# Market neutral investing: Exploring the potential benefits and sources of return

## Executive summary

Equity markets, especially in the United States have enjoyed quite a run. For periods ended May 31, 2017, the S&P 500 has returned 8.7% year-to-date, 17.5% for the trailing 12 months and 10.10% annually over the past three years. Volatility[1], despite a spike during the summer of 2015 and more recently related to last year's presidential election, has declined to historically low levels. Economic growth appears to be stabilizing in many parts of the world and growth has returned to the Eurozone. Even Emerging Markets have rebounded from three years of negative returns[2]. Why diversify away from equities?

While we believe that the fundamental backdrop for equities is positive from an absolute sense and perhaps more attractive relative to bonds, the benefits of diversifying your investment portfolio with strategies that are expected to exhibit little-to-no correlation with the broad equity and bond markets still remain. Moreover, as the US continues into its second longest economic expansion over the past 50 years, there are macro and market conditions that may interrupt this most recent period of high risk adjusted returns for equities.

- The bull market in the S&P 500 is in its ninth year; the second longest in post-World War II history and the run has pushed the forward P/E ratio to a ten-year high.
- Bond yields, while rising post the presidential election, are still at historic lows with limited room to rally unless economic growth declines.
- Political risk is on the rise as populist sentiment grows (BREXIT, Trump) and acts of terrorism appear to be increasing.
- Disconnect in the capital markets as both "safe haven" assets (gold and bonds) and risk assets (equities, bitcoin) are rallying. Something has to give.

The Invesco Quantitative Strategies team believes one potential way to buffer the effects of market downturns, volatility and rising interest rates is to add market neutral equity strategies to traditional portfolios, as they potentially offer a unique approach to generating return regardless of the general movements of the equity and bond markets. Many market neutral equity strategies are designed to strip away all other exposures (i.e. beta, sectors, size) by creating offsetting long and short positions; therefore, returns are driven primarily by stock selection, and are a purer representation of a portfolio manager's skill. Market neutral equity strategies may offer several potential benefits, including:

- Very low levels of correlation to other asset classes (stocks, bonds and commodities) that may represent a significant portion of investors' portfolios.
- Lower levels of total volatility, which may lower risk further.
- A history of attractive downside protection during extreme market stress, as these strategies typically exhibit near-zero beta exposure.
- Opportunity for higher returns in a rising interest rate environment.

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## Introduction

Market neutral equity strategies offer a unique style of investing and typically seek to produce attractive returns for investors whether the larger equity markets are climbing, falling or bouncing around in a narrow range.

Unlike traditional equity strategies, where portfolio managers can only generate returns by buying stocks that they expect to perform well, managers employing a market neutral equity strategy can also borrow and sell stocks expected to perform poorly in a process known as "short selling," or "shorting." Long positions profit when the price of an investment goes up, and short positions are designed to profit when the price of an investment goes down. To produce attractive portfolio returns, the stocks being held long must outperform the stocks sold short, thus earning a positive "spread."

Take for instance a hypothetical situation where a portfolio holds a long position in one financial services firm, such as a bank, but holds a short position on another bank. In this scenario, the portfolio manager has effectively neutralized the client portfolio's exposure to fluctuations in the banking industry and will make or lose money only based on the relative performance of the two stocks.

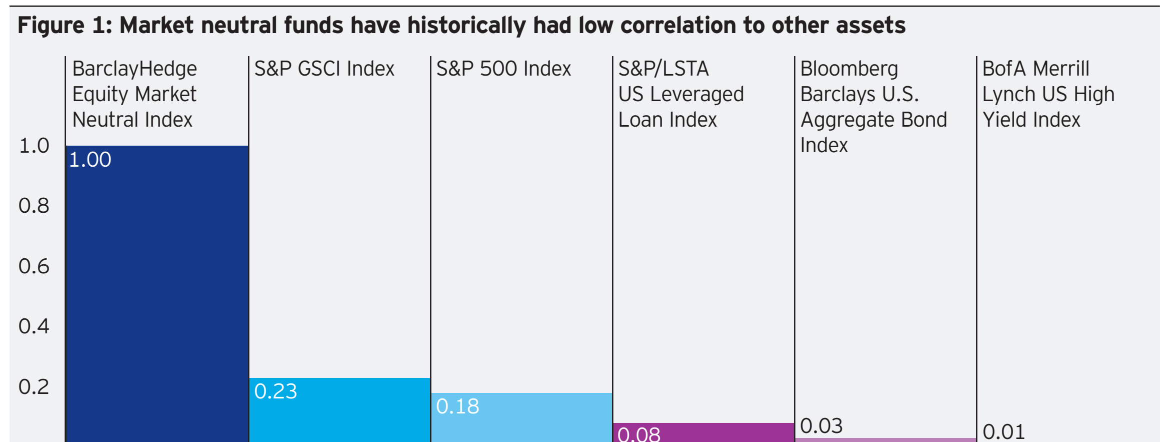
## Potential benefits

Due to their unique investment approach, market neutral strategies offer several important potential benefits to investor portfolios, including diversification from traditional asset classes, the ability to dampen overall volatility, a cushion against severe equity market declines and a return boost from rising interest rates.

### Diversification[3] potential

Investing is a classic tradeoff between risk and return. One of the ways investors attempt to manage and mitigate the risk part of that equation is by combining strategies that differ within and across asset classes to help diversify their return pattern over time. Using this approach, investors' wealth creation is not tied to the fortunes of just one or a few investment options. Furthermore, with all else being equal, the lower the correlation of one investment option to another, the greater the potential for reducing overall volatility across the investment lineup.

**Figure 1: Market neutral funds have historically had low correlation to other assets**

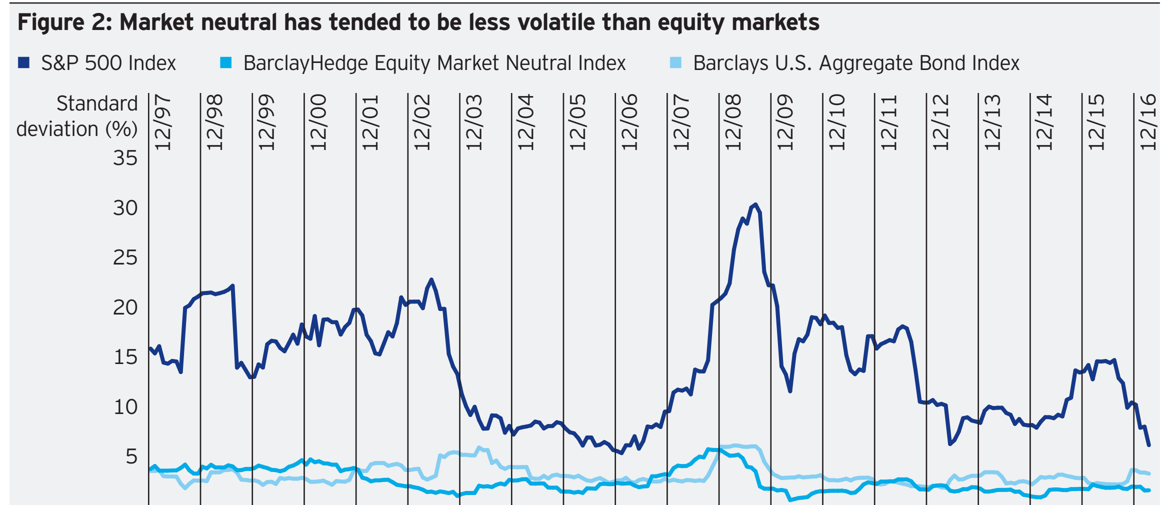



Sources: Invesco and StyleADVISOR. (January 1997 – March 2017)
BarclayHedge Alternative Investment Database. This computerized database tracks and analyzes the performance of approximately 6800 hedge fund and managed futures investment programs worldwide. BarclayHedge has created and regularly updates 18 proprietary hedge fund indices and 10 managed futures indices. BarclayHedge indexes reflect performance of hedge funds, not of retail investment strategies, and are used for illustrative purposes only solely as points of reference in evaluating alternative investment strategies. Please note: BarclayHedge is not affiliated with Barclays Bank or any of its affiliated entities. Performance for funds included in the BarclayHedge indices is reported underlying fees in net of fees. Past performance is not a guarantee of future results.

Stocks and bonds are a great example of investments that usually (but not always) exhibit low correlation levels. Since market neutral strategies typically seek to eliminate exposure to the broader market, these strategies have also delivered attractively low levels of correlation, not only to the equity markets, but to other broad asset classes as well. As you can see in Figure 1, from January 1997 to May 2017, market neutral strategies had only a 0.18 correlation to equities and a 0.03 correlation to bonds. Market neutral also had low correlation to another popular asset class, commodities, as well as to other segments of the fixed income market, such as leveraged loans and high yield. As investors seek to diversify their holdings in order to lower overall volatility, we believe market neutral strategies should be considered as a way to achieve that goal.

**Volatility dampening**
Diversification works when strategies behave differently relative to each other at the same point in time. Another way to mitigate risk across an investment lineup is to include strategies that may offer lower levels of total volatility (variation in portfolio returns). Even if these strategies were perfectly correlated with other investments, their potentially lower total volatility profile will help lower the overall average volatility of the full lineup. Market neutral strategies also may be appealing to investors from this total volatility perspective, as their volatility has tended to be less than the broader equity markets, and in some cases, similar to broad fixed income indexes (see Figure 2). Furthermore, since market neutral returns are expected to be independent of the broader equity market, a spike in market-level volatility may not necessarily mean a spike in market neutral volatility.

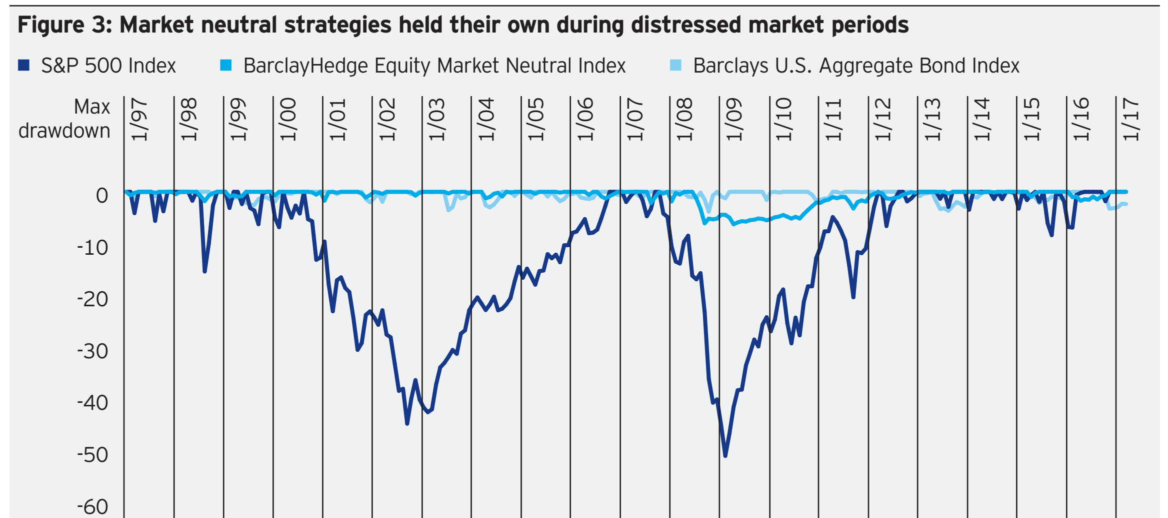
**Figure 2: Market neutral has tended to be less volatile than equity markets**




Sources: Invesco and StyleADVISOR. (January 1997 – March 2017). BarclayHedge Alternative Investment Database. Past performance is not a guarantee of future results.

**Downside risk mitigation**
Another often-cited potential benefit of market neutral is that the strategies may offer investors a way to mitigate severe losses during a sharp equity market sell-off. Because these strategies typically have beta exposure to the market that hovers around zero, a big drop (or surge) in equities should not influence the performance of the strategy. This contrasts sharply with traditional, benchmark-centric strategies, which typically have very high levels of market exposure and tend to vary similarly to the broader market.

**Figure 3: Market neutral strategies held their own during distressed market periods**




Sources: Invesco and StyleADVISOR. January 1997 – March 2017. BarclayHedge Alternative Investment Database. Past performance is not a guarantee of future results.

The asymmetry of portfolio returns is not kind to investors who panic and sell at inopportune times. After all, a 50% decline in a portfolio requires a 100% return to recover all losses. Sometimes the best way to compound wealth over time is not to lose it in the first place. Over the last 20 years or so, investors have experienced two "once-in-a-lifetime" drawdowns in US equities: the technology-media-telecom bubble burst in early 2000 and the Global Financial Crisis of 2008. Relative to broad equity indexes, equity market neutral strategies held up tremendously well compared to the broad equity market in these periods of extreme market stress (see Figure 3).

**A tailwind from rising interest rates**

While a June increase in the federal funds rate from the US Federal Reserve is almost certain, investors have become skeptical of the timing of a further increase. Data dependency should introduce a level of uncertainty to the bond markets as economic releases are parsed for clues to the Fed's actions. Many investors are concerned by this anticipated rise in rates because a rate increase can be a headwind to returns from their bond holdings, as the price of bonds and the direction of interest rates are inversely related. In addition, equities may struggle as well in a rising rate environment since their borrowing costs increase (as do the borrowing costs of their customers).

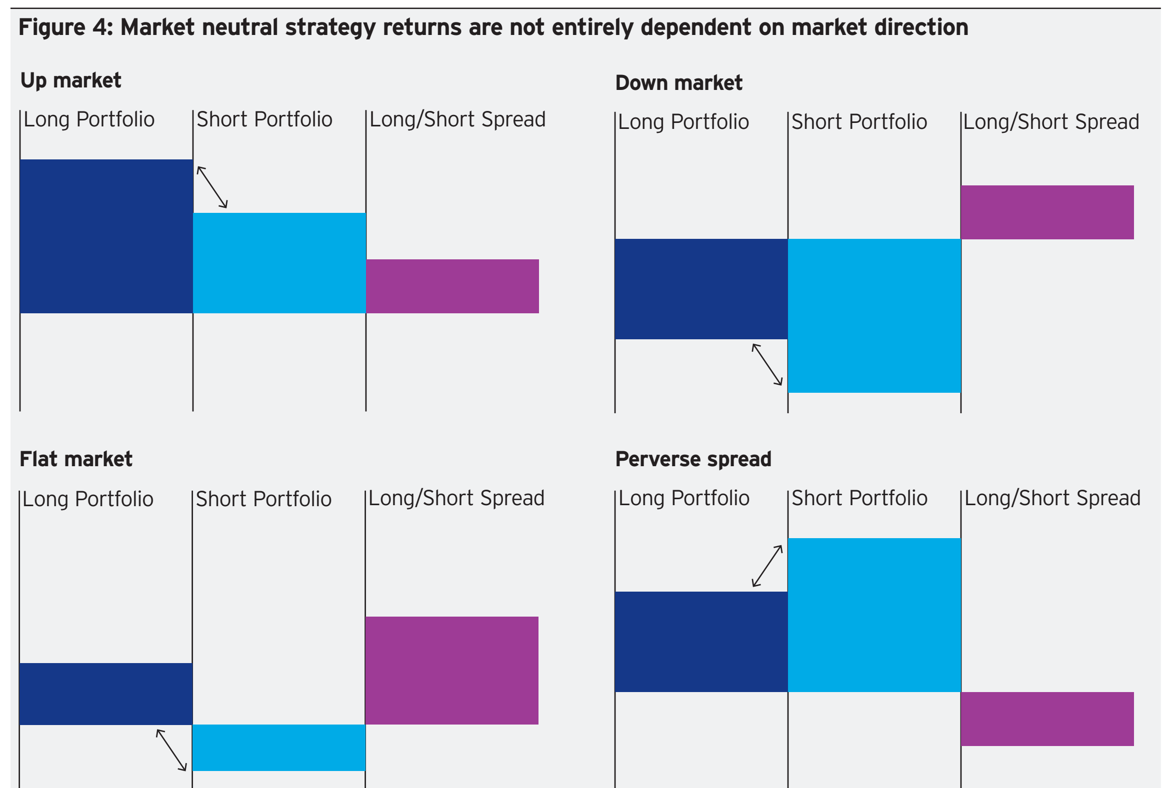
## Return expectations

**Returns independent of the market's direction**

Because market neutral equity strategies typically operate with beta exposures near zero, their returns are not dependent on the direction of the market. Rather, managers seek to produce positive returns regardless of the market direction, should their long holdings outperform their short holdings on average.

To illustrate, consider the upper-left panel in Figure 4. In this hypothetical example, the stocks underlying both the long and short positions have risen in price, which is likely in a strong bull market. While rising prices cause a loss on the short position, they benefit the long positions. This relationship can benefit the strategy as a whole. Why? Because a profit is made if the gain on the longs exceeds the loss on the shorts. Alternatively, in a strong bear market, as represented hypothetically in the upper-right panel, the stocks underlying both the long and short positions have declined in price. This causes a loss for the long positions, but a gain for the shorts. As long as the decline in the longs is less severe than that of the shorts, the portfolio will generate a profit on those assets. Returns would also be positive in flat markets (bottom-left panel of Figure 4) when the longs outperform the shorts.

**Figure 4: Market neutral strategy returns are not entirely dependent on market direction**




Source: Invesco. For illustrative purposes only.

**Returns driven by success of investing style, not market direction**
Of course, market neutral equity strategies can also suffer losses. This occurs when the strategy's long positions underperform its short positions (as seen in the lower-right panel of Figure 4). While equity market neutral strategies tend not to be influenced by the direction of the overall equity market, they are influenced by the environment for their investment themes, which is reflected in the characteristics of the long and short positions. For example, if investors are generally rewarding those themes, market neutral equity strategies may perform well. If investors are not rewarding those themes, then market neutral strategies may lag.

Rather than the direction of the equity markets, the key return driver for market neutral equity strategies is the spread earned between the long and short holdings. That spread, in turn, is determined by the success – or lack thereof – of the investing style or stock selection skill of the manager. Market neutral equity investing boils down to portfolio managers trying to correctly identify winners and losers relative to each other. When other investors in aggregate agree with the portfolio manager's view on which stocks will lead and which will trail, a positive spread is earned; when they don't, the spread will be negative.

## Conclusion

We believe a market neutral equity strategy is a valuable complement to a traditional portfolio of stocks and bonds, as well as an excellent diversification tool that enables investors to pursue increased returns from assets that respond differently to changing market conditions. Diversifying your portfolio during a time of strong equity and bond returns and low levels of volatility can be difficult, but it is often those decisions that have the potential to benefit clients when markets change.

1 Volatility is measured by standard deviation.
2 Emerging Markets are measured by the MSCI Emerging Markets Index.
3 Diversification does not guarantee a profit or eliminate the risk of loss.


### About risk

Short sales may cause an investor to repurchase a security at a higher price, causing a loss. As there is no limit on how much the price of the security can increase, exposure to potential loss is unlimited.

Alternative products typically hold more non-traditional investments and employ more complex trading strategies, including hedging and leveraging through derivatives, short selling and opportunistic strategies that change with market conditions. Investors considering alternatives should be aware of their unique characteristics and additional risks from the strategies they use. Like all investments, performance will fluctuate. You can lose money.

Stock and other equity securities values fluctuate in response to activities specific to the company as well as general market, economic and political conditions.

Fixed income investments are subject to credit risk of the issuer and the effects of changing interest rates.

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