

Taking our example one step further, as long as low PE stocks outperform high PE stocks the investor earns a spread which is the difference in performance between the two groups. In this instance, it doesn't matter if the stock market (e.g. S&P 500) is going up or down as the investor has equal dollar amounts on both sides of the market. This indifference to market movements is where the term market neutral was born. As we all know there are two sides to every story and the inverse of this example is where the investor loses money. Specifically, if high PE stocks outperform low PE stocks the spread is negative and is amplified by the fact that the investor has assets on both sides of the market (e.g. both long and short). Clearly, there are more factors than just price to earnings ratios which affect stock prices and this is why market neutral strategies must have some inherent form of risk. In the absence of risk there is no return.

Exhibit 1 illustrates the basic mechanics behind a market neutral strategy. Regardless of the factors utilized to select securities, the primary driver of return is the ability to buy undervalued securities and sell or short overvalued securities. This creates a spread between the securities' returns which in turn creates the core return of the strategy.

Exhibit 1 – Mechanics of Market Neutral Investing

Basic M/N Strategy	In an Up Market	In a Down Market
Invest \$1 million in a diversified portfolio of undervalued stocks	Long positions make money	Long positions lose money
+	+	+
Sell short \$1 million of a diversified portfolio of overvalued stocks	Short positions lose money	Short positions make money
+	+	+
Invest short sale proceeds of \$1 million in market market instruments	Money market income from short sale proceeds	Money market income from short sale proceeds
Basic M/N Summary	Up Market Summary	Down Market Summary
+/- Gain/Loss on Longs	+ Gain on Longs	- Loss on Longs
+/- Gain/Loss on Shorts	- Loss on Shorts	+ Gain on Shorts
+ Money Market Income	+ Money Market Income	+ Money Market Income
= Total Return	= Total Return	= Total Return

Pros & Cons

Market neutral in a mutual fund wrapper first came on the scene in the late '90's thanks to the repeal of the "short-short" rule in 1997. This rule limited the amount of income a mutual fund could generate from short term gains. Market neutral strategies at the time had notoriously high turnover which made the strategy nearly impossible to use within mutual funds. Once the limitation was lifted, funds began popping up quickly. First out of the gate was the Barr Rosenberg Market Neutral fund which was launched in December 1997. The appeal of getting alpha on both sides of the portfolio was simply too good to pass up. In a Barron's article in March 1998, Sandra Ward pointed to a number of investment advisors who were quite excited about the proliferation of market neutral funds. For example, the article quoted an advisor in Coral Gables, Florida who noted, "We think it is the best newest thing since sliced bread."¹ Other advisors touted the returns that these same managers had generated in private funds dating back nearly a decade. With the backing of advisors, Rosenberg's fund gained nearly \$200 million in the first few months. Other money managers lined up to launch their mutual fund versions including offerings by Montgomery, Value Line, Zweig and Boston Partners. It seemed like everything pointed north yet there were those that weren't as convinced.

As previously discussed, market neutral funds are typically composed of two portfolios, which means that in theory an investor could lose on both sides of the trade. Other concerns included the high level of fees and the difficulty of maintaining hedges with significant inflows or outflows from fund investors. Finally, many investors were still cognizant of promises made by earlier versions of exotic market

¹ "Risky Business?", Sandra Ward, Barrons, March 30, 1998

neutral models that didn't quite work out. Things like trades between mortgage backed securities and U.S. Treasury bonds were the end of certain managers just a few years before.

In addition, fees on alternative mutual funds including market neutral are often criticized unfairly. Many analysts point to expense ratios that typically exceed 2% and contend that this is high especially relative to traditional long only funds. On the surface this appears to be the case if one were to look at the category averages. For example, according to Morningstar, the average expense ratio on a U.S. large company blend fund is 1.38%. The average for large foreign blend is 1.53% and the average for U.S. small company blend is 1.68%². However, these same analysts seem to forget that market neutral funds really consist of two portfolios (one long and one short) so the managers are doing twice the work. They also fail to point out that the average large company fund has produced negative alpha or risk adjusted return. Over the last 5 years, the average alpha of a U.S. large blend fund was -1.06% and for foreign large blend funds the average was -1.48%. One could question why actively managed long only mutual funds deserve any fee at all. Finally, when compared to hedge fund expenses mutual funds seem downright cheap. Hedge funds charge both a management fee (typically between 1.5% and 2% per year) and 20% of the profits. For a fund with a 12% gross annual return, the total fee works out to be somewhere in the neighborhood of 4%.

As pointed out in a recent article by Morningstar³, market neutral funds made somewhat of a comeback during the technology bust from 2000-2002. The author points out that these funds held up quite well as the traditional equity markets plummeted during this time. Unfortunately, they failed because they couldn't deliver meaningful returns over the long term.

The critical mistake made by the sponsors of these products was promising the holy grail; very little

risk and very high returns. Instead of great returns and low risk, funds like Rosenberg's saw double digit draw downs. As is usually the case, there was clearly more risk than advertised although the source of the risk was difficult for the average investor to identify. Funds launched later protected the downside in years like 2008 but had difficulty generating attractive returns in years like 2010. Maybe there was overcompensation on the risk control side which squeezed out the necessary return potential. Either way, investors seemed to have developed a "love-hate" relationship with funds in the market neutral category.

As is often the case with investment strategies and products, it is critical to establish reasonable expectations and properly educate investors. Investors should understand the sources of return and how that translates to potential risks. More important, investors should have a reasonable understanding of when a strategy will struggle and why as well as when a strategy should perform well and why.

How Should Market Neutral Perform?

In order to develop realistic expectations for performance it is useful to review the historical performance of market neutral strategies and compare the performance and characteristics against other hedged strategies as well as traditional long only strategies. We should point out up front that one of the primary misconceptions about hedged or arbitrage strategies is that they are riskier than traditional investments such as long only equities or fixed income. For a variety of reasons many arbitrage strategies are actually less volatile than traditional investments and offer a good diversification benefit within a well-constructed portfolio. Unfortunately, lack of understanding often skews an investors thinking.

To simplify comparisons we will focus on *equity* market neutral strategies. Equity market neutral represent the vast majority of market neutral strategies and tend to be the easiest to understand. Exhibit 2 illustrates the historical risk and return since January 1, 1990 of market neutral funds relative to various hedge fund strategies as well as

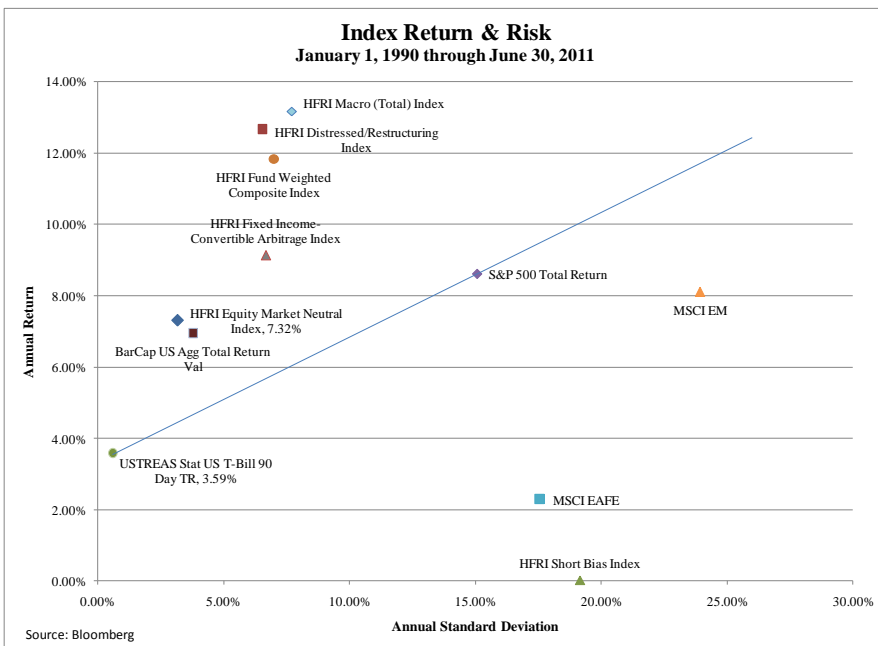
² Source: Morningstar Direct

³ "The New Wave of Alternative Mutual Funds", John Rekenhaller, CFA, Morningstar Alternative Investment Observer, First Quarter 2011

common long only indexes. The first thing to note is the historical return which is 3.73% per year in excess of U.S. Treasury bills. This is right in line with common return expectations of T-bills + 3-4% per year. The next thing to note is the historical volatility or risk which is 3.18% per year. Again, this is right in line with common expectations. In fact, it is very difficult for the vast majority of true market neutral strategies to incur annual volatility of more than 4%. This is due to the fact that market neutral strategies hedge the vast majority of market risk.

Finally, it's worthwhile to note the similarity of both risk and return between equity market neutral and the Barclays Capital Aggregate Bond index. This is important because the two strategies actually have complimentary underlying risks. Specifically, bonds suffer from an increase in interest rates whereas market neutral strategies benefit from rising rates. This is due to the fact that market neutral strategies earn money market returns on the proceeds from their short sales. When short term rates rise, absolute returns on market neutral strategies increase as well.

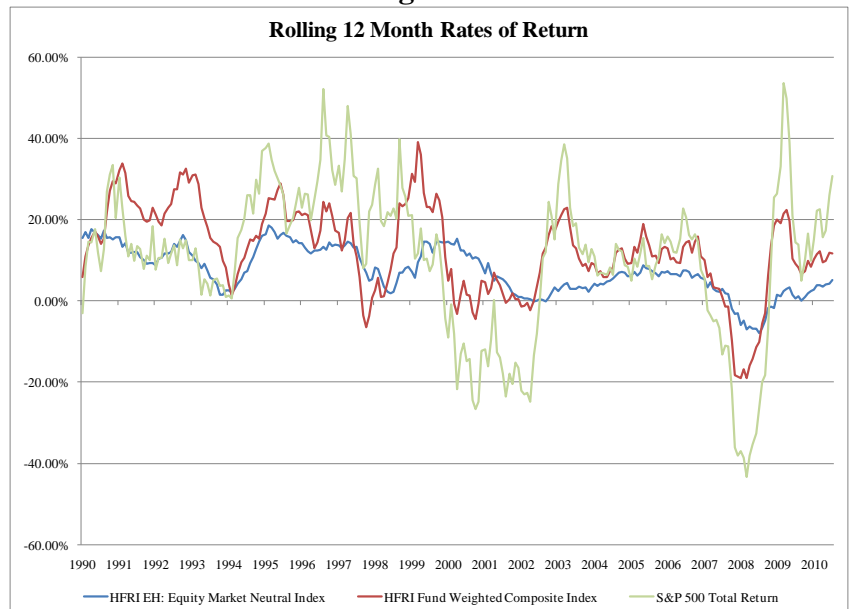
Exhibit 2 - Return vs. Risk



Another way to view volatility of returns is to review rolling 12 month returns. Exhibit 3 depicts

the rolling 12 month returns of equity market neutral relative to hedge funds in general as well as the broad equity market. Clearly market neutral products provide a smoother ride especially as compared to the wild roller coaster ride of the S&P 500. Conversely, market neutral strategies will struggle on a relative basis during huge bull markets. In periods like the late 1990's, or years like 2003 or 2009 market neutral strategies will severely lag the broad equity markets.

Exhibit 3 – Rolling 12 Month Returns



In addition to a smoother ride, market neutral strategies often provide protection in down market environments. Exhibits 4 and 5 illustrate the average monthly return for market neutral strategies compared to the average monthly return for the S&P 500 index in both up and down markets. The average return for equities when the S&P 500 is up during the month is just over 3.3%. Market neutral strategies on the other hand manage to gain only 0.72% on average during up months for equities. The real benefit of market neutral strategies can be witnessed during months when the equity market is down. In the 93 months when

the S&P 500 was negative⁴ the average return was -3.71%. During these periods, market neutral funds averaged a gain of 0.37%.

Exhibit 4

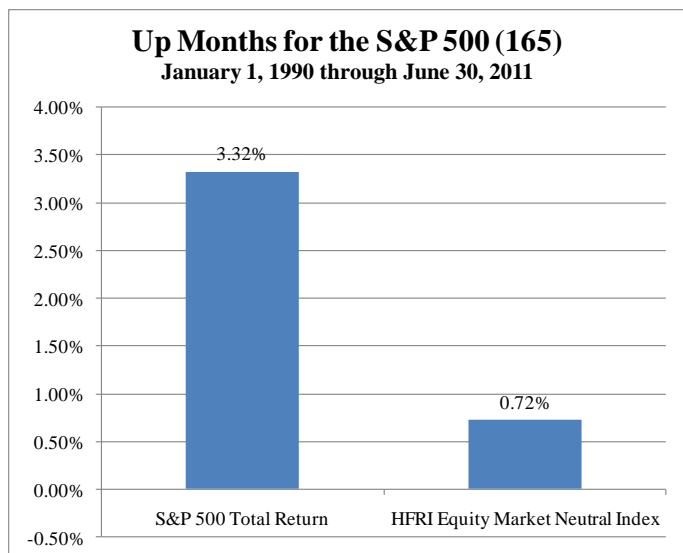
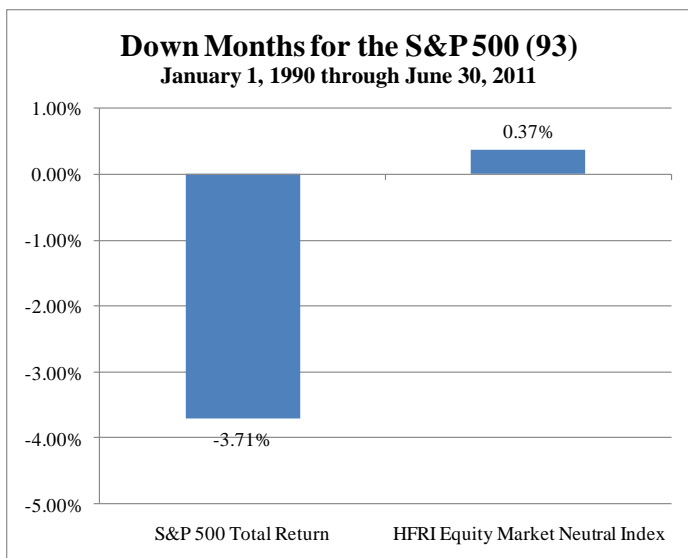


Exhibit 5



Another way of looking at downside risk is largest drawdown. A drawdown is defined as the rate of return from peak to trough. Limiting the size of a drawdown is important due to the return necessary to recover from a large loss. For example, a decline of 25% requires a gain of 33% just to get back to even. A 50% loss requires a subsequent return of 100% to get back to even. Exhibit 6 lists the largest drawdowns for various asset classes and strategies.

⁴ For the period from January 1, 1990 through June 30, 2011

Outside of bonds, market neutral strategies have been the superior choice for limiting downside risk. Interestingly, market neutral has actually had fewer down months than bonds.

Exhibit 6 – Largest Drawdown from January 1, 1990 through June 30, 2011

Asset Class or Strategy	Largest Drawdown	Months with Negative Return
BarCap US Aggregate Index	-5.15%	75 out of 258
HFRI Equity Market Neutral Index	-9.15%	57 out of 258
HFRI Macro (Total) Index	-10.70%	86 out of 258
HFRI Fund Weighted Composite Index	-21.42%	72 out of 258
HFRI Multi-Strategy Index	-21.50%	42 out of 258
HFRI Event-Driven (Total) Index	-24.79%	60 out of 258
HFRI Distressed/Restructuring Index	-27.41%	57 out of 258
HFRI Equity Hedge (Total) Index	-30.59%	77 out of 258
BarCap High Yield Index	-33.31%	65 out of 258
HFRI Fixed Income-Convertible Arbitrage Index	-35.32%	51 out of 258
S&P 500 Total Return	-50.95%	93 out of 258
HFRI Short Bias Index	-53.36%	137 out of 258
MSCI EAFE	-58.24%	111 out of 258
MSCI Emerging Markets	-62.67%	99 out of 258

We have evaluated risk and return but the benefit of diversification is best viewed through the lens of correlation. Correlation tells us how one particular asset class or strategy performs in relation to another. In other words do they move in the same direction all the time? If so, they would have a correlation close to 1 and there would be no diversification benefit. On the other hand, if two strategies do not perform in lockstep then overall portfolio volatility can be reduced. Exhibit 7 shows the correlation of a number of hedge fund strategies and traditional indexes relative to market neutral. The highest correlation to any asset class is 0.39 and that is U.S. T-bills. To put this in perspective, most advisors recommend diversifying a portfolio among large and small stocks as well as foreign and domestic stocks. However, these various flavors of the same thing (i.e. stocks) typically have correlations of 0.90 or greater. Therefore, in a severe market downdraft when diversification is needed most, the different types of stocks will all lose money. Relative to other traditional asset classes such as stocks and bonds, market neutral has very little or low correlation which means that it

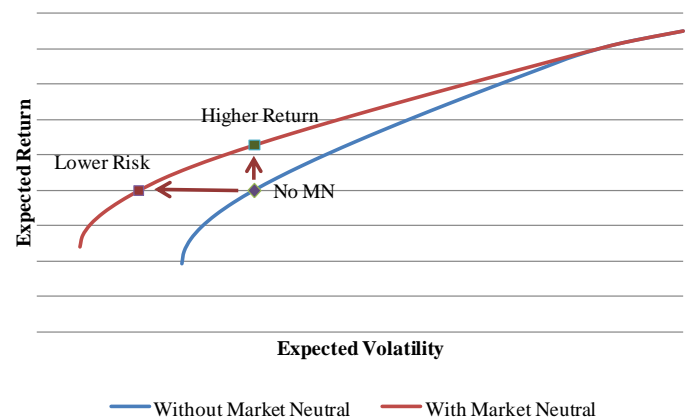
should provide a good diversifier within a well balanced portfolio.

Exhibit 7 - Correlations⁵

	Equity Market Neutral
HFRI Equity Market Neutral Index	1.00
HFRI Distressed/Restructuring Index	0.34
HFRI Short Bias Index	-0.11
HFRI Event-Driven (Total) Index	0.35
HFRI Macro (Total) Index	0.32
HFRI Fixed Income-Convertible Arbitrage Index	0.26
HFRI Multi-Strategy Index	0.34
S&P 500 Total Return	0.21
MSCI EAFE	0.19
MSCI Emerging Markets	0.12
BarCap US Aggregate Index	0.12
BarCap High Yield Index	0.09
US T-Bill 90 Day	0.39

Finally, the question many investors ask is how will a portfolio be improved (or not) by adding market neutral. The answer is interesting as it can be used as either a return enhancer or risk reducer depending on the investor's objectives and preferences. Exhibit 8 is the result of a traditional mean variance asset allocation model. The asset classes and strategies used in the model include domestic and foreign equities, fixed income, market neutral and cash equivalents. The graph includes two "efficient frontiers" which illustrate the most efficient portfolios or mix of assets for each level of risk. In other words what is the maximum expected return along the risk continuum? One of the models/frontiers includes market neutral and one does not. It is clear that the addition of market neutral shifts the efficient frontier up meaning for nearly every level of risk an investor should expect a higher return. Conversely, as is pictured in the graph, the addition of market neutral also provides an opportunity to lower risk for the same level of expected return.

Exhibit 8 – Efficient Frontiers



⁵ Correlations based on monthly returns from January 1, 1990 through June 30, 2011