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Building a Better Market Neutral Portfolio

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We have established that market neutral as a strategy has the ability to enhance the risk/reward structure of a portfolio. The next logical question is how does an investor maximize their experience with this portion of their portfolio? In other words, are there ways to enhance returns and at the same time reduce risk within the strategy. As we have illustrated the historical returns of market neutral strategies has been in the T-bills plus 4% range. Likewise, historical volatility has been just over 3% which has been less than the general bond market. Assuming that investors could tolerate slightly higher levels or risk, say just over the historical risk level of fixed income, would it be worth the potential pick up in return. The answer is it depends on how much return could be generated. Clearly it has been difficult for strategies that hedge out the vast majority of market risk to increase volatility and potential returns. What if however, a manager could tactically adjust their market exposure to take advantage of short term market movements and enhance return potential?

First, we should explore the definition of market neutral. Morningstar defines market neutral funds as “portfolios typically have(ing) net equity exposure between -20% and 20% and a beta between -0.3 and 0.3”. In other words portfolios don’t always have to be exactly neutral to the market but can actually vary their exposure (both long and short) over time. Assuming that a manager had a methodology for adeptly adjusting this exposure it is conceivable that returns could be boosted with minimal impact on longer term volatility. In fact, in today’s volatile environment, such

tactical adjustments may actually be favorable over a static allocation.

Another potential enhancement could be made by diversifying among a number of money managers and styles. Theoretically this could reduce short term volatility by taking advantage of lower correlations between managers. The following example correlation matrix takes the top five open ended market neutral funds as defined by Morningstar and then sorting by the largest five in assets that have at least a three year track record. The highest correlation between any two managers is 0.48 and the typical correlation is much lower.

Exhibit 1 – Correlation Matrix of Market

	Fund 1	Fund 2	Fund 3	Fund 4	Fund 5
Fund 1	1.00				
Fund 2	0.48	1.00			
Fund 3	0.18	0.08	1.00		
Fund 4	0.18	0.08	0.29	1.00	
Fund 5	-0.20	-0.12	0.07	0.05	1.00

Neutral Funds

We then took these same five funds, built an equally weighted portfolio, and calculated the annual volatility or standard deviation. The five manager portfolio had an annualized volatility of 3.22% whereas the average volatility of each manager alone was over 6%¹. Clearly there is an advantage to diversifying among multiple managers. In a perfect world, this would be accomplished through one multi-manager vehicle but an investor could do this by buying multiple funds.

¹ Positions were rebalanced monthly over the time period from August 1, 2008 through July 31, 2011.

Another reason for using a multi-manager vehicle or portfolio is the dispersion between top and bottom performing strategies. Again, using the Morningstar Open Ended Market Neutral peer group, we sorted managers by returns over the three and five year period ending June 30, 2011. For the latest three year period the top 10% of market neutral funds returned 2.60% per year. The bottom 10% by contrast lost 2.57% per year for a return differential of over 5% annually between top and bottom decile funds. The statistics over the latest five year period was similar with a difference of over 5.5% per year between top and bottom decile performers.

Conclusion

Market neutral as a strategy has definitely had its ups and downs, but we believe that was due to a lack of understanding and over-promising by early entrants into the field. Historically, the strategy has performed as it should have and today's products seem to be built in line with expectations. It is one of the more easy to understand alternative strategies and can provide a significant diversification benefit to a traditional portfolio. However like any strategy there are a few key points that investors should focus on:

1. Return and risk expectations should be realistic.
2. The strategy can be used as either a return enhancer or risk reducer. Therefore, there is significant flexibility in the asset allocation process.
3. Returns might be enhanced through the use of tactical allocation around the plus or minus 20% net long/short exposure.
4. Risk or volatility can be reduced significantly by employing numerous managers within a portfolio. The most efficient vehicle for doing this is a single, multi-manager fund.