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Market Neutral - History

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The concept of market neutral or low risk arbitrage investing is certainly nothing new. Investors who lived through the 1987 crash remember the promises of riskless arbitrage in something known as “program trading”. Program trading was designed to take advantage of temporary pricing inefficiencies between the cash equity markets and the futures markets. Both markets focused on an index such as the S&P 500 and institutions (primarily brokerage firms) would purchase one side of the market such as the equities composing the S&P 500 and sell or short the other side of the market such as the S&P 500 futures. These temporary imbalances in the pricing of different instruments in the same market created a spread which in turn was arbitrated away by the proprietary trading desks.

As technology has advanced over the years, arbitrage opportunities and the potential return inherent in such strategies have dissipated. On the other hand, advances in the speed with which information flows to and from various market participants have created new opportunities. Highly experienced and knowledgeable investors have taken advantage of this information flow to build new and different ways to strive for the holy grail of high returns with little risk. However, Finance 101 taught us that there is no return without risk and the higher the return potential, the higher the risk necessary to garner a particular return. That said certain methodologies can provide the edge necessary to significantly reduce portfolio risk but mislabeling and misunderstanding often lead to unrealistic expectations.

Market Neutral as an Arbitrage Strategy

Enter the market neutral strategy which is often one of the least complicated, yet least

understood strategies around. Part of the reason for this misunderstanding is the fact that market neutral is a label which can be applied to numerous arbitrage strategies. These different strategies can trade in a variety of underlying instruments which can add to the confusion. The common thread that links all market neutral strategies is a desire to eliminate or at least minimize certain broad market related risk factors. Things such as broad equity or interest rate risk are often rung out of market neutral portfolios. What make each variation unique are the ingredients that remain in the mix.

It is important to note that market neutral is not an asset class but a strategy that utilizes asset classes. Bruce Jacobs described market neutral as “...a portfolio construction technique that encourages the use of both long and short positions, where the securities are selected from a particular asset class, but the risk of the asset class itself is neutralized.”¹ Being a strategy, market neutral can use a wide variety of securities for implementation. This includes things such as equities, mortgage backed bonds, government bonds, convertible securities and derivatives such as futures and options. As a result, the risks inherent in any particular strategy are numerous and include the volatility of the underlying securities, the application and complexity of the models used to implement the strategies and the amount of leverage involved.

In order to clarify, let’s take a simple example. Suppose a money manager believes that over time, stocks with low price to earnings (PE) ratios outperform stocks with high price to earnings ratios. In other words they believe high PE stocks are overvalued and low PE stocks are

¹ Market Neutral Strategies, Chapter 2, Questions and Answers About Market Neutral Investing, Bruce Jacobs

undervalued. Furthermore, their research indicates that the top decile of stocks in a particular index, say the S&P 500, significantly outperform the bottom decile of stocks. Therefore, they develop a system whereby each quarter, they rank stocks in the S&P 500 by price to earnings ratios. The manager then buys the 50 stocks (top decile) with the lowest PE's and sells or goes short the 50 stocks with the lowest PE's. A fund or portfolio with \$1 million in assets would hypothetically have two portfolios, one with \$1 million invested in the low PE stocks and one with \$1 million sold short in the high PE stocks. Mechanically, this is accomplished through simple margin or lending by a brokerage firm who takes the long positions as collateral against the short sales.