

COMPLIANCE - COVER STORY

BACK TO BASICS WITH EQUITY MARKET NEUTRAL HEDGE FUNDS

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Since Alfred Winslow Jones started the first hedge fund in 1949 by investing in long and short equity positions, hedge funds have grown into an impressive force within the asset management business. As returns grew, managers multiplied and investors' expectations rose. That is until the credit crisis of 2008 changed all of that and a host of long-held assumptions cracked. It is back to basics now, and that original equity market neutral strategy has many of the qualities that investors are again looking for in hedge funds.

So what happened to hedge funds in 2008? Several worst case scenarios came together into a "perfect storm" to generate losses, stress liquidity, and permanently change investor expectations. Perhaps the biggest disappointment for institutional investors was that their allocation to alternative investments was not uncorrelated with the major markets and losses in their hedge fund portfolios were steep at the same time that the markets fell. In addition, illiquid investments, lock ups and gates to redemptions further stressed cash requirements and asset allocation targets within institutional programs.

A hedge fund bubble burst in 2008, leaving behind a smaller number of managers and strategies each refocusing on how to add value to the investment world. Certainly, much of the landscape has changed, with several prime brokers disappearing, leverage greatly curtailed, regulatory requirements on the rise, and onerous management terms and fees in the recycle bin. In this new hedge



fund environment, equity market neutral is worth another look.

Equity market neutral strategies rely on the stock picking ability of a manager to find the most undervalued stocks for the long portfolio and the most overpriced for the short portfolio. The strategy has a "double alpha" effect because a manager can, at the same time, hold favorite stocks and bet against least favorite stocks. To maintain market neutrality, the funds are typically managed to be zero beta with the market exposure of the long positions offset by the exposure of the short positions. Dollar neutrality is also maintained by matching the asset value of the long portfolio with an equal and opposite value in the short portfolio. Some market neutral strategies also keep the portfolio neutral to industries by matching the industry weight in the long portfolio with an opposite weight in the short portfolio. The end portfolio will reflect a manager's strategy in its clearest form since unwanted bets and exposures are offset between the long and short portfolio, and become neutralized.

Equity market neutral investors have lived through a number of market cycles, and still today continue to benefit from key characteristics of the strategy. The



market crisis in particular has strengthened many of the benefits offered by equity market neutral. For example, equity market neutral occupies a distinct place in the hedge fund landscape by exhibiting one of the lowest correlations with other alternative strategies. Evaluating the Hedge Fund Research index returns for 28 different strategies from January 2005 to April 2009 showed that equity market neutral had the second lowest correlation with any of the other strategies, behind only Short Bias funds which typically have a negative correlation with all other funds. This result is not surprising given that each fund utilizes the unique insights of a manager and these insights are not replicated across funds.

The non-directional benefit of equity market neutral funds was tested in 2008 as a slew of unexpected changes to commodity prices, market direction, interest rates and liquidity severely impacted hedge funds. The average return in September and October 2008 across 28 fund strategies was -11%, the S&P 500 index was down -27%, but equity market neutral was flat over the same period. With such wide swings in the equity markets, the tight performance of equity market neutral was achieved with successful hedging of positions that kept the funds truly market neutral. Losses from the long positions were offset by equal gains in the short positions, leaving the net returns unaffected by the market fall.

Risk control is another important feature of equity market neutral funds because in keeping the long and short positions in balance with respect to beta, dollar value and sectors requires a constant review and adjustment of exposures. A manager cannot afford to let positions become unbalanced because this creates exposures to market movements that could generate volatility and even losses in the fund. At 5% volatility during 2008, equity market neutral funds were one of the least volatile strategies.

One of the unintended benefits of equity market neutral funds in 2008 was the ability of managers to meet the liquidity needs of their investors. As the equity market experienced record swings, equity trading volume remained at high levels, offering plenty of chances for managers to trade positions. Even the ban on short selling of financial stocks was not much of a hindrance as managers opted either to hold their short positions or to cover them. The continuous pricing in the equity markets gave equity market neutral investors a real-time valuation of their portfolio at the same time when other hedge funds were facing liquidity and valuation problems. As a result, equity market neutral and other equity strategies became what one public fund board member called "the program's ATM machine" so even managers with a positive track record in 2008 saw redemptions to fill their client's liquidity needs.

What does the aftermath of the 2008 market crisis look like for hedge funds? If the first part of 2009 is any indication, several trends seem to be in place:

Leverage is gone. Strategies that relied on abundant and cheap leverage can no longer get it and so future returns will be smaller and much different than past returns.

Transparency is king. Investor demands for stronger due diligence processes and transparency of positions will change the competitive landscape for funds that relied on non-disclosure.

Liquidity is required. Lock-up periods, redemption gates and few exit time windows in funds will be looked down upon by investors who will demand better terms for redemptions.

High fees are out. The 2 and 20 fee structure is gone from the mainstream manager as clients put more emphasis on sustainability of performance.

Bigger is not safer. Large hedge funds offered no better defense against the market crisis in 2008 than did smaller funds.

By all measures, equity market neutral passed the market stress test of 2008 and will likely regain a spot in investor's allocations following a modest performance period prior to 2008 when other hedge fund strategies were racing ahead. With market conditions returning closer to normal in 2009, equity market neutral is performing according to expectations as the HedgeFund.net Equity Market Neutral Index is up 1% year-to-date through April 30th.

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