

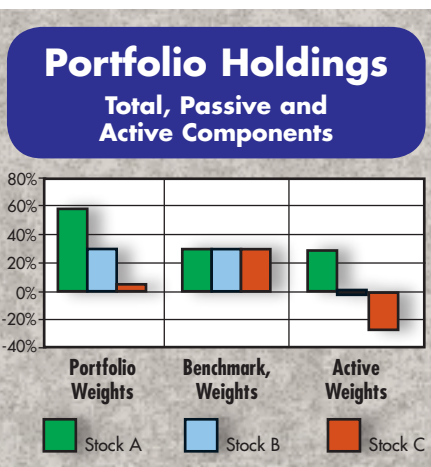


Looking At Equity Market-Neutral

By: Steve Huang & Dion Roseman

Equity long/short portfolios strategies aim to generate positive returns by buying stocks with higher than average expected returns and selling short stocks with below average expected returns. In a 'market-neutral' long/short strategy, the long and short positions are balanced aiming to deliver positive returns in both up and down markets. While market-neutral strategies can seem exotic or mysterious, these portfolios have more in common with traditional equity strategies than meets the eye.

To understand this, think of a traditional long-only portfolio. First, it



is an investment in the equity market – as represented by the benchmark. This provides market exposure. Second, it is an investment in active management, whereby the manager adds value. The portfolio's return is a combination of the equity market return and the added value from active management.

Hypothetical Portfolio

The chart illustrates how a hypothetical portfolio can be separated into a benchmark and an actively managed component. The set of bars on the left and in the middle are the portfolio and benchmark weights. The active weight, the bars on the right, is the difference between the portfolio and the benchmark weight, commonly called overweight and underweight positions. In this example, the manager favours stock A, therefore it has a positive active weight (overweight). The manager has a neutral view for stock B, and thus its active weight is zero. Lastly, the manager expects poor performance for stock C, therefore it has a negative active weight (underweight). By definition, the active weights total zero – the overweight in A is offset by an underweight in C. If A outperforms while C underperforms, then the portfolio's return will be higher than the benchmark's so the added value from active management will be positive.

Unlike long-only portfolios, the goal of market-neutral strategies is to provide returns that depend solely on active management. The long and short positions in a market-neutral portfolio play the same role as the active weights in a long-only portfolio. A market-neutral manager will have long positions in attractive stocks and short positions in unattractive stocks.

As well, just as with long-only active weights, a market-neutral portfolio's long and short weights should sum to zero to ensure that there is no net equity

exposure. Long-only active weights and market-neutral weights are so similar that an actively managed long-only portfolio can be thought of as a market-neutral strategy that happens to be packaged along with the benchmark. In this sense, investors in traditional active equity portfolios are already invested in market-neutral strategies!

Why Bother?

If long-only active management is so similar to market-neutral strategies, why bother with market-neutral? The answer, in short, is efficiency. Since a long-only manager cannot sell stocks short, an underweight cannot be larger than the stock's benchmark weight, regardless of how unattractive the stock is. If a portfolio's benchmark happens to include many stocks with very small weights, a long-only manager will be severely restricted in their ability to underweight the unattractive stocks. Because market-neutral managers can sell stocks short, they are not subject to this limitation.

Pension plans can incorporate market-neutral strategies by replacing a traditional equity portfolio with a combination of an index product and a market-neutral portfolio. The index product provides market exposure while the market-neutral portfolio provides efficient active management. This structure is appealing because it allows plans to choose benchmarks that best offset their liability structure. ♦



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