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Putting a price on market neutrality

By Jason Huemer
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For the past few years "equity market neutral" as a strategy has struggled, leading many investors to question whether it lives up to its name. With the release of two studies, these investors may be closer to an answer, although it may not be the answer hedge fund managers have been hoping for.

To many industry participants, equity market neutral is the quintessential hedge fund strategy, offering the promise of true absolute returns without market sensitivity. Indeed, the first hedge fund, founded by Alfred Winslow Jones in 1949, was a type of market neutral fund, seeking to balance long market exposure with offsetting short positions.

Equity market neutral strategies have come a long way from their relatively simplistic "dollar neutral" roots. In today's market most such funds seek to create portfolios that are beta neutral, removing exposure to the broader market, or even factor neutral, eliminating a variety of factors such as interest rates and oil prices.

For much of the 1990s, equity market neutral was the darling of the hedge fund world but as the bull market gave way to the bear market of 2000-2003 equity market neutral fell on hard times, causing many investors to question the strategy's ability to generate true market neutral returns.

Perhaps the most important threshold question is whether equity market neutral funds are at all neutral. One recent effort that attempts to find an answer is a working paper by Andrew Patton at the London School of Economics called: "Are 'market neutral' hedge funds really market neutral?"

Mr Patton looks beyond the traditional measure of market neutrality - that is, a correlation with a broader market - and expands the definition to include such risk sensitivities as variance neutrality, value at risk neutrality and tail neutrality as well as what he terms "complete neutrality", or a full disassociation with the markets.

Measuring 217 market neutral funds between April 1993 and April 2003, Mr Patton finds two-thirds of these funds fail at least one test of neutrality.

In a slightly different take on the same question, First Quadrant, a leading quantitative shop, recently studied the issue in a partners' message called "Alpha and beta in market neutral". Like Mr Patton, First Quadrant's approach begins by redefining what it means to be market neutral in today's hedge fund market. "How the question about risk is answered defines what it means to be market neutral," the First Quadrant team explains. "Ultimately, how risk, or 'beta', is defined will determine how value added, or 'alpha', is defined."

Tracking the evolution of our notions of beta from simple correlation to a benchmark through to more modern hedge fund conceptions, including style beta in various strategies, First Quadrant notes that a much deeper and more detailed notion of risk and beta is appropriate today.

First Quadrant then looks at 24 factors in categories such as sensitivity to stock price, style, yields, volatility and economic trends. Their conclusions may not be surprising to active market neutral participants. Although the First Quadrant fund scored remarkably well, sensitivity has crept into the strategy in yield, volatility and momentum, all areas that have plagued market neutral investors.

Why do these factors matter? Simply put, the measures that First Quadrant has identified are all forms of noise in the market place. And as noise declines, quantitative programmes seem to have less grist for their mill. Building on that notion, an even more interesting reference point is provided by Sanjay Santhanam and Sudhir Krishnamurti of Rock Creek Group with Samir Varma of VS Asset Management.

In their recent paper, "When equity market neutral is not 'market neutral'," the researchers look at sensitivity of market neutral strategies to dispersion of stock returns, a classic measure of market noise, in this case measured by the correlation to S&P 500 stocks. What they found was striking: a strong negative correlation between equity market neutral returns and the dispersion in the index, in some cases greater than negative 0.8. In other words, there is very strong statistical evidence that equity market neutral returns fall as dispersion contracts. And since dispersion typically falls in a bear market, this observation goes a long way toward explaining the recent difficulties of the strategy.

So, what does the future hold for equity market neutral? If the bear market is behind us, we should expect greater dispersion and more opportunity. So far, that has yet to happen. "The interesting thing is that correlations have not dropped at all as you would expect in a normal bull market," notes Mr Varma. "What that tells me is that the market is still responding to large-scale macro factors."

Of course, with recent market trends, whether we are in a bull or a bear market may seem somewhat less clear.