MATARIN CAPITAL

Investing with Insight and Integrity

# The Role of a Market Neutral Strategy in Your Diversified Portfolio

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A market neutral strategy, properly apportioned, should act as a hedging vehicle in investors' overall strategic asset allocations. Because of its lack of correlation with broad markets in the long run, a risk-managed market neutral portfolio can diversify the risks of traditional stock and bond investments, and also provide a hedge against other classes of alternative investments (e.g. private equity, real estate, and even directional hedge funds, many of which will tend to demonstrate positive correlations with the stock market and some of which will also tend to benefit specifically from lower interest rate environments).

## Hedging Your Bets

A February 2013 Wilshire Associates report shows the average asset allocation of 134 state retirement systems in each of the 50 U.S. states and the District of Columbia. The study reveals that while investments in U.S. equities themselves have decreased substantially over the past ten years, those investments have been replaced by asset classes which themselves can tend to be quite correlated with U.S. equities (non-US equities, private equity, real estate, and other). Notably, the "other" category, which has gained the most in the past ten years is made up of cash, "hedge funds, and other absolute return/zero net-beta strategies." The increase in hedge fund and absolute return investments is most likely intended to achieve diversification, but, sadly, too many hedge fund strategies bear direct or indirect long exposure and positive correlation to equity markets and other asset classes in investors' portfolios, making it difficult for them to offer the "hedge" when it is needed. Thus, simple asset allocation logic suggests that quite a valuable objective for a market neutral strategy is to be truly "market neutral" — to provide cushion during years in which traditional multi-asset class portfolios miss their return targets. The difference in correlations of market neutral funds vs. all hedge fund styles can be seen in the HFR Hedge Fund Return Indices, shown at right. The benefit of diversification from market neutral hedge fund investments is best evaluated over a full business cycle – a full cycle of return and risk environments across asset classes. In the long run, the diversification benefit that can be offered by a market neutral portfolio should allow investors to achieve higher overall wealth for the same level of risk at the end of the day.

**Change in Average Asset Allocation for State Pension Plans**

| | | | | Change in Exposure | |
|---|---|---|---|---|---|
| Equity | 2002 | 2007 | 2012 | 02-12 | 07-12 |
| U.S. Equity | 42.3 % | 41.0 % | 28.0 % | -14.3 % | -13.0 % |
| Non-U.S. Equity | 12.9 | 18.2 | 19.8 | 6.9 | 1.6 |
| Real Estate | 4.0 | 5.2 | 7.3 | 3.3 | 2.1 |
| Private Equity | 4.2 | 4.6 | 9.8 | 5.6 | 5.2 |
| Equity Subtotal | 63.4 | 69.0 | 64.8 | 1.4 | -4.2 |
| Debt | | | | | |
| U.S. Fixed | 35.2 | 26.4 | 24.2 | -11.0 | -2.2 |
| Non-U.S. Fixed | 1.4 | 0.9 | 1.8 | 0.4 | 0.9 |
| Other | 0.0 | 3.7 | 9.2 | 9.2 | 5.5 |
| Debt Subtotal | 36.6 | 31.0 | 35.2 | -1.4 | 4.2 |

Source: Julia Bonafede, Steven Foresti, Russell Walker, Wilshire Associates, "2013 Report on State Retirement Systems: Funding Levels and Asset Allocation," February 27, 2013

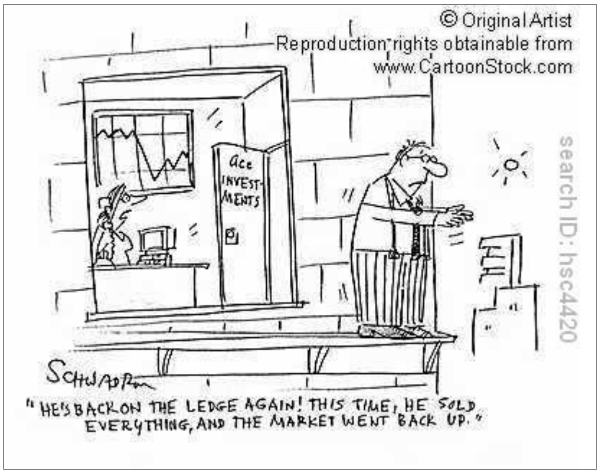
**Hedge Fund Correlations with Broad Markets**[1]

| | All Hedge Funds | Market Neutral Equity Hedge Funds |
|---|---|---|
| S&P 500 Index[2] | 0.22 | -0.08 |
| MSCI World ex US Index[2] | 0.56 | 0.33 |
| Barclays Aggregate US Bond Index[2] | 0.75 | 0.58 |
| Real Estate[3] | 0.79 | 0.55 |
| Private Equity[4] | 0.88 | 0.43 |

[1] Source: Bloomberg
[2] Data as of December 31, 1997
[3] Based on S&P/Case-Shiller 20-City Composite Home Price Index , Data as of January 31, 2000
[4] Based on S&P Listed Private Equity Index, Data as of December 31, 2003

## Easier Said Than Done

The importance of downside protection in maximizing overall wealth is compounded by effects of investor behavior. A major behavioral challenge presented by portfolios that are prone to large drawdowns is the pain of sticking with such investments through their recovery periods after deep losses. The fear-driven tendency is to sell at or near the bottom, locking in losses and bypassing any rebound. Thus, a subtle but important benefit provided by downside protection is that it allows investors to remain cool-headed and make better decisions during downturns.

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**Taking It To The Next Level**

We said specifically at the outset that a "properly apportioned" market neutral strategy can act as a hedging vehicle against other investments. What do we mean by this? In fact, there are some steps which market neutral portfolio managers can take to help minimize the correlation of their portfolio returns with other investment strategies and asset classes, thus lowering the correlations that their strategies will have with them even below those shown for the average market neutral manager in the table on the prior page.

For starters, a market neutral strategy should be dollar neutral: for every dollar long, the portfolio is also a dollar short, so that raw market risk is hedged out. But there are a lot of other sources of risk that can also lead investment strategies to be correlated, and which can specifically magnify drawdowns as well. These are things like large net industry or sector exposures — it would be undesirable for a run in any individual industry or sector to move the entire market neutral portfolio because these runs can also be correlated with broader market moves (think of the dot-com boom or financial crisis) — so sector and industry risk should be hedged out. Another potential source of risk would be disproportionate exposures to beta on the long and short side of the portfolio. Imagine being long all high-beta stocks, and short all low-beta in an environment where the market is overcome with risk aversion, and punishing riskier names. Although one's portfolio may be dollar neutral, the lopsided exposure to beta could cause the portfolio to move like the market, simply because the market's returns are being characterized by risk aversion. Similarly, disproportionate exposures to large or small market cap companies are to be avoided; disproportionate exposure to growth or value style stocks are to be avoided, etc. To truly offer diversification and manage downside risk, it is clear that dollar risk is definitely not the only risk worth controlling in a market neutral portfolio.

**Setting Appropriate Goals**

In trying to offer a strategy that provides downside protection, a market neutral manager shouldn't attempt too aggressively to shoot out the lights on the return side, because of the proportional (although non-linear) relationships between risk and return. In order to achieve a higher level of return, more risk needs to be taken, but increased levels of risk must also lead to increased drawdown expectations. In similar logic, the more and more risks that a market neutral manager hedges away, (dollar risk, beta risk, size risk, etc.), the lower return expectations are likely to become. So, a market neutral manager really has to make important decisions about not only where to eliminate risk, but also where to take it. Needless to say, the most risk should be taken in the areas where the investor has the most skill, or edge.

For example, as we wrote in a recent research piece, All Active Share is Not Equal: "At Matarin, we attempt to add value via stock selection. Because our investment process focuses on capturing unique fundamental insights in order to forecast individual stock returns, stock-specific return is the opportunity set in which we have the greatest 'edge.' Statistically, all other things being equal, specific stock picking is also one of the most fruitful arenas in which a manager can express an investment edge, because of the sheer number of opportunities available in this space – every stock in the investable universe is fair game."

**Buy Low, Sell High**

It's tempting to want to underweight risk-protective investments after a period in which risky assets have been demonstrating strong returns, and tempting to want to overweight risk-protective assets after risky assets have tumbled. However a simple and very effective rebalancing discipline would actually lead us to *add* to risk-protective assets after risky assets have rallied, and rebalance *away* from them after riskier assets have suffered periods of underperformance. This is counter to humans' natural behavioral instincts which are governed by fear and greed, but such a rebalancing approach is effective because it forces a discipline of buying low and selling high — a common goal for all investors which is easy to say, often emotionally hard to do, and unfortunately never achievable in hindsight.