

When equity market neutral meets momentum

Stockholm (HedgeNordic) – By combining an equity market dollar neutral portfolio with a directional overlay, Naqvi Van Ness Asset Management (NVAM) aims at capturing relative mispricings in the equity space while at the same time benefiting from the irrational behaviour that appears during distressed market conditions as behavioural aspects come into play.

NVAM's Strategy could be characterized as a hybrid between a market neutral long/short equity fund and a CTA. Using a systematic approach the strategy allocates 60 per cent of the risk to the equity book while holding 40 per cent in directional models exploiting investor biases. In describing the fund's approach, Ali Naqvi, co-founder and portfolio manager, uses a sailing analogy.

"One could say that our long/short equity book is our sail while the directional book is the rudder, helping us manage direction when there is more uncertainty in the waters"

Naqvi, previously a senior portfolio manager at Citibank, together with co-founder Albert Van Ness decided to launch the fund to US investors in 2008, based on their research into behavioural systematic models. They were joined in 2010 by their third partner Charles Dubois who brought 30 years of quantitative strategy design and testing skills to the firm. They were all of the strong belief that a number of biases were present in the market and that these biases could, if properly researched, be systematically tested and serve as an efficient alpha-engine in a broader portfolio context.

"We look at fundamental factors through a quantitative lens. Some people call it a "quantimental" process. Such as building multi-factor screens and well-known technical models for figuring out market direction. Those approaches are known to have predictive value. We have "gene-spliced" them with our insights into investor biases. It has been our experience, and it is born out in our performance numbers that this approach enhances the alpha extraction on both the long and the short side". Naqvi says.

In the core long/short equity portfolio, NVAM looks for mispricings in a diversified universe of 2500 stocks, selecting around 100 stocks long and 100 stocks short. On the long side, the models look for companies with an attractive combination of free cash flow yield, growth and profitability.

On the short side, the system targets companies that express multiple signs of possible fundamental vulnerability including negative free cash flow, abnormal growth in inventories and excessive capital spending. According to Naqvi, the fact that the fund focuses on free cash flow rather than on earnings gives it an edge with regards to its stock selection capabilities.

"Even though it is well understood that free cash flow is a better and more information-rich way of investing in stocks, investors on average prefer to avoid the complexities. You hear a lot of people talk about free cash flow but actually being able to implement it and use it is a whole other matter", Naqvi argues.

Many of the behavioural biases exploited in the program are modeled in the directional overlay part of the strategy fund program. These models base their signals on a number of well-documented factors and are implemented in the US equity markets.

"We use four main factor groups in the directional overlay; technical, sentiment, seasonal and fundamental. Inherent in these factors are a number of repetitive biases that we systematically seek to exploit", Naqvi explains.

Among the behavioural biases that the models aim to extract alpha from are anchoring, ambiguity aversion and herding.

"Anchoring is related to levels in the markets that are often referred to by traders using technical inputs. The anchoring bias comes about as a result of investors having a tendency to get anchored to the price they buy the stock at. These are essentially just numbers that become very important to people even though they have no great relevance. Ambiguity aversion relates to the fact that investors tend to shy away from things they do not understand. Herding relates to a sentiment imbalance that is typically present when momentum dictates market action."



Albert Van Ness, Ali Naqvi and Charles Dubois

With regards to herding effects, the fund uses proprietary models that are derived from extensive research with the aim of identifying durations of sentiment imbalances.

"We have done exhaustive research into herding effects based on sentiment surveys with long histories and have developed insights regarding the duration of sentiment imbalances. These insights are integrated into our directional models", Naqvi says.

The sentiment-driven part of the portfolio has played an important part in its ability to generate competitive risk adjusted returns and serves as an important diversifier in times of turbulent equity markets such as those experienced in the first two months of 2016, according to Naqvi.

"The start of this year was difficult for many long/short equity funds as they tend to have a significant long bias built into their models. The fact that we are dollar market neutral with a directional overlay has helped us in periods of strong risk aversion in the past and provided us with diversification this time around as well".

According to Naqvi, the strong results of the strategy are explained by the defensive positioning going into the year and the contribution from sentiment-driven models.

"We started the year rather defensively with a net exposure of around 15 per cent. The strategy returned approximately 1 per cent in January alone and the sentiment driven models generated buy signals by the end of the month which helped us outperform significantly in March.

In a forward looking statement, Naqvi says that the models remain upbeat about near-term equity market prospects. "Looking ahead we see both moderate earnings and economic growth. The change in the "multiple" is, as always, uncertain. However, we do expect interest rates and inflation to remain relatively benign. Consequently, the bull market should remain intact."

"Within this big picture, our indicators currently lean clearly to the favorable side. Fundamentally,

the Fed is still accommodative, credit spreads have been narrowing and overall stresses and potential vulnerabilities in the financial system appears to relatively low. Even as the market has recovered there has not been an outbreak of enthusiasm. Separately, our measures of the “technical” environment indicate bull market conditions.”

The NVAM Criteria Investment Partners International Limited fund has been notified in Sweden and is approved for distribution to professional clients as from March 2016.

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