed that transparency was low and investors really didn't know what the manager was doing. However, market neutral funds have been a shining light and have performed admirably, as shown in the data above. Moreover, they are inherently fair: funds under management are not driven by rising markets, but by the manager's performance and ability to attract investors. Why should a manager, either a long only or hedge fund, make more money simply because the market has risen irrespective of their performance?

Of course, the hedging of risk comes at a price: properly hedged market neutral funds are likely to underperform sharply rising equity markets. While some equity market neutral funds have experienced strong returns for periods of time, the essence of the strategy is to provide steady positive returns in both rising and falling markets, not to 'shoot the lights out' one period only to give back a chunk of the gains the next. Capital preservation should be a key feature of any market neutral fund, as should lower than market volatility. Therefore, these funds should be viewed as a complementary portfolio diversification tool.

Therefore, notwithstanding my obvious bias towards market neutral funds and, with hand on heart, I suggest investors consider market neutral funds for inclusion in a balanced, diversified portfolio. ●

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Footnotes

1. *The Mainstreaming of Alternative Investments: Fuelling the Next Wave of Growth in Asset Management, Financial Services Practice, McKinsey & Company, June 2012.*
2. *Zenith Investment Partners Equity Market Neutral Sector Review, January 2012, Zenith Approved Funds.*
3. *Equity Market Neutral: Diversifier Across Market Cycles. Jordan Low, CFA, Director Quantitative Equities Group, Credit Suisse Asset Management, LLC, September 2009.*

Chart 8: Equity Market Neutral (EMN) Returns in Positive and Negative Markets (January 1994 to June 2009)

	EMN Negative Months	EMN Positive Months	Total	EMN % Positive Months
S&P 500 Positive Months	21	96	117	82%
S&P 500 Negative Months	20	48	68	71%
Total	41	144	185	78%

Source: Credit Suisse/Tremont Hedge Fund Index, Bllomberg[3].

Chart 9: Maximum and Minimum Monthly Return: Equity Market Neutral versus S&P500

	EMN	S&P500
Best Positive Month	4%	10%
Worst Negative Month	-5%	-17%

Source: Credit Suisse/Tremont Hedge Fund Index, Bllomberg[3].

Chart 10: Quick Comparison

	Traditional 'Long Only'	Typical Hedge Fund	Market Neutral
Strategy	Beat the market, whether it is going up or down	Hold both long and short positions (often unrelated) to achieve high returns	Eliminate market risk to provide steady, low risk returns
Risk to Capital	Medium	Typically high (long positions > short positions)	Low
Driver of Returns	Primarily market direction	Market direction and stock selection	Stock selection and portfolio construction
Volatility of Returns	Medium	High	Low
Impact of Market Timing	High	Medium	Very low/nil