Briefing Note

STRATEGY DESCRIPTION – MARKET NEUTRAL (NON-DIRECTIONAL)

Definition

Market Neutral strategies are similar to Long/Short strategies but they attempt to keep equal exposure to the long and short side of the portfolio at the sector and country level. By attempting to neutralise market risk in this way, Market Neutral managers strive to add value purely through stock selection. Most stocks in an index comprise such small weights that little opportunity exists for traditional long-only managers to meaningfully underweight them. However, the ability to underweight stocks by significantly more than 0% provides the potential to generate higher returns than traditional active managers. The non-directional nature can also provide lower volatility relative to traditional products linked to capital markets.

Performance Drivers

Market Neutral managers usually take more of a quantitative, or systematic, approach to identify relative mispricings. Since quant managers have a view on every stock in their universe, they rank them from best to worst, in order to identify opportunities and maximise the insights uncovered by their quantitative strategy. The key to Market Neutral strategies is to find relative mispricing anomalies, which can sometimes be quite small, and leverage them. Some Market Neutral strategies can leverage as much as seven times.

Other potential sources of return come in the form of short rebates (interest earned on cash proceeds of short sales) and the transfer of relative manager returns from one asset class to another, known as alpha transfers. If we look in greater detail at the sequence of events that result in a short sale we will see that a short sale occurs when an investor sells a security he or she does not own. In fact, the investor has borrowed the security from a third party. Ultimately, the short seller must buy back the shorted security and return it to the lender. Short sellers profit if the shorted stock declines in value.

More detail on short sales

Short sales involve two sets of transactions involving three parties: the investor initiating the short, a securities lender, and a broker-dealer that acts as an intermediary between short seller and lender. When an investor decides to short a security, the order is entered with the broker-dealer (i.e. the prime broker), with whom the investor maintains a margin account. The broker-dealer borrows the security, sells it short and credits the investor's account with the proceeds of the short sale. The short sale proceeds remain in the account at the broker-dealer to pledge as collateral to borrow the securities needed to complete the short. When the investor decides to close out the short position, he or she instructs the broker to do so by buying the security. The investor pays for the security, and the collateral supporting the position is freed up and may be removed from the investor's margin account. The investor is credited with interest on the cash collateral at a rate that is negotiated with the broker-dealer.

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