Why a Market Neutral Strategy

Employing a market neutral strategy within a broad portfolio has the potential to provide:

- Ability to add incremental returns irrespective of market direction;
- Reduced volatility;
- Superior risk adjusted returns;
- A return stream uncorrelated to other asset classes providing diversification benefits in a broader portfolio; and
- Reduce draw downs in negative equity markets.

Market neutral strategies differ from traditional long-only strategies in that they take both long and short positions. If a long-only manager has a negative view on a stock the available options are for the manager to have an under-weight exposure or to have no exposure at all. Restricted to these options the manager may not be able to take full advantage of the investment opportunity. By adopting an extended portfolio that includes both long and short positions, a manager is fully utilizing the investment opportunities to take advantage of both attractive and unattractive stocks.

Being able to apply a short selling approach also allows cash proceeds from the short portfolio to be used to fund exposures to attractive positions in the long portfolio, thereby increasing the active exposure within the overall portfolio.

Given a portfolio with a long and short component a manager can insulate the portfolio from market direction, potentially producing returns in both up markets and down markets.

Ideally when markets are positive the long positions should be adding incrementally more than any potential losses from the short positions. Conversely, when markets are negative the short positions should be incrementally adding more than any potential losses from the long positions. It is this ability to add value irrespective of overall market direction that makes a market neutral strategy attractive, especially when positive equity markets are over extended and prone to turnarounds.

The volatility from market neutral strategies will often be lower than a long-only based strategy. This assists in lowering the overall volatility of a broad diversified portfolio and is further assisted if the market neutral return stream is uncorrelated with traditional asset classes. And in the event of a volatility spike in the equity market, the increased volatility may not fully translate to the returns of the market neutral strategy.

Headline returns are a key consideration in selecting a strategy or an investment manager. What is often overlooked is the risk being taken in selecting a strategy or a manager. Comparing returns on a risk adjusted basis allows investors to determine whether they are being adequately compensated for the risks of a given strategy. For example, a top performing fund might achieve its returns with excessive volatility (or variability of returns). This may lead one to question the ability of the manager to maintain headline returns. Market neutral strategies, which typically have a lower volatility return stream, may provide superior risk adjusted returns.

As market neutral strategies attempt to remove the impact of the equity market, the return stream is largely uncorrelated to the broader equity market. This uncorrelated nature of the return stream extends to other traditional asset classes, making the addition of a market neutral strategy within a broad diversified portfolio highly effective in reducing risk, improving returns and preserving capital over the long term.

Market neutral strategies attempt to remove or reduce exposure to market risk, otherwise known as beta risk. With a beta exposure close to zero, in the event of a major market correction the low exposure to beta should result in shallower drawdowns and preserve capital. This contrasts with traditional long-only type portfolios that are benchmark based and derive the majority of returns through exposure to market direction. As a result, a market neutral strategy offers the potential for smaller drawdowns and better preserves capital when markets are negative and volatile.

Equus Point Capital manages a systematic market neutral strategy based around the idea of harvesting the momentum premium from the Australian equities market, within a clearly defined risk management process. Whist the Fund was launched in November 2018 the strategy has been simulated from June 2000 to December 2018 providing an indication of how the Fund may have performed under the same investment and risk criteria and after fees and costs.

Consistent with a market neutral strategy the simulated returns provide:

- An attractive headline return;
- Lower volatility than index returns;
- A return stream uncorrelated to the returns from the index; and
- Preserves capital in negative markets.

	Equus Point Capital	S&P/ASX 200
Return	14.3%	7.4%
Volatility	8.0%	12.5%
Reward to Risk	1.8	0.6
Sharpe Ratio	1.3	0.3
Max Draw Down	-13.3%	-47.2%
Beta	0.1	
Correlation	0.1	

Notes:

Reward to Risk	Ratio of the annualized return divided by annualized volatility
Sharpe Ratio	Annualized excess returns over cash, divided by annualized volatility
Draw Down	Maximum loss measured from peak to trough of cumulative returns
Beta	Measure of the risk arising from exposure to general market movements as opposed to idiosyncratic (or stock specific) factors
Correlation	Correlation of strategy returns to market returns

Simulated results encompass the period from June 2000 to Dec 2018. Results are after fees and costs. The index is the S&P/ASX 200 Accumulation Index.

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