

■ Put It in Neutral

In the battle to avoid market ups and downs, one strategy claims a highly contested victory.

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By Britt Erica Tunick

The creation of a portfolio able to weather any market conditions is the objective of market neutral investing. But the feelings financial advisors have about the strategy are anything but neutral. Proponents of market neutral investing praise it as a means of adding insurance to an individual's portfolio, while skeptics liken it to a fairy tale—decrying the idea of true neutrality in any portfolio as unobtainable. Yet, despite wide-ranging views on the strategy, this tactic has made its way into the mutual fund community over the last decade, and a growing number of fund managers are adopting it. Long a staple of the hedge fund community, market neutral strategies essentially play strong investments off weaker ones—most commonly by making bullish investments in equities thought to be undervalued and attempting to hedge against them by shorting equal portions of stocks that seem overvalued. Not limited to equities, market neutral tactics range from this long/short approach to the use of options as well as fixed-income, merger and convertible arbitrage—tactics designed to benefit from the difference between the bid and the ask price of an asset or security. Market neutral fund managers also maintain a portion of their portfolios in cash, hoping to generate interest off any profits made from shorts.

Since some of these methods can be extremely complicated, it is not surprising that confusion abounds. Many market neutral-averse financial advisors say they simply prefer to steer clear of a strategy they find difficult to understand, and even harder to explain to investors. Still others reject the strategy simply because they equate its complexity and hedge fund origins with risk.

"The biggest misconception about market neutral hedge funds is that because they're called hedge funds, they're risky. But in fact, mutual funds—long-only vehicles—are actually much riskier than a hedge fund strategy," says Jeff Spotts, a portfolio manager for New York-based hedge fund Prophecy Capital Management. In fact, he notes that there have actually been 10-year periods where equities have been all but stagnant, and the benefits of investing in an index such as the S&P 500 would have been negligible.

Market conditions are another factor in determining the type of returns market neutral investments generate at any point in time. Volatile markets are more conducive to shorting stocks and tend to make market neutral strategies more appealing, while steadily rising markets are clearly more conducive to long-term investments. "When you are in a loosening cycle, where the Fed is cutting rates, the average equity return is somewhere around 27 percent," says Spotts. "However, when you drop into a tightening cycle where the Fed is raising rates, it's more like 10 percent for equity returns."

Hardly surprising then, that as experts' market predictions become more and more uncertain in the wake of rising interest rates, market neutral fund managers believe now is a good time for investors to increase allocations to their funds. In the 20 years between 1979 and 2000, interest rates consistently trended downwards and remained low, creating little to no competition for equity returns. But after the dot-com bubble exploded in 2001, significant rises in interest rates, coupled with the declining value of the dollar, made the sustainability of equity returns a bit more uncertain. In the face of that uncertainty, some fund managers and financial advisors say that being long-only no longer makes any sense.

Lewis Stanasolovich, CEO and president of Pittsburgh-based Legend Financial Advisors Inc., is an advocate of market neutral investing, but he's also quick to admit that the strategy's performance has been less than impressive over the last few years. "We've recently come out of an environment where it was very tough for this strategy to work because interest rates were so low," says Stanasolovich. He points out that virtually all hedge fund strategies struggled in the wake of historically low interest rates, since a lack of volatility in the market made it extremely difficult to find attractive shorting opportunities.

Lower interest rates have also made it much easier for equities to outperform risk-free rate-of-return vehicles that serve as the benchmarks for nearly all investments: Treasury bills, 10-year notes and 10-year U.S. Treasury Inflation Protected Securities. In recent years returns from these products have been as minimal as 1.5 percent. But as rates go up—and volatility with them—Stanasolovich predicts the tables will turn for hedge strategies like market neutral. "When these funds short securities, the proceeds from the short sales go into money market securities to increase returns, and that's now at a higher rate. Furthermore, rising rates will increase volatility, which will provide more opportunities to buy certain things long and sell others short," he says.

Of course, most advocates of the strategy say timing should be irrelevant and believe market neutral should always comprise a portion of any sizeable investment portfolio.

"Apart from mania periods when the whole world goes upside down, market neutral is a real steady performer," says Barry James, president of James Advantage Funds and manager of the \$75 million James Market Neutral Fund.

Year-to-date, his fund is up roughly 5 percent, while it is up 9.68 percent on a three year basis and 5.12 percent for the

last five years. Nadya Mirza, a financial advisor for Smith Barney, agrees: "Having part of your investment portfolio exposed to a market neutral strategy can help enhance returns and may reduce volatility in a down market."

However, both warn that market neutral funds should not be used to pursue gangbuster returns, but should instead be used to help lower the risks of an investor's total assets and as an aid to raising overall returns. "Market neutral is not something where you should keep 50 percent of your assets, but 10 percent to 20 percent as an insurance policy and sort of lifeline for lowering risk" says James, who has nonetheless been suggesting investors raise their allocations because the market seems poised for a downturn.

On the flip side, financial advisors such as Frank Armstrong, president of Miami-based Investor Solutions Inc., which has roughly \$400 million under management, believe the very idea of market neutral is absurd, and that it is impossible to create a truly neutral investment portfolio. "Just as with any other management scheme, some guys are going to win short-term with market neutral. But the strategy gives you twice as many opportunities to run into problems and not much expected return," says Armstrong. "A strategy that requires not only positive bets, but negative bets as well, doesn't make a lot of sense," he says. "It's kind of like 'Alice in Wonderland'—if you believe impossible things, then the market neutral strategy is right up your alley."

Don Martin, principal of Los Altos, Calif.-based Mayflower Capital, is a bit less skeptical of the strategy, but still steers his clients clear. "It might work in theory, but I'm concerned that hedge funds are going too far, and there is no guarantee that they can correctly predict which paired trades will offset each other to allow for market neutral trades," Martin adds.

"Remember what happened to Long Term Capital Management when they thought they had hedged—it just didn't work." Since most of his clients have just short of \$1 million in liquid assets, Martin advises them to stick with standard mutual funds and to avoid hedge-type strategies. "For people who only have \$1 million, it's your fiduciary duty as an advisor to advise them not to take much risk," he says, adding that such strategies are a different story for investors with \$10 million in assets.

Dan Polizzotti, senior financial advisor with Signator Investors, Inc., and a representative of Acorn Financial Services, also errs on the side of caution when it comes to hedge-like strategies such as market neutral—particularly in light of the hedge fund industry's light regulation. "It is hard for me, and for my broker/dealer to allow me, to go ahead and make recommendations for hedge fund strategies. There is little to no regulation and, outside of pure returns, there are no guidelines we can follow in order to say 'this is an investment that fits your goals and objectives,'" says Polizzotti. "You can't really be sure where hedge funds are getting their returns." Instead, since many of his clients tend to be retired, or nearing retirement, Polizzotti says he is currently focusing his attention on investing clients in less risky solutions. Despite the caution and skepticism of many financial advisors, market neutral strategies seem to have taken root within the mutual fund community, and as early adopters have succeeded, others have followed. Still, ongoing skepticism is not surprising, since the strategy is still somewhat new for mutual funds. Before the Taxpayer Relief Act of 1997, mutual funds were not permitted to derive more than 30 percent of income from the sale or disposition of certain investments held for less than three months. The so-called "short-short test"—which limited the funds' ability to hedge investments—was repealed in a provision of the '97 act. As funds using the strategy develop longer track records, industry observers believe skepticism will begin to abate, and the assumed risks of anything hedge-related will diminish. "You heard some of the same types of negative things when mutual funds were first introduced—everything from data to support why you shouldn't invest in mutual funds to negative statements regarding what were the new products at the time. And it's the same thing you're seeing in hedge funds today," says Prophecy's Spotts.

At the same time, there are concerns that investors could get hurt if they start jumping into market neutral strategies without truly understanding the intention of such funds or how they should be used.

"I think market neutral has become a new buzzword, and it's important to know exactly what people are calling market neutral," says Randy Carver, president of Ohio-based Carver Financial Services Inc. Not all funds labeled "market neutral" should really be classified that way, he notes, and few actually manage their long and short positions equally enough to significantly diminish risk. Still, he believes there is merit to the strategy, but that alternatives investments aren't necessary to pursue it. Instead, Carver says his firm, which manages roughly \$550 million, takes its own market neutral approach.

Dennis Barba, a managing partner of Raymond James' Oxford Group, is also concerned that as market neutral becomes trendier, there is a danger of people investing for the wrong reasons or using it incorrectly. "Sometimes people will substitute this asset class for bonds, which is a mistake," says Barba. "Long-term it has had very similar performance to some of the bond asset classes. But it carries more risk than bonds, is typically more expensive to hold, and it's not as efficient tax-wise as other asset classes." Of course, the trend could also go the other way. Since many people view [bonds and market neutral] to be somewhat interchangeable, there's also the danger that rising interest rates could coax investors away from market neutral in favor of bonds. Moreover, market neutral can be a far costlier approach. Because of the expense of employing short and arbitrage strategies, fund managers say fee structures above 2 percent are not uncommon for such hedge strategies.

While Barba doesn't go for alternative investments, he pursues his own market neutral strategy through ETFs—in an approach he has named "index combination strategies" that he is in the process of patenting. "We use open-ended mutual funds and separate account managers. And for our high-net-worth clients we've got anywhere from 5 percent to

15 percent of the value of their portfolios in alternative investments, of which market neutral is just one strategy," he adds. Barba—whose firm has a presence in several states with roughly \$100 million under management and average client assets of \$1.2 million—also says he will not invest with any market neutral fund manager who doesn't have at least a 10-year track record.

David Twibell, president of wealth management for Colorado Capital Bank, also uses market neutral, but as one of nine core asset strategies he relies on. And he, too, is skeptical of investing in just anything labeled market neutral. "If something says it is market neutral, you have to know if that's just a marketing gimmick or if it is really market neutral," says Twibell. "In my experience, most of the equity long/short funds—while they try very hard to be market neutral—are really just variations on hedge equity strategies that try to balance them as best they can."

Twibell believes arbitrage funds are a better bet and allow fund managers to remove market risk more easily. Of course, as strategies like convertible arbitrage became more popular after the dot-com bubble, and new investors and fund managers alike poured in, finding arbitrage opportunities has recently become difficult. And though the crowd has begun thinning out a bit, Twibell says it can still be difficult to find attractive arbitrage opportunities. Nonetheless, his firm's model portfolio aims to keep roughly 12 percent in market neutral strategies—an allocation Twibell recently raised and may increase further in anticipation of a slight market downturn. Colorado Capital has \$35 million under management, with investor assets averaging \$1 million.

If the market does turn down, and Twibell and other market neutral users fare well, there is little doubt that regardless of ongoing skepticism, others will be quick to follow.

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