

HOW TO OUTFLANK FLAT MARKETS

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Market-neutral hedge funds are survivors

If you're like me, one of the worst things about the current flat markets is how long they've been "hanging around."

And statistics are not comforting: Lacklustre markets have sometimes lasted for significant periods. For example, the S&P 500 trod water from 1967 to 1981 and today is posting 1999 figures.

Yet one doesn't have to retreat to a cash-only position just because traditional investments are not paying off. For stable positive returns in **all** markets (and especially in the highly volatile ones we've been experiencing since the 9/11 terrorist attack on the United States!), one need look no further than hedge funds.

Equity market-neutral hedge funds are an excellent case in point. They thrive on the profitable interaction among undervalued securities held long and overvalued securities sold short. Having little or no correlation to the marketplace, they are insulated ("neutralized") against the market ups and downs that otherwise determine a portfolio's return. As a result, they normally chalk up higher Sharpe ratios — that is, better risk-adjusted returns — than other types of hedge funds do.

The Sharpe ratio calculates the reward for every unit of risk, through two factors: standard deviation (the historical volatility of a mutual fund or portfolio) and excess return (returns greater than certain asset-producing models or those produced by such market indicators as the S&P 500). Basically, the higher its Sharpe ratio, the better a fund's risk-adjusted performance.

One can think of equity market neutral managers as football coaches deciding which play patterns are most likely to put points on the board. They begin by lining up their long and short stock positions, generally in the same market sectors, in ways that will minimize market exposure.

The players (individual stocks) are carefully chosen so the portfolio team is liable to score whether markets are falling or rising.

The aim is to even the playing field by taking interest-rate shifts and other potentially disruptive market variables out of the game. This frees the stocks to perform on their own merits.

In effect, the portfolio's overall volatility has been reduced to reflect only what is termed the "specific risk" of each component stock.

As with long/short equity hedge funds, leverage may be used to boost equity market-neutral returns. The difference is that "neutrals" managers try to balance long holds against shorts so precisely that the returns can be virtually risk-free.

The Credit Suisse First Boston/Tremont Hedge Fund Index (January 1994 to March 31, 2002, calculated using a 90-day T-bill) shows the following Sharpe ratios for hedge funds: 1.97 for market neutrals; 1.12 for convertible arbitrage, and 0.69 and 0.67 respectively for global macro and regular long/short equity. As of March 1, the CSFB/Tremont index comprised 377 funds.

Most of the half-dozen or more Canadian market neutrals have not been established long enough for Sharpe-ratio tracking, but their annual performance figures as of March 31 range up to 15.30 per cent — compared to 4.88 for the TSE 300 Total Return Index..

Hedged products are ideal for portfolio diversification and a recent study confirmed that market neutral are popular with U.S. professionals who include hedge funds in corporate and public pension funds, endowments and foundations.

For an additional level of diversification, check out the Toronto-based SciVest Market Neutral Equity Fund which this year, to March 31, was up 9.24 per cent (vs. 2.53 for the TSE 300 TR Index and negative 0.07 for the S&P 500). Founded last May 1, this \$10-million fund contains an impressive array of longs and shorts — more than 350 altogether!

We at iPerform have just launched a market neutral fund managed by Dr. John J. Schmitz of SciVest Capital Management.

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