



What's in a Name? Market-Neutral for Example

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With the dramatic increase in market volatility witnessed over the past couple of months there is increased interest in investment funds with titles such as "market-neutral". What exactly does the expression market-neutral mean?

To answer the question we need to review the basic tenets of "Modern Portfolio Theory" or MPT. The essence of MPT is that the returns on any portfolio can be separated into two components: the return attributable to the market (known as the "beta" return), and the return attributable to the unique skills of the Manager (known as the "alpha" return). For example, if a portfolio was up 10% and the market was up 10% over the same period, the alpha return would be 0%. Had the portfolio returned 15%, the positive alpha would have been 5%.

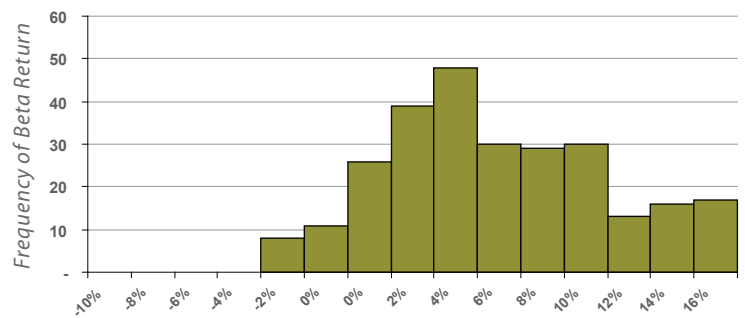
The expression or name "market-neutral" implies that a portfolio or fund will have no market – or beta – exposure. To accomplish the zero market risk, the portfolio manager must find an asset or security with negative correlation to the market. More often than not the portfolio manager will opt to "short the market" by using index funds or other derivative products. If one had a \$100 million portfolio of Canadian common shares, one would hedge their equity market exposure by "shorting" \$100 million of the S&P/ TSX Composite index. The manager would then solely rely on his or her skills in stock picking to generate a return for the fund's investors.

While the concept is very attractive, the reality is very few managers can generate positive alpha over a meaningful time horizon. If your time horizon is very short, perhaps 6 months or less, then being "market-neutral" may make sense. However, most investors have time horizons of much longer. Historical studies show that equity markets tend to show an upward bias over longer time periods. This makes it more challenging for market neutral managers to outperform the index, because they discount this rising tendency of markets to zero. Research indicates that over a 5-year time horizon, the order of this annual handicap against large cap managers equals the risk-free rate + 6%.

If you, as an investor, utilize a "market-neutral" strategy over a long time period, you place yourself at a considerable disadvantage relative to a traditional equity strategy because you negate this market or beta return. In fact, because of their short index exposure, market-neutral managers have to pick stocks that consistently outperform the index just to have a positive return! Accomplishing this feat year after year requires an almost superman-ability to pick winners (very few managers beat the index consistently).

Rolling 5 Year Annualized "Beta" Returns

TSX Composite - January 1980 - August 2007



Source: Thomson Financial, Barlow

The question that bears consideration for investors who intend to be invested for a full market cycle: does it make sense to intentionally negate the market or beta return? While the notion of avoiding market risk is attractive (especially during turbulent times like today), over any meaningful time horizon the loss of the market returns is too steep a price to pay.

A better alternative, in our opinion, is to structure a portfolio that will exhibit less than market volatility but allow for market type returns over the full cycle. This is the precise objective of our True Balance™ strategy at Barlow. For long-term investors the opportunity cost of a pure market neutral strategy is simply too high. We strive to have superior risk-adjusted returns and recognize that we will encounter period of volatility. Volatility is not something to be avoided at all costs; it's simply the price of superior long-term performance.

References

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