December 2015

HEDGENORDIC

To Pair Trade, or not to Pair Trade...
exploring different views and routes to an equity market neutral portfolio

Michelin Stars in the Market Neutral World
What makes Market Neutral strategies attractive for institutional Investors

This Time, it IS Different
A Rationale for Market Neutral Strategies

Königsdisziplin
The Art of being Market Neutral

Market Neutral Strategies
The Key to Alpha in any Market Direction

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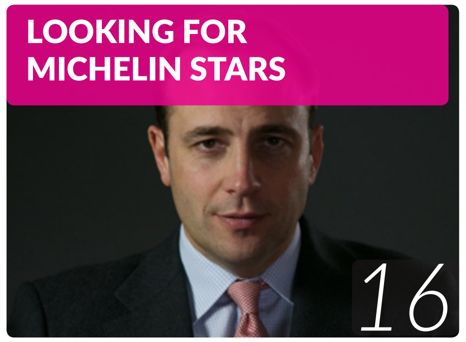

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INTRODUCTION

HedgeNordic is the leading media covering the Nordic alternative investment and hedge fund universe. The website brings daily news, research, analysis and background that is relevant to Nordic hedge fund professionals from the sell and buy side from all tiers.

HedgeNordic publishes monthly, quarterly and annual reports on recent developments in her core market as well as special, indepth reports on "hot topics".

HedgeNordic also calculates and publishes the Nordic Hedge Index (NHX) and is host to the Nordic Hedge Award and organizes round tables and seminars.

Upcoming Industry & Special Reports:

February 2016:
Real Estate & Infrastructure

February 2016:
Managed Futures / Global Macro

March 2016:
HedgeNordic Industry Report

May 2016:
ESG / SRI in the alternative space

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The Editor

My opening lines...

Kamran Ghalitschi – Publisher, HedgeNordic

Unlike the gentleman on our front cover, most investors do not have the benefit of a crystal ball to their aid when making investment decisions. With interest rates still at all time lows at near zero level and lingering rate hikes, shaky equity markets that may have run hot and geopolitical uncertainties, investors are increasingly turning to alternatives. And the hedge fund world is readily waiting on the sidelines for allocations of assets coming out of more traditional investments.

Hedge funds are by no means a homogeneous group of investment vehicles. They come in all shapes and colors. This is certainly dissecting the space with a bulldozer rather than a scalpel, but there is growing critical reflection from managers themselves on lagging returns, as well as from allocators (who are of course somewhat louder and outspoken). One hears reasons aplenty explaining why performance seems to have all but evaporated. These may range from market volatility being too low or too high, "market manipulation" by central banks, sudden shifts in correlations, and convergence of entire asset classes. Sometimes all one hears is portfolio managers mumbling single words in agitated disbelief that sound like "Swissy" or "China". Diversification has therefore been a welcome instrument in portfolio managers' toolkits.

But, where to hide when the storms hit the shore? An area that may in fact be possible to decouple from market dynamics and synchronized moves which delivers uncorrelated, positive returns and the holy grail - Alpha - is the Market Neutral space. Historic numbers seem to indicate the equity market neutral space has lower annualized volatility than other hedge fund strategies over longer periods. To further generalize, the market neutral space also largely provided positive risk-adjusted returns in recent years. A market-neutral strategy may therefore be a useful tool for reducing and diversifying an investment portfolio's overall risk while preserving return potential.

In a market-neutral product, manager skill and the size of the risk budget account for the bulk of the return. Assessing the skill of a market-neutral manager is difficult, given the variations in tactics among managers and the relative novelty of the category. It may help to have a detailed understanding of the main product types, their risk/return trade-offs, and the correlations among them. What we aimed to do in this paper is take a closer, deeper look at market neutral strategies, what their benefits and pitfalls are, describe them, and investigate the different approaches.

As always, we wanted to get the voices of those who manage, allocate to and distribute the products. There is not a huge nest in the Nordics that shelters market neutral managers. Those that do hatch out of it though, are well worth taking a closer look at. We are very pleased, therefore, to feature a good number of Nordic Market Neutral managers in this report, some of whom may still be somewhat unknown gems on a broader scene, alongside some of the big, well-established names of the trade.

But, enough said. Time to get those Christmas cookies out of the oven, sing a carol or two and make yourself comfortable in front of the fire place with some glögg and enjoy the HedgeNordic special report on market neutral strategies.

Wishing you a lovely holiday season, much joy, pleasure and some quality time away from the desk.

HoHoHo!

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THE MARKET NEUTRAL STRATEGY – AN INTRODUCTION

By Jonathan Furelid

In this primer, we will give an overview of the market neutral hedge fund strategy, defining its characteristics and outlining the strategy´s benefits and risks from an investment perspective.

Market neutral – what is it?

A market neutral hedge strategy takes long and short positions in such a way that the impact of the overall market is minimized. Contrary to a long/short equity strategy, the market neutral strategy does not hold a long bias. It typically aims to neutralize the market impact by either employing a dollar neutral or beta neutral positioning. A dollar neutral strategy has zero net investment (i.e., equal dollar amounts in long and short positions), whereas a beta neutral strategy targets a zero total portfolio beta (i.e., the beta of the long side equals the beta of the short side). Neutrality can also be applied to other factors such as currency, sector or market capitalization.

There are two main market neutral trading strategies; statistical arbitrage and fundamental arbitrage. The statistical arbitrage strategy aims at finding pricing anomalies (based on historical prices) and uses quantitative models and technical analysis to find profit opportunities. A typical statistical arbitrage strategy is pair trading which involves simultaneously buying and selling short stocks of companies in the same economic sector or peer group. Positions are established when positions fall outside of normal correlation bands.

Fundamental arbitrage aims at buying fundamentally strong companies while selling short companies showing signs of weakness. The analysis is fundamental rather than technical in nature. Factors used in the valuation includes valuation ratios, discounted cash flows and return on equity.

Given its volatility-reducing characteristics, the market neutral strategy employs leverage. Most market neutral portfolios have a gross market exposure of 200%, although large global market neutral portfolios may use leverage with gross exposure of between 300-400%. Statistical arbitrage strategies tends to use more leverage compared to fundamental ones.

Market neutral – Not a single strategy

Apart from dividing the market neutral space into fundamental and statistical arbitrage, there are also differences that are linked to the assets that the strategies invest into, or differences that relate to what kind of arbitrage opportunities the strategy seeks to exploit. The most common asset to use in a market neutral strategy is equities, but there are also fixed income strategies that fall within the market neutral definition. Examples of different subsets of the market neutral space are given below.

- Convertible arbitrage - takes long positions in convertible securities and short positions in common stock
- Equity market neutral - Goes long and short equities while mitigating market risk through hedging
- Fixed-income arbitrage - exploits pricing differentials between fixed-income securities
- Merger arbitrage - takes long and short positions in the stocks of companies involved in mergers
- Mortgage-backed securities arbitrage - Mortgage arbitrage Portfolio Managers typically take long mortgage-backed positions and attempt to hedge interest-rate, prepayment and other risks.
- Relative value arbitrage - Relative-value arbitrage is an investment strategy that seeks to take advantage of price differentials between related financial instruments, such as stocks and bonds, by simultaneously buying and selling the different securities

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Historical performance – Why invest?

Market neutral is a defensive strategy that typically outperforms in environments that tend to be more difficult for long-only and other hedge fund strategies. On the other hand, it has limited upside potential given its market neutral stance. One of the main advantages of the market neutral strategy is a greater emphasis on hedging against market volatility. Market neutral is the hedge fund strategy that has the lowest correlation to market performance, except for shorting. As a result, investors often use market neutral strategies as a hedge in times of market distress.

Chart 1 shows the long term performance of the HFRX Equity Market Neutral index compared to hedge funds and equities. Worth noticing is the resilience of the strategy during the significant equity market downturns in the early 2000s, as well as in 2008. Also during the equity market reversals as of late, the strategy has performed exceptionally well.

In a study from Hedge Fund Research, findings show that the equity market neutral strategy (both fundamental and statistical arbitrage) exhibit superior risk adjusted returns relative to U.S. stock and bond indices.

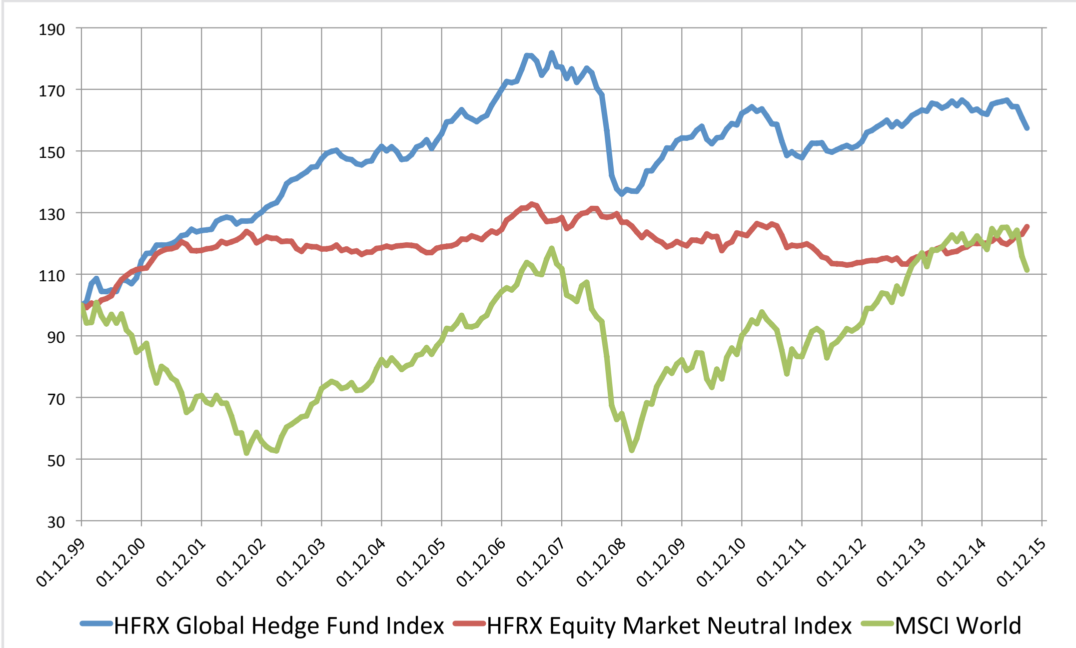


Chart 1: Long term performance of market neutral versus hedge funds and equities. The resilience of the strategy is clearly shown during the market turmoil in 2008, as well as during the equity market downturn as of late. Source: www.hedgefundresearch.com, www.msci.com

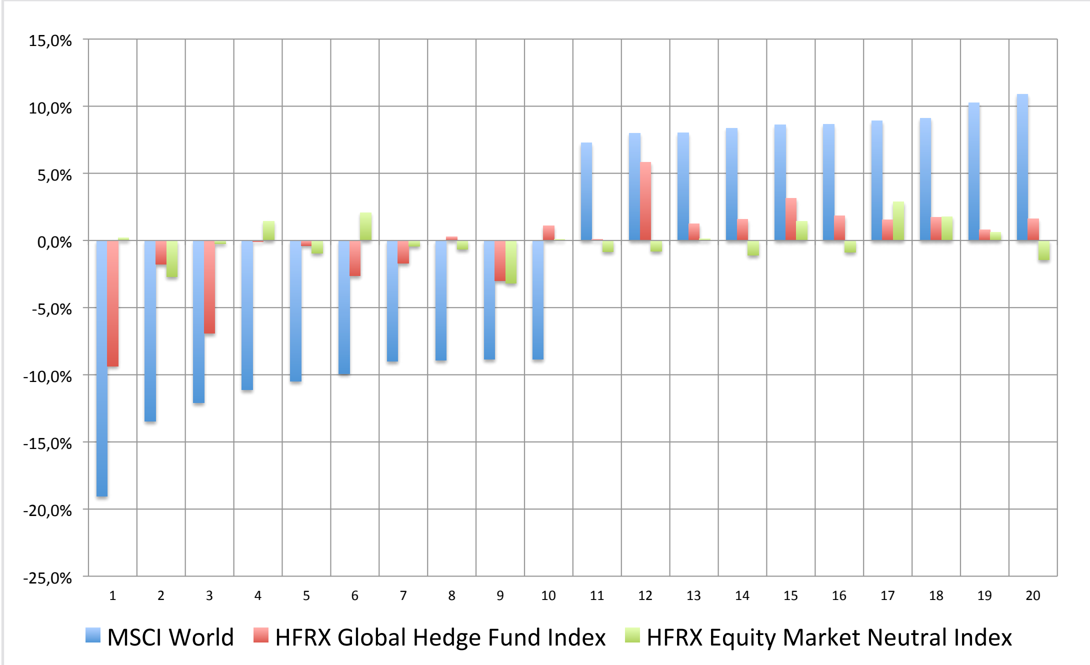


Chart 2: Market neutral returns in the 10 worst/ best months for the MSCI World Index. Hedge funds tend to suffer in the same periods as equities while market neutral shows little correlation. Source: www.hedgefundresearch.com, www.msci.com

Separating Alpha from Beta

The question of alpha versus beta is central to market neutral investing, since the strategy wants to isolate the alpha component. However, the alpha/beta separation is rarely clear-cut, and depending on what risks the market neutral strategy aims to mitigate, the beta will be defined differently from case to case. The question to ask when evaluating a specific market neutral strategy is what risks the strategy claims to be indifferent to. In retrospect, this is the only way to evaluate if the strategy has done its job.

In a paper from First Quadrant*, the U.S. based manager discloses the sensitivities or betas of their market neutral strategy to different risk factors. Among these were sensitivity to stock prices, sensitivity to style betas (value/growth), sensitivity to yields, sensitivity to volatility and economic sensitivities (such as change in the consumer price index, or change in credit spreads).

A simple measure is of course to measure the sensitivity of stock prices (in the case of a market neutral equity program). By looking at the covariance of the portfolio return with the overall market using a broad market index, this gives a hint of whether the strategy is actually doing its job or not.

Chart 3 shows the 24-month rolling correlation of the HFRX Market Neutral Index to the MSCI World. Over time the correlation has fluctuated in a band of -0.6 to +0.6 with an average number of as close to zero as one can possibly get. On an aggregated level, the strategy has thus delivered on its promises, minimizing the impact of the equity market risk.

Market neutral – what are the risks?

Despite its obvious diversification benefits, there are several potential risks with the market neutral strategy. The first major risk is the practical ability of managers to maintain a beta of zero. While possible in theory, it is sometimes very difficult to achieve a truly market neutral fund. This could be the result of an unintended beta mismatch or an unintended factor mismatch, where large market moves will affect one side of the portfolio differently from the other. The use of extensive leverage is another potential risk. Extended periods of low volatility or positive returns may encourage the manager to use leverage in excess of the strategy´s risk parameters. Finally, the limited upside in bull markets is a disadvantage to be aware of when considering investment in a market neutral strategy.

* https://www.firstquadrant.com/system/files/0403_Alpha_and_Beta_In_Market_Neutral_0.pdf

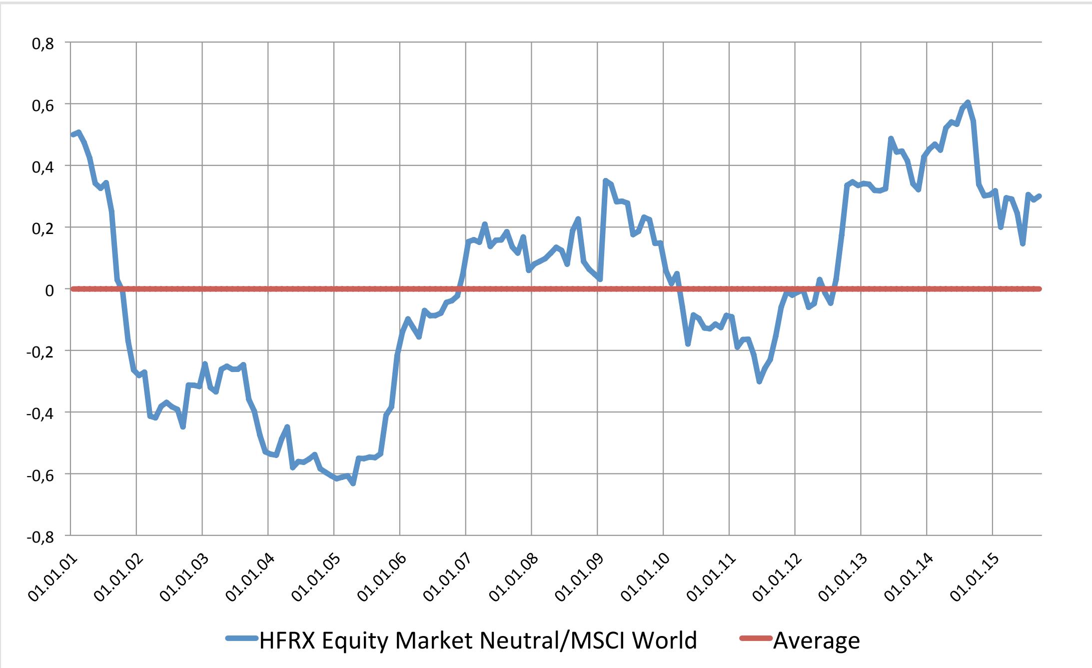


Chart 3: 24-month rolling correlation between HFRX Equity Market Neutral Index and MSCI world. Read line indicates average number. Source: www.hfr.com and www.msci.com

MARKET NEUTRAL HEDGE FUNDS – THE NORDIC LANDSCAPE

By Jonathan Furelid

Scanning the universe of market neutral hedge funds in the Nordics reveals a highly dispersed fund category. As always, one needs to do the homework in order to separate the wheat from the chaff.

Using the Morningstar database to filter out market neutral hedge funds in the Nordics, there are five funds that fit the criteria. Although the category is somewhat bigger than that (given that some funds are a boxed into other categories and that one simply is not listed) the universe is undoubtedly very limited.

In the list below, we have gathered what we believe to be a representative universe of the Nordic equity market neutral space and fund of hedge funds. We have combined funds that we have found to be market neutral from the description in the HedgeNordic database and combined them with those that are listed in Morningstar as "hedge fund, market neutral". There are some market neutral funds active in the fixed income space, especially by Danish managers, which have not been considered here.

As can be seen from the year to date numbers as well as from the different statistics, the group is far from homogenous. Danske Invest Europe Long/Short Dynamic and Sector Healthcare have the strongest YTD returns, the latter also having the highest compound ROR. When looking at risk adjusted returns, as expressed here by Sharpe Ratio, two fund of hedge funds, Peak Core Hedge and Merrant Alpha Select are by far the strongest performers in this context, followed by SEB True Market

Fund	YTD	Compound RoR	Sharpe Ratio	Max Drawdown
Coeli Norrsken	-1.9%	5.8%	1.0	-10.3%
Danske Invest Europe Long/Short Dynamic	10.6%	5.8%	1.1	-2.9%
DNB TMT	4.7%	2.8%	0.4	-15.4%
DNB ECO Absolute Return	-5.4%	-1.1%	0.0	-26.9%
Merrant Alpha Select	3.8%	5.1%	3.4	-1.5%
Peak Core Hedge	3.8%	5.2%	4.5	-0.3%
QQM Equity Hedge	2.5%	4.4%	0.7	-11.0%
SEB True Market Neutral	3.3%	3.8%	2.0	-1.5%
Sector Healthcare	10.8%	8.4%	1.8	-4.0%
Zmart Alpha	2.8%			

Table 1: Nordic market neutral hedge funds, since inception *Zmart Alpha started in March of this year and we have no statistics on the manager, YTD date as at 2015-12-09, other programs YTD data as per 2015-10-30

Neutral, yet another FoHF. How come the strategy group shows such a difference in performance? There are a few traits that are worth mentioning that make the group difficult to categorize.

First of all, even though all these funds are defined as market neutral, the underlying strategies and exposures differ. For example, the DNB ECO fund is focused on companies within the renewable energy sector whereas DNB TMT focuses on the technology, media and telecom sectors. The sector exposure could of course explain the relatively poor performance of ECO.

Three of the funds are Hedge Fund-of-Funds (Peak, Merrant and SEB True Market Neutral), somewhat different animals. These funds are investing into other market neutral funds meaning that they hold an allocation to a group of managers using different market neutral strategies in order to diversify risk. They are also potentially subject to a heavier fee burden given that FoHF charge fees on their own fund level while also paying fees to underlying managers. Apparently, this has not had a major impact on the performance of the managers and the skill selecting the right managers outweighs the cost layer. The top three performers, in risk adjusted terms, are Fund of Funds.

Secondly, funds differ in the way they approach risk. While some have a very tight risk budget, others allow for the fund to take on more risk in order to capture a larger upside potential. This could of course be the result of different use of leverage within the funds mentioned, but is a very important feature to consider as a potential investor. The Fund of Funds typically hold a highly defensive stance in order to reduce single manager risk.

Thirdly, the ability of the funds to hold a truly market neutral approach might differ. Also the definition of market neutral could vary with some employing beta neutrality while others use dollar neutral approach.

A comparison over time

Another aspect to consider when comparing funds in general, and funds that are prone to outperform in certain market regimes in particular, is when they were launched. Out of the group of funds reviewed in this sample group, the oldest fund, celebrating its tenth year since inception, is Sector Healthcare, which launched in September 2005, followed by Coeli Norrsken in October 2006 and Danske Invest Europe Long/Short Dynamic which picked up trading in December of 2007.

The performance over time for the Nordic market neutral space is demonstrated in the chart below. While the table above expresses statistics since the individual funds´ inception, the following graph has all funds based at 100 in January 2010 to make the recent track more comparable as the largest part of the funds had been already trading then. Some things are worth stressing: The volatility

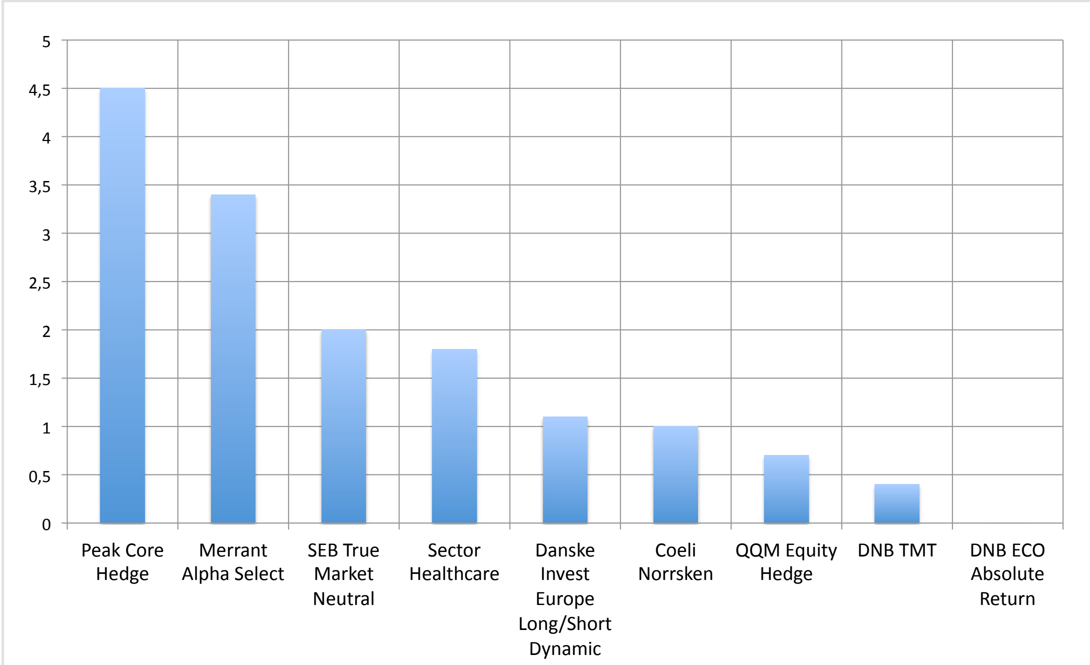
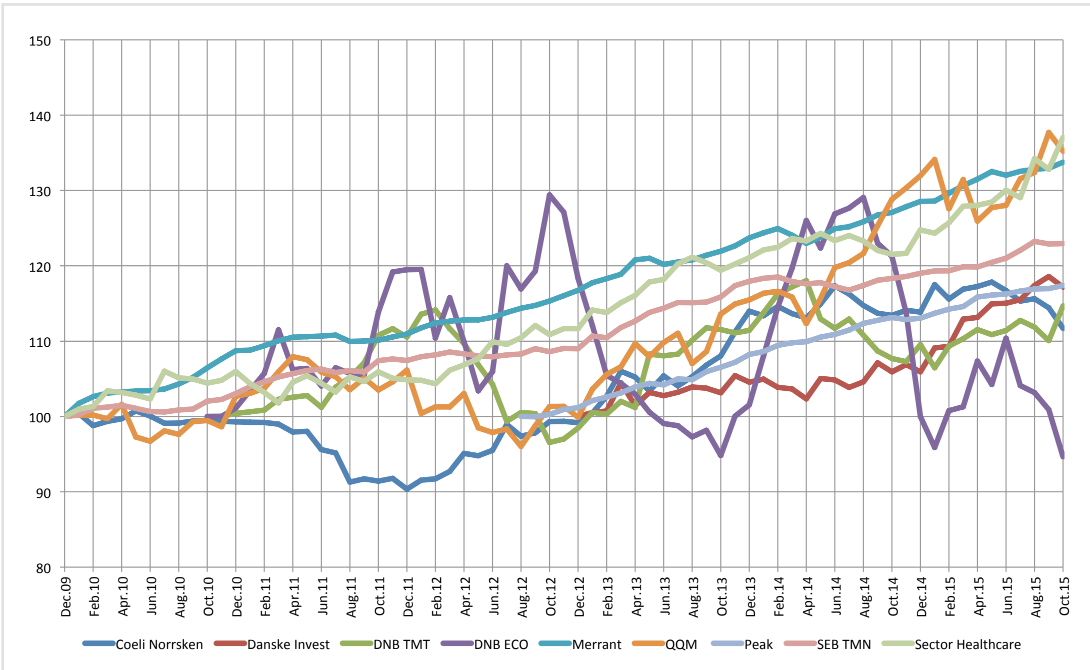


Chart: Sharpe ratio ranking of Nordic market neutral funds

profiles vary immensely. At one end of the spectrum are the fund of funds, trading at very low volatility levels. At the other end, DNB ECO fund shows wild swings over time. The market neutral strategy is described to be defensive in nature capturing small pockets of alpha with low volatility while hedgeing out market risk. The profile of DNB ECO with the high volatility and a maximum draw down of nearly 27% does appear to stand out within the group taking those parameters into account.

What are the key takeaways with this comparison? As always, the advise is to be selective and to do your homework before making an investment, but perhaps even more so when it comes to market neutral strategies given the underlying differences within the fund category.



THIS TIME IT *IS* DIFFERENT

A RATIONALE FOR EQUITY MARKET NEUTRAL STRATEGIES

OVERVIEW

- Expectations in respect of the risk/return dynamics achievable from a fixed-income allocation have become progressively distorted over a period of many years
- As such, the strategic asset allocation mix of many institutional investment portfolios is lacking a component capable of delivering incremental returns with low volatility, which display a low correlation to potentially destabilised capital markets
- An equity market neutral strategy has the potential to deliver a persistent source of return with constrained volatility in most environments and carries a low or negative correlation to traditional bond and equity exposure, making it an ideal diversifier

HOW LONG CAN BOND MARKETS DEFY GRAVITY?

The phrase 'this time is different' has been described as the four most expensive words an investor can utter. It is also the first part of a title of a best-selling book, the remainder being 'eight centuries of financial folly'[1]. The authors state that, throughout history, countries have been lending, borrowing, crashing into financial crises and recovering. On each occasion, experts claim that the old rules of valuation and portfolio construction no longer apply – only to be proven hopelessly wrong.

Since the late 1950s, if not earlier, bonds have proved the core holding for the majority of institutional investment portfolios. Equities were considered more volatile than bonds, with some justification, and we became accustomed to the idea that bonds typically yield more than equities. So, the solution to the investment conundrum seemed obvious - invest in bonds and sleep easy! However bonds have now been in a secular bull market for more than three decades, pushing yields to new lows at a time of rising aggregate debt levels. Low interest rates have also made it possible for corporations to avoid potential default by refinancing on favourable terms ('amend and extend').

Consequently, it is reasonable to question whether the risk/reward asymmetry of investing in bonds has now become skewed to an extent that it really is different from anything we have seen before; we have no precedent for a 'bond bubble' driven by a massive expansion of central bank balance sheets, which has coincided with spiralling government indebtedness.

> **"Trading in debt securities is based on trust and confidence – the system will work until it doesn't"**

As academic researchers take pains to point out, there is no absolute limit for total indebtedness or a certain percentage of debt-to-GDP where the structure of debt markets begins to break down. The system is based on trust and confidence, so it will work until it doesn't - and then things could get really messy if everybody tries to head for the exit simultaneously.

The challenge is, therefore, to provide an alternative solution to a bond allocation, which can act as a partial substitute within a portfolio context. This bond proxy clearly needs to possess the attributes that are readily associated with bonds, such as positive return expectations, limited volatility and a low correlation to equity markets.

The solution will also need to have a low correlation to bond markets, if it is to diversify and mitigate the prospective market-event risks that could potentially arise across the fixed-income spectrum. So, like bonds and yet, not bonds!

THE CASE FOR EQUITY MARKET NEUTRAL

Interestingly, the opportunity set for equity market neutral (EMN) managers is not driven by the actual returns of the asset class, but return dispersion between components within a market (the difference between the returns of the best performing stocks and those of the laggards). Dispersion is a persistent phenomenon across regions, countries and sectors around the globe.

One highly intuitive, but typically unconsidered, aspect of dispersion is that it is, by definition, always a positive number, unlike market beta, which can be decidedly negative. Consequently, long-only managers may find that the value they create through stock picking

1. Carmen Reinhart and Kenneth Rogoff (2009)

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is, on occasion, overwhelmed by market turbulence. Conversely, EMN managers only need their relative conviction to prove justified in order to generate incremental gains for their investors (assuming effective hedging of market-related risks).

Indeed, an additional and desirable property of dispersion is its relationship to overall market volatility, which means a higher risk environment can actually be advantageous, because it creates a broader spectrum of stock price movements. Consequently, the possibility of EMN strategies generating profits at a time when other portfolio components may be under-performing enhances their diversification potential.

Those unfamiliar with the dynamics of the EMN strategy may therefore not appreciate the extent to which its historic return characteristics of greater persistence, low volatility, a positive return bias, constrained draw-downs and thus, faster recovery times, are more bond-like than equity orientated.

SEEKING TO DELIVER A PERSISTENT SOURCE OF INCREMENTAL RETURN

In conclusion, EMN is not intended to be a risk-free strategy, but one that seeks to provide a persistent and incremental source of risk-adjusted returns. We believe that it has the capacity to deliver the risk/reward dynamics associated with a conventional fixed-income allocation, and can therefore serve as a bond proxy or alternative in an environment in which the market outlook is uncertain and risk asymmetries look unfavourable (greater downside than upside potential).

> **“Short selling is a specialist skill and investment discipline is therefore an essential attribute”**

It must, however, be borne in mind that risk arises as a result of being able to capture alpha from both positive and negative investment theses. Losing short positions have a negative compounding effect, meaning that they become a larger rather than smaller proportion of the portfolio as the share price moves against the manager. Short selling is a specialist skill, and investment discipline is therefore an essential attribute.

Equally, for EMN to prove a suitable ‘alternative’ component of a broader bond allocation, it is essential that the risk management process is not entirely focused on managing idiosyncratic, stock-specific risk. The portfolio also needs to be managed in a way that looks to protect it from equity market shock scenarios, and also accounts for factor risks, such as value, growth and momentum, and those arising from other asset classes.

For example, extreme movements in FX and commodity markets have the capacity to distort equity valuations, and we are very mindful of the portfolio effects these influences have on the efficacy of our risk management framework. However, as is the case with the dispersion opportunity that is likely to arise from a normalisation of monetary policy, it is important that we do not simply neutralise FX and commodity sensitivities, but seek to take advantage of them judiciously.

As we stated earlier, the challenge facing investors is to find an alternative solution to a bond allocation, which can act as a partial substitute within a portfolio context. This bond proxy clearly needs to possess the attributes that are readily associated with bonds, such as positive return expectations, limited volatility and a low correlation to equity markets. In all of these respects, EMN matches the requirements.

EMN: BOND-LIKE RETURN CHARACTERISTICS

	HFRI EH: Equity Market Neutral	World bonds	World stocks
Annualised return	5.5%	5.6%	7.0%
Sharpe ratio[1]	0.78	0.83	0.27
Annualised volatility	3.1%	3.0%	14.1%
Number of positive months	197	186	162
Average return in positive months	0.8%	0.9%	3.1%
Number of negative months	65	76	100
Average return in negative months	-0.6%	-0.6%	-3.4%

Past performance is not indicative of future results. Source: Bloomberg. Hedge Fund Research Indices (HFRI) are equally-weighted performance indices used by numerous hedge fund managers to benchmark their own performance. MSCI World Net Total Return Index hedged to USD is the proxy for world stocks while Citigroup World Government Bond Index hedged to USD (Total return) is the World Bonds proxy. Period analysed January 1994 to September 2015.

ABOUT THE AUTHORS

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Simon joined Man GLG (‘GLG’) in 2004 and has focused on active risk management in the European and Global Long Short portfolios. Simon graduated from Oxford University in 1990 with a BA in Physics and started his career in the quantitative aspect of equity trading and risk management, joining the equity derivatives team of Nomura. In 1994 he moved to Bear Stearns to start their European portfolio trading business, moving to Morgan Stanley in 1997 to head up their risk program operation.

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Looking for Michelin star quality
in the world of Market Neutral strategies

by Aline Reichenberg Gustafsson

Ludwig Holmgren, Head of Capital Introduction at SEB in Stockholm, discusses what makes Market Neutral strategies attractive for institutional investors.

In theory, Market Neutral is a great idea for any portfolio; a cost-effective uncorrelated asset. As fixed-income is not a lucrative option nowadays, Market Neutral should constitute an attractive alternative for any investor. However, for some, this style still doesn't currently have the status it deserves.

Ludwig explains: "For any product you add to your portfolio as an institutional investor, you will ask yourself: what do I add for my clients? Does this product provide the right level of expertise? And then you will care about how you will explain that to the board." In medium and smaller organisations, this means staying away from complex products. In larger institutions, investment parameters are well defined in terms of risk, return target, liquidity and costs, which could de facto exclude some Market Neutral strategies.

First, let us define what Market Neutral strategies are and how we can categorise them. In terms of assets, potentially any asset that has an exposure to the market can be hedged out and thereby "neutralized". Clearly the most common Market Neutral asset class is equity, but we find some fixed income and convertibles as well as a mix of assets in various arbitrage and systematic strategies. "Convertible arbitrage in particular presents interesting opportunities nowadays, says Ludwig, as most of the large prop desks that held huge trades left the market after the Volcker rules were implemented."

Typically, any of these Market Neutral types falls into two categories: the fundamental and the quantitative strategies. This was easy. Now, one who speaks about Market Neutral automatically implies alpha generation and that's where we need to call in the experts. The proper evaluation of risk and risk premia is key to isolating alpha. On average, quantitative managers are more successful in identifying, and perhaps more importantly explaining, risk than fundamental managers are.

"...some of the funds that had been sold as Market Neutral were not so neutral after all."

For any style, it can be difficult to evaluate the question from an external point of view, since risk premia can lurk in many a disguise: liquidity premium, size premium, sector-specific risk premium, etc. and sometimes the managers themselves mistakenly account for some risk premia as alpha. "In fact, says Ludwig, the reason many investors sometimes underappreciate Market Neutral strategies is that in the difficult markets we have experienced a few years ago, some of the funds that had been sold as Market Neutral were not so neutral after all. Investors should really ask themselves how well the risk has been hedged out. From what we have seen in our team, unleveraged real alpha generation can be as high as 200 basis points." Beyond this, one might become suspicious.

Again, in theory a well-diversified portfolio providing 200 basis points with no market risk sounds attractive in a zero risk-free rate world, but how does a manager make money with such a low return? AUM size obviously matters but it is mostly gearing that does the trick. According to Ludwig, providing a well-hedged and widely diversified (500+ positions) portfolio of highly liquid assets, the bank will be comfortable with approximately 600% gross exposure (300 long/300 short. With fees, such a strategy could just pass the coveted 10% target return mark.

For some older funds that have a proven track-record, this limit could be higher, but for the more fundamental strategies that have a lower number of positions and less perfect hedges than pair trades for example, the limit might be as low as 300%. Given their fees, these funds might not be attractive enough for some of the institutional investors that expect double-digit target returns from their alternative investments. As a consequence, getting up to the size at which they can operate profitably might be a long and arduous road. Whatever the strategy, any fund with a fundamental approach, and a relative performance to a benchmark would most likely benefit from going Market Neutral. Relative-value funds get paid for their outperformance, but due to their beta exposure, they cannot obtain the same level of gearing.

As far as management fees go, long only or unhedged absolute value funds can hardly cover their costs unless they are very large. Neutralizing their strategies and thus isolating the precious "portable alpha" could allow them to target a wider audience, as well as increase their own profitability.

Another solution could be to find partners to reach the right operational size. Besides the obvious economies of scale, Ludwig strongly believes in the existence of operational alpha. "Some of the top firms who have created a solid organization wake up every morning with a small performance advantage", he explains. When you are gathering alpha basis points, every little counts. Trading costs are low for everyone today, but even a few basis points together with a better execution and higher trading speed can make a difference. The ability to attract talent is also key. Larger funds can easily seed promising managers, test them and keep the best ones on board. "The organizational alpha is hard to measure," admits Ludwig, but we can all see it."

Scale is essential in the fund business in general, but it is perhaps even more visible in the Market Neutral space. In fact there is a type of Market Neutral fund that almost deserves a category of its own: what Ludwig refers to as the "centre book" strategy. These are very large funds (so far mostly US-based composed of many underlying strategies (such as in a multi-strategy fund and the fund manager at the top balances out the risk to neutralize it.

"...the amount of alpha to be harvested is finite in any arbitrage type of strategy."

The top manager can activate different levers to manage the risk, first through dynamic allocation between strategies and then by hedging out the residual market exposures. Multiple pools of expertise meet state of the art risk-management, and as a cherry comes the precious operational alpha. That being said, one must remain vigilant when looking at large portfolios in an environment where markets get over-inflated. "In 2007 and 2008 for example, says Ludwig, Goldman Sachs allegedly had to trade at 10-20x gross to maintain the level of alpha. Then these massive unwinds took place and they blew up. Hence it is important to assess market participation as well, because the amount of alpha to be harvested is finite in any arbitrage type of strategy."

When it comes to appetite for Market Neutral strategies in Sweden, Ludwig admits that the culture of alpha still has a lot of room to grow. Traditional beta-oriented strategies are not only mainstream when it comes to the local offering, but from the demand side also. Many investors have yet to grasp the idea that a large amount of return in alternative investments comes from geared risk premia and not from actual expertise. That being said, Ludwig believes it is only a matter of time until more local investors get used to the concept.

With a smile, Ludwig explains: "Like everyone, I can go and buy some expensive ingredients like truffle and lobster but I can't transform them into the exceptional meals that three Michelin-starred chefs produce. I am certain and I promise you that you would much rather pay Robuchon to cook for you than Ludwig Holmgren. You are willing to pay for his talent, the same way investors are willing to pay for real alpha. " Many investors who have experienced what Market Neutral strategies can do to their portfolio, will soon be ready to invest in additional similar funds, which can produce the same effect. At that point, it will also be easier to explain it to the board.

Ludwig Holmgren, SEB

In his position as Head of Capital Introduction at SEB, Ludwig Holmgren meets a plethora of funds and investors alike, giving him a privileged sight on the hedge fund industry locally as well as internationally. Previously, Ludwig accumulated a broad experience with various categories of investors, first from his position in institutional equity sales at Erik Penser, as well as from his time as Private Banker at SEB Wealth Management.

"Skill can never be underestimated and should be a crucial part of selecting a manager of a market neutral strategy."

SAME NAME DIFFERENT ANIMAL

- the evolution of market neutral strategies

by Pirkko Juntunen

In the wake of the financial crisis Equity Market Neutral became somewhat of a bogeyman for many investors who had been caught up in the negative deleveraging spiral of August 2007. One of the main problems at the time was that many of Equity Market Neutral strategies were following the same models as well as using the same research, resulting in crowded trades and rapid asset growth. Relying on the same risk models led to everyone making the same adjustments, increasing correlation which ended in losses for many investors. How has this changed, and is there now a business case for Equity Market Neutral?

The expensive lesson of the global financial crisis led to diversification among the providers of Equity Market Neutral strategies, and many specifically blame crowding for a lot of the problems. Diversification is achieved through increasing the quantity and quality of factors under consideration such as style, yields, volatility and economic trends, to name a few. Significant improvements have also been made in investment processes, specialization of expertise, independent research capabilities, proprietary data sets, use of multiple and flexible risk models, macro analysis as well as IT systems. In addition, most successful managers now blend both statistical arbitrage and fundamental arbitrage techniques, depending on market conditions.

Donald Pepper, managing director of alternatives at Old Mutual Global Investors, argues there is still very much a business case for market neutral strategies. He said these strategies are an important component for investors looking to reduce correlation to both to equity markets but also other hedge fund strategies. "The opportunity set has increased because there is less capital in the sector. In particular now that the Volcker-rule prohibits investment bank prop-trading desks to operate on the market," he explained.

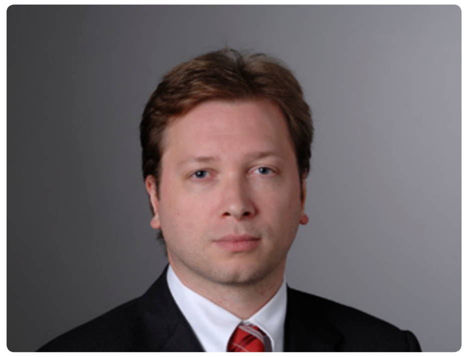
The extreme levels of leverage were generally the trademark of investment banks, but some Equity Market Neutral strategies were also over-leveraged, magnifying the losses. The levels of leverage are significantly lower today; gross market exposure is often below 200%, whereas prop-desks sometimes had gross market exposure of up to, and in some cases, even greater than a thousand percent before 2007.

Pepper said the Equity Market Neutral sector is now so well dispersed that it is difficult to define who the competition is because most players have such diverse strategies. "Rather than feeling crowded, our Statistical Arbitrage manager remarked recently he feels lonely!", Pepper mused.

The criticism of high transaction costs for Equity Market Neutral is not necessarily true for everyone, either, as it depends on the portfolio turnover and rebalancing strategies. High frequency trading does incur higher costs but it also depends on commissions paid and

Trond Horneland

Donald Pepper



Nicolas Rousselet

how the trades are executed, Pepper said. "We pay lower commission rates than discretionary managers using brokerage to pay for research, and we dedicate serious effort to ensure market impact is as negligible as possible when we trade," he says.

Some argue that the fee structures are too high compared to active managers, forgetting the skill and cost that shorting requires. Nicolas Rousselet, head of hedge funds at Unigestion, said shorting is very different to underweighting an index. "You cannot take the long book and just reverse it. Simply, you have to be good to mitigate the transactions costs." He also pointed out that you cannot short everything and in order to be on the right side of the trades, you have to have a strong process as well as having size on your side.

Some Equity Market Neutral managers also manage long-only portfolios. Sector Gamma, a Norwegian hedge fund, has an actively managed long-only fund replicating its healthcare Equity Market Neutral strategy. The long-only version has significantly more systematic risk than the hedge fund, something investors often forget. Trond Horneland, who manages the Equity Market Neutral fund, said the sector was cheap and fundamentals were improving, so healthcare beta exposure made sense. "Instead of buying an ETF or a passively managed fund, we argued that investors should buy our fund to get both beta and alpha exposure towards healthcare stocks," he explained.

Rousselet and Pepper both concur that the criticism that the true risk of Equity Market Neutral portfolios is hidden may have been a more valid point before 2007. The industry's adaptation and move to diversification with an increasing number of metrics to expose the true risk of a portfolio is now the norm. They said that skill can never be underestimated and should be a crucial part of selecting a manager of a market neutral strategy. Having liquid portfolios and an adaptive model for sizing position relative to the riskiness of the security is also key. Horneland added that crowding, liquidity and options-implied volatility are some of the risk factors that are continuously monitored for the securities in the portfolio.

Despite some investor misgivings for Equity Market Neutral strategies, Old Mutual Global Investors has attracted significant capital into its Equity Market Neutral strategy, now totalling $4.7 billion, up from $78 million in December 2012. Pepper explained that the performance target of cash plus 6% with a volatility of 5-6% has caught the attention of investors. The majority of the investors are from mainland Europe (63%), followed by the UK (25%) and the remainder equally split between Latin America and Asia. Private banks and wealth managers are the largest category of clients (70%) followed by fund of hedge funds, pension funds and insurance companies as well as family offices and IFAs. The strategy is available as a UCITS fund as well as an off-shore fund.

Unigestion invests in a lot of long/short funds but is now in the starting blocks to launch its own Equity Market Neutral fund which will be a factor-based long/short low-beta market neutral fund, targeting large institutional investors.

Despite bad experiences in the past, investors should remember that even if it is still called Equity Market Neutral, the industry has evolved, and they should perhaps focus on the fact that these strategies tend to be very transparent, something which has become something of a buzzword. In addition, the skill and process of the managers, the liquidity of the underlying stocks and the valuation of the portfolio are also strengths that investors do well to keep in mind before they throw the EMN baby out with the hedge fund bath water.

The Rationale of being Beta Neutral

Juliette Chevalier

RAM Active Investments – A beta neutral approach to equity investing

by Jonathan Furelid

> "We base our analysis on the fundamental data reported by companies and analyst estimates. We do not do company visits"

Juliette Chevalier, Senior Sales Manager for the UK and Nordic countries at RAM Active Investments UK, explains how a systematic approach to analyzing fundamental data can generate consistent alpha, without carrying the inherent equity market risk.

Headquartered in Geneva and with offices in London, RAM today runs approximately 3.7 billion USD of client assets, with over 3 billion allocated to its equities strategies. The company has a strong institutional footprint and has won several top-tier international awards. In the Nordics, RAM has been running institutional mandates for several years.

RAM's equities strategies are based on a systematic and proprietary bottom up stock-picking methodology which focuses on company fundamentals. The funds are All-Cap with no bias in terms of capitalisation, country or sector and optimal allocation is based on three uncorrelated underlying strategies (Value, Defensive and Momentum), each capturing excess return at different stages of an investment cycle. All equities strategies follow the same philosophy and process and are run by the same team.

"A discretionary manager might monitor a universe of around 200 equities, allocating 10% of its portfolio to a single stock targeting double capital appreciation over the medium to long term. The RAM approach however, aims to compare and contrast an investible universe of thousands of individual equities, building a highly diversified portfolio. Small levels of alpha are then extracted from this very large number of stocks and through a blend of uncorrelated strategies," Juliette Chevalier explains.

The models used screen stocks in three distinct ways. The first is based on fundamental information such as cash flow statements, income statements and balance sheets. Secondly, momentum models work to identify price and earnings trends, and finally, defensive models seek to capture stocks with solid dividends and strong dividend growth prospects.

"We have three different strategy buckets; value, defensive and momentum. Each strategy is given a fixed weighting which is decided using historical data from the three previous economic cycles. In other words, rather than trying to time strategies, conduct top-down macro analysis or implement market - timing decisions, investment decisions are based solely on the quantitative analysis of the data inputs," says Chevalier.

The strength of RAM's systematic approach is, according to Chevalier, that it covers a huge investment universe, allowing models to detect inefficiencies across fragmented markets.

"Bottom up screening of an investment universe including all stocks, regardless of geography of market capitalization, allows RAM to identify opportunities neglected by traditional equities strategies, which are usually confined to stocks included in broader benchmarks or a subset of that universe," continues Chevalier.

Managing long-only equity strategies since 2004, the investment team launched its first long/short European equity strategy in 2009. An Emerging Markets focused strategy then followed in 2011. By isolating alpha generated from stock selection on the long side and supplementing this with short alpha generative strategies, the goal is to neutralise the overall market risk and offer investors a genuine beta-neutral approach.

"We recognized from running long only mandates that most of the alpha was coming from our stock selection. We then wanted to find a way to carve out market risk for our clients, developing short strategies which could do this whilst also generating alpha. To this end, six years ago, we launched our beta neutral long/short approach covering both Europe and Emerging Markets regions."

Going beta neutral means that the manager neutralizes beta risk by taking short positions in individual equities as well as broader indices via derivative instruments. The short models, however, are not a mirror image of the strategies employed on the long side, and have their own factors.

Exploiting fragmented markets

The key is to exploit the fragmentation and pricing inefficiencies across markets. "We are dually focused on Europe and the Emerging Markets because we believe that these markets are the two displaying the most fragmentation. For example, arbitrage opportunities are much more evident in less developed markets, even in Europe relative to the US," Chevalier argues.

To find profitable trading opportunities, RAM's systematic models screen over 3,500 Emerging Market stocks and 1,500 European stocks. As a result, the constructed portfolios constitute around 600 names at any given point in time.

"We take all stocks into consideration if they are listed in countries considered by MSCI as European or as Emerging Markets, depending on the strategy. We also do not limit ourselves to stocks that constitute part of the broad equity benchmarks. However, there is one limit: liquidity. Many stocks are not investable due to liquidity constraints. To pass screening, stocks must have a market capitalization of a minimum of 150 million USD and trade at at least 500,000 USD daily in volume", Chevalier says.

An active, diversified and liquid strategy

RAM's long/short strategies are highly active by design and highly diversified in nature, which Chevalier believes to be crucial to its systematic approach.

"We base our analysis on the fundamental data reported by companies and analyst estimates. Given the volume of stocks screened it is impractical for us to do company visits, and for the same reason, there are no high conviction trades. This approach therefore demands that the portfolio be highly diversified and that single stock allocation is capped at 2.5 per cent, helping to mitigate single stock risk" Chevalier says.

The fund is very active and has a high turnover. In addition, the management of liquidity and slippage is key and is embedded within the investment process.

"We are highly active, with a turnover of around 30 per cent of the portfolio every six weeks. Although this of course makes us sensitive to transaction cost, our main goal is to maximize alpha while strictly controlling liquidity and slippage."

> "Diversification mitigates the risk of not knowing the companies in person."

by Stephen Isaacs

...exit pursued by a bear

(with an apology to the bard)

After a six year bull run beta strategies that depended on ever higher asset prices now need to be questioned. Investors should favour market neutral strategies that hedge out risk by concentrating on the generation of alpha performance. Skilled fund managers can deliver real results irrespective of market backdrops.

Economic and Political risks - 'the great fall of China'

"It doesn't matter whether the cat is black or white as long as it catches the mouse." When Deng ushered in market reforms 30 years ago, few foresaw quite what an incredible story would unfold. It is however, a long time since China emerged.

This success story depended on cheap labour, high savings, fixed capital formation and growing export markets - all of which are now at risk. Massive over-investment, the draining of a once abundant workforce in the countryside, plus stagnant overseas opportunities and an overvalued currency all presage tough times. Will the unusual political system, and nominally Communist one-party state, be able to cope? A Hard landing or worse (civil conflict, expropriation, etc.) is the most likely outcome.

European Refugee crisis - the law of unintended consequences

Facebook advert for refugee passage to Europe
(Source: Mail online 28/11/15)

We do not wish to comment on the political or humanitarian issues at stake. Rather, we wish to explain that this is already having negative effects on the economic stability of not just the continent, but world markets. In a world of rising income inequality and stubborn pockets of high unemployment, rejectionist political players and themes are already gaining traction.

If Jeremy Corbyn can lead the Labour party, or Tsipiras can overturn the establishment in Greece, then this new crisis can lead to dramatic events. With recent polls in the UK already showing a shift away from continued membership of the EU, Marine LePen must be relishing each twist and turn of this story. The free movement of goods within the Schengen zone since 1995 had been taken for granted. Many companies have set up supply chains, and advanced seamless documentation; if this now ends or is effectively impaired, business will suffer.

Deflationary Ice age - 'peak oil' theory dead

Examples of US deflationary periods (Source: Zero Hedge Tyler Durden 4/4/14.)

For most baby boomers, inflation - at some level - is the natural order of events. From a longer- term perspective, prices do not always rise; rather, there have been pronounced periods of deflation. These have tended to occur at moments of technological change, spurring the overthrow of established businesses. An economy that is developing fast, has vast scale and hence can deploy resources efficiently, can revolutionize productivity. Unless monetary policy is consequently very flexible, this can lead to deflation.

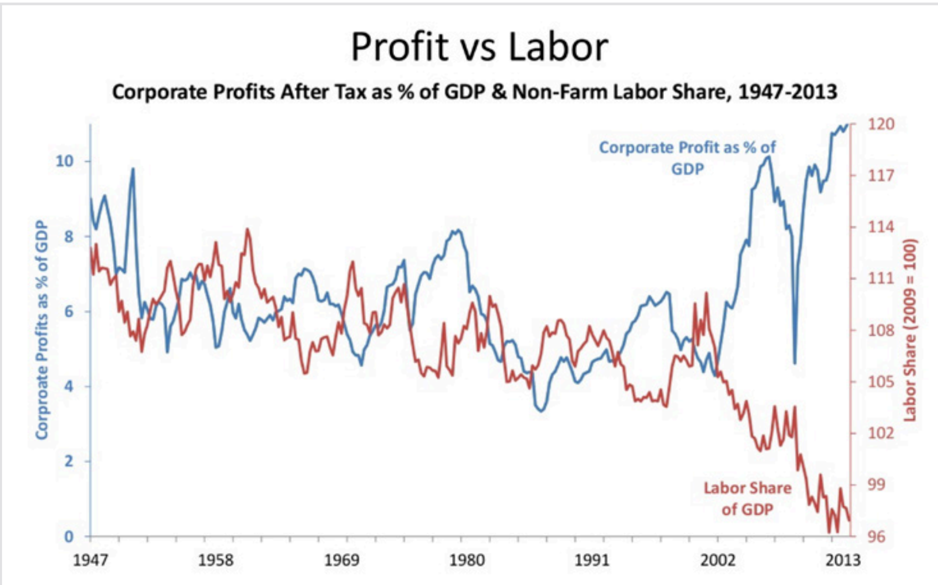
Technology - of Unicorns and Men

The fortunes and new businesses from new technologies are well known. As a revolutionary impact, these forces may destroy as much value as they create. Rounds and rounds of funding at extraordinary valuations have allowed management to splurge on growth, rather than profits. As with Amazon, this tends to depress prices across the economy. Smart phone capability beyond what an IBM mainframe could once do can wreak havoc with long established profitable franchises across a variety of industries.

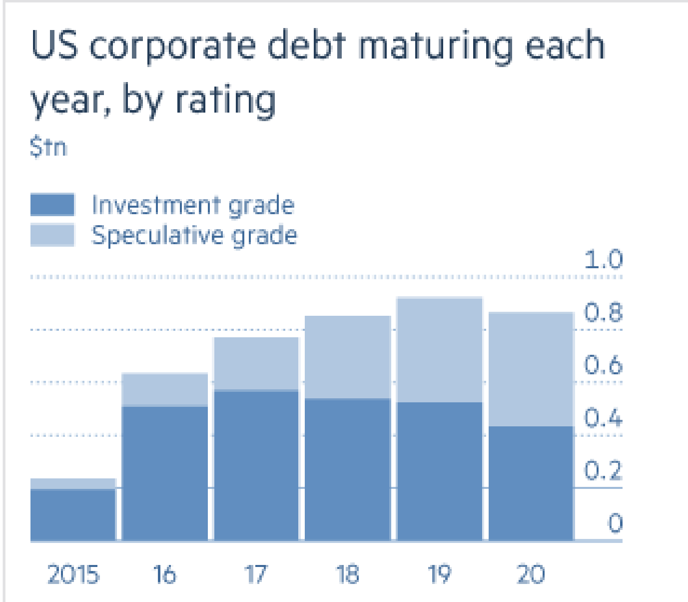
US economy - watch corporate balance sheets

This has not been a usual expansion. The strong dollar and subdued overseas markets have already dented revenues for many internationally focused companies. Even in the US, earnings growth often relied on squeezing soft labour costs with the share of profits as a percentage of GNP at historic highs.

American CEOs use leverage by taking in funds from the bond market, enabling payouts and buybacks to flourish. Record low historic yields have led to ever more bond issuance. This was a great strategy to boost temporarily share prices, but it invites a day of reckoning when these bonds redeem.



© Andrew McAfee, 2014; Source: research.stlouisfed.org



Source: Standard & Poor's

Underwriting standards in this frenzy have deteriorated, leaving a substantial amount of low-quality debt that has to be re-financed somehow. Even a slight freezing up in bond market conditions can lead to this tap being turned off. It will then be the stock market that no longer receives the oxygen to pay dividends, etc.

'Companies are getting less cash than they used to, they are not optimistic that they can invest it productively, and so they are choosing to deploy it in a way that weakens the chances of sales growth in the future. Not encouraging.' (john.authers@ft.com 6/11/15 FT.com)

Central banks short of ammunition and authority

As the world headed into the Lehman crisis seven years ago, at least there was ample room for both monetary and fiscal easing. For a 2016 slowdown or market crisis, prospects for a similar antidote are slim. In theory the Fed could instigate QE4 but with one part of the mandate at full employment, this almost has to be an impossibility. We would need a return to crisis conditions before stimulus could be re-admitted.

Of bulls and bears - timing matters

"Economists seldom call recessions, downturn, recoveries or periods of boom, unless they are staring them in the face," says Buiter. "We believe this may be one of those times." (Source: Bloomberg.com 9/9/15.)

Walls of worry, siren bears we have heard them all. Bears markets can be a lot longer, and sharper, than is commonly understood. Those 'long term' investors who bought in 1929, 2000 or 2007 had an uncomfortably long time, and a big drawdown, before their decision paid off. It's time to take as much beta risk off the table as possible and engage with expert managers who can find value and performance in markets.

Stephen Isaacs
Chairman of the Investment Committee
Alvine Capital

About Alvine Capital

Alvine Capital is an independent London based alternative advisory firm founded in 2005. Alvine Capital advises institutional clients on both alternative investments and traditional portfolios across different asset classes, markets and investment strategies.

The investment team has an average of more than 15 years' experience with alternative and traditional investments. It specialises in uncovering less well-known high-quality managers and offering bespoke portfolio services based on a thorough understanding of an investor's needs.

by Jonathan Furelid

Two to Tango – The pair trading approach to market neutral investing

Andy Kastner, CFA, CAIA
MD European Equities
GAM Investment Management

Based on disciplined stock selection, Andy Kastner and the team behind the Julius Baer (JB) Absolute Return Europe Equity Fund use long /short pair trading as a means to create a portfolio that exhibits low correlation to the overall market, as well as to underlying sectors. In an interview with HedgeNordic, Kastner explains his approach and elaborates on the pair trading investment style.

BENEFITING FROM STOCK SELECTION

Together with a team of four portfolio managers, Andy Kastner runs the JB Absolute Return Europe Equity Fund, an absolute return UCITS fund that since its inception in 2010 has generated annual returns of above 4 % to a standard deviation of 2 %.

The fund relies on a market neutral pair trading strategy to select its trades. By scanning the universe of developed market European equities, the strategy aims to detect opportunities in the relative value or ”spread” of equities that historically have shown high correlations.

According to Kastner, the pair trading approach is the most efficient way of isolating the stock selection skills of his team without exposing the fund to market or sector-specific risks.

”By using the pair trading approach, we extract value from our stock selection. Instead of trying to time markets, sectors, currencies or even countries, our focus is to remain neutral in all of these aspects. I would say that we are among the strictest in the market neutral space when it comes to hedgeing out beta exposures.”

The way the strategy detects opportunities follows a very systematized process: it includes both a quantitative and a qualitative evaluation processes. ”Our potential investment universe is around 100,000 pairs. In order to filter out investment opportunities, we have developed a quantitative screening tool. Our quantitative screening starts on sector level, where we look at operational quality, sector specific valuation criteria as well as momentum indicators. On top of that we employ a fundamental screening involving company visits.”

SECTOR NEUTRAL POSITIONING

In order to neutralize the effect of external factors or beta risks, the fund’s pair trades are always initiated within the same underlying sector.

”The current portfolio consists of 45 pairs. Always within the same sector. We focus on sectors where we believe prices are determined by stock specific factors, rather than external factors. As a result, we hold no positions in the energy sector today as this is determined by the development in commodity prices. Our focus is rather on the technology and consumer discretionary sectors”, Kastner says.

Positions are also beta-adjusted in order to neutralize the impact of the market exposure.

”The pairs are risk-adjusted as it can be that one leg has a higher beta than the other leg. Therefore, the fund may have some positive or negative net exposures. Historically, our longs have had a lower beta than our shorts, meaning that we have a little higher weighting on the long side to compensate”, Kastner explains.

When asked for an example of how a typical trade looks like, Kestner explains the rationale behind the fund´s position in the Dialog Semiconductor/ST Microelectronics pair.

”We are long Dialog semiconductors and short ST Microelectronics, both in the technology sector. Dialog to us is more innovative, has a stronger growth profile and good return on capital; ST Microelectronics, on the other hand, has high exposure to low-end technology products, they are losing market share and have low returns on capital”.

The strategy is not to be viewed in the context of high frequency programs, as it holds on to trades for 12-14 months, and in some cases, even longer, Kastner says.

RISKS TO PAIRS TRADING

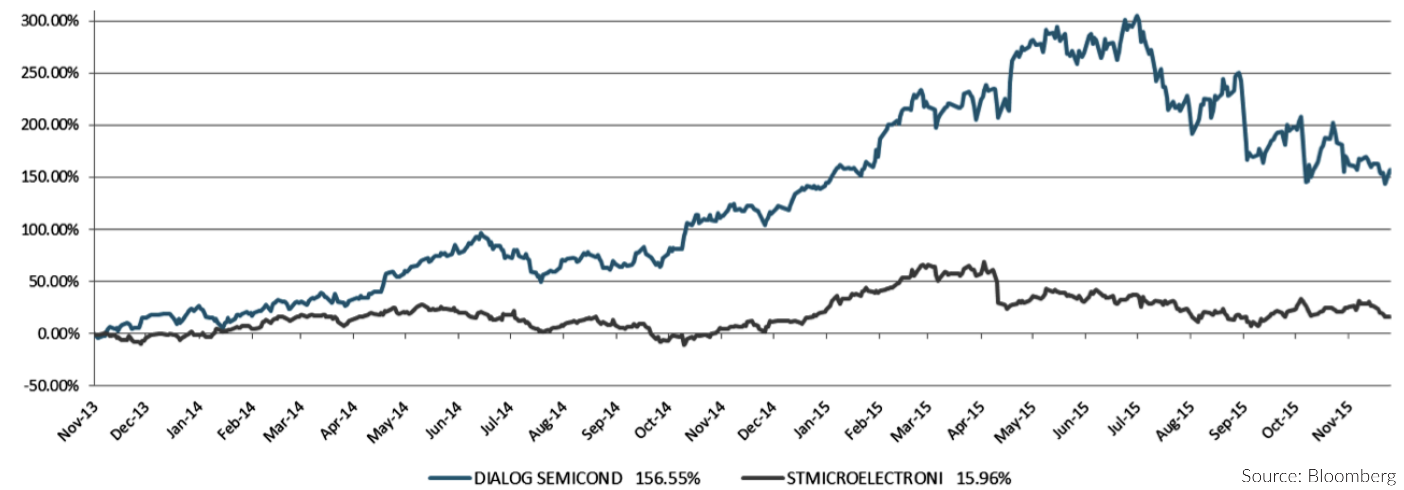
When asked for risks related to the pair trading strategy, Kastner admits that there are risks that are difficult to control for, no matter how diligent one is in adjusting for beta exposures.

”Being exposed to an external risk factor that you did not anticipate would affect the relative pricing of the pair is obviously a risk. There is also a risk that you are not finding the right pairs leading you to losses as you are stopped out. Another potential risk is that you use too much gearing, in this regard we are very defensive, our core strategy only holds an exposure of 80 %”, Kastner says.

Overall, Kastner points out that the portfolio has shown a very robust performance, but the fund is now looking to soft close to evaluate another potential risk factor: capacity issues.

”In the case of our strategy, I believe it has stood the test of time, putting in positive numbers for each calendar year since the fund launched in 2010. We have experienced all sorts of markets during this time without seeing any major structural impacts on our portfolio.” ”The fact that the fund is now approaching 2,5 billion euro makes us wary of potential capacity issues. For that reason we are tightening soft closing measures for the fund within short in order to evaluate what impact further assets would have on our trading”.

EXAMPLE OF LONG/SHORT PAIR TRADE: TECHNOLOGY SECTOR



Source: Bloomberg

Does Size Matter in the Hedge Fund Industry?

by Melina Sanchez

It's a common belief in the financial sector that larger active managers underperform smaller managers. When AUM growth is linked to style drift that forces managers out of their area of expertise, it could translate into lower returns.

One of the style drifts we commonly see among our public managers is a shift in the average Market Cap as AUM increases. It correlates to broad swaths of market theory that says inefficiencies (alpha opportunities) are riper in smaller capitalization companies because they are less covered and thus less efficient.

One could argue, then, that as managers are forced to ramp up their market cap exposure because of an increase in AUM, this may have a negative spillover effect on alpha generation. We are going to show that the connection between market cap investing and performance is not as tight as many in the financial sector believe. For that, we will analyze:

Weighted Market Cap exposure: in what market caps have managers (of different Market Value buckets) been investing in the last 10 years?

Alpha performance: how have managers of different market value buckets perform over time?

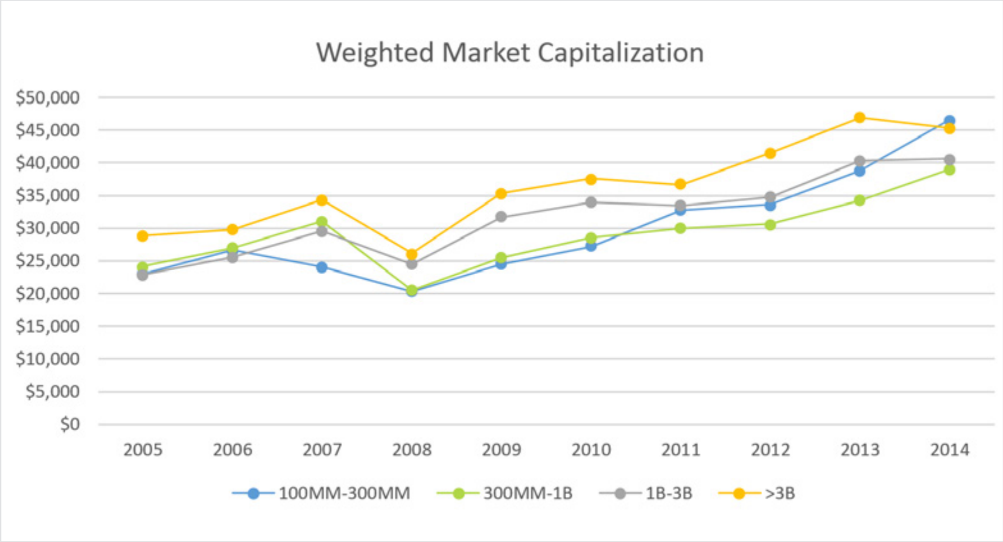
About our Data

Everything mentioned in this post is sourced exclusively from public regulatory data, including the manager's profile, simulated performance, and all other analysis and commentary. The data used here omits the short side, non-equity securities, many non-US securities and all non-public information such as actual fund performance.

Investing in Different Market Caps

The first assumption to tackle is whether smaller managers invest in smaller companies, where they presumably have access to more alpha opportunities. But what does the data say?

We have divided the ~1150 managers of our Hedge Fund Universe (HFU) into four Market Value buckets: $100-300MM, $300MM-1B, $1-3B and >$3B. These represent the reported assets under management of the underlying funds. We then calculated the average of the Weighted Market Cap per year of these funds' underlying investments. The results are as follows:



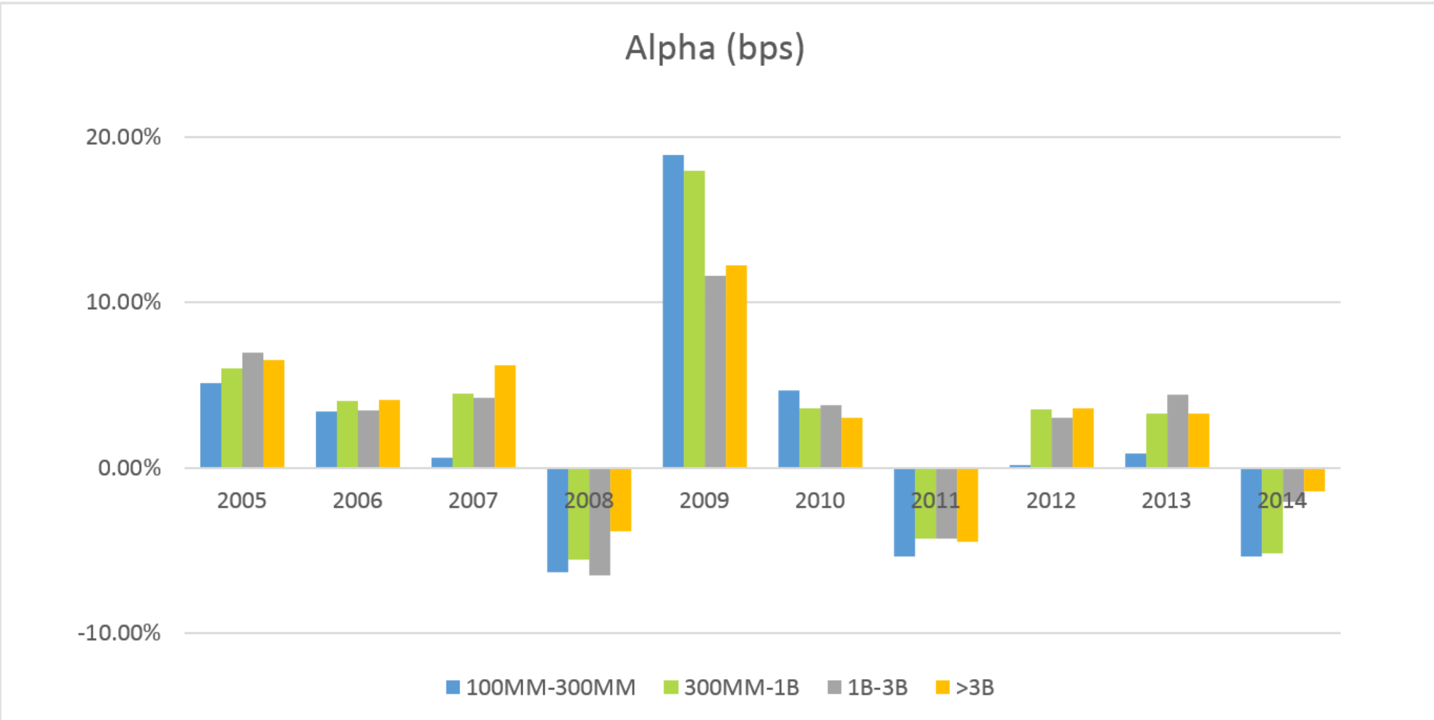
Since 2008, all of the manager groups have increased the weighted market cap of their underlying investments by at least 55%. There are two main observations we can draw from the above graph: 1. while historically smaller managers have invested on average in smaller companies, that trend has been reversing since 2013; and 2. across all Market Value ranges, the average of the weighted market cap per range is a large-cap company.

The above destroys the first of the arguments: across the entire Hedge Fund Universe, it cannot be said that an increase in Market Value will necessarily lead into an increase in the average of the Weighted Market Cap.

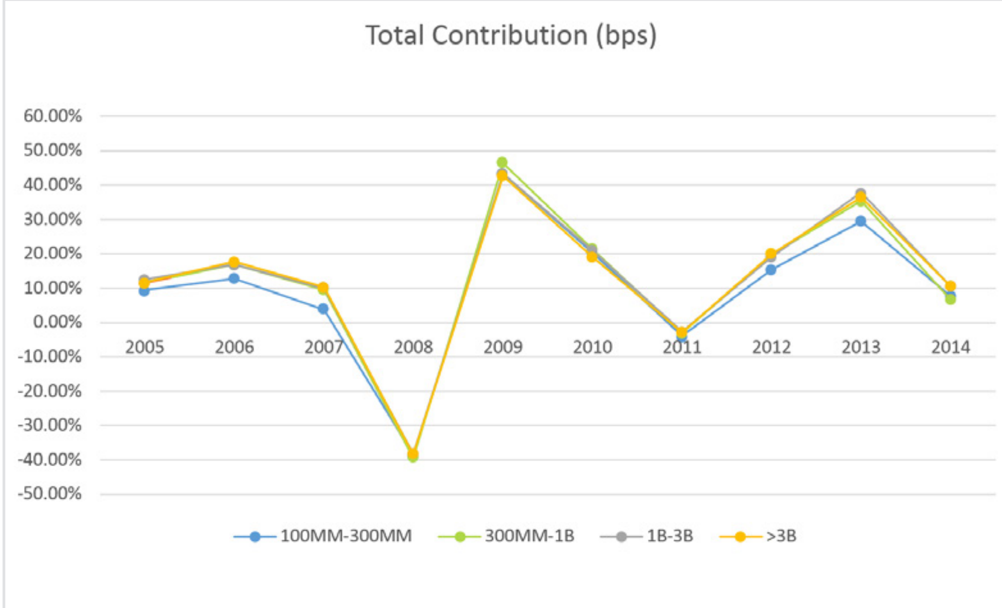
Alpha by Market Value

Before looking into the numbers, it's essential to clarify that our main data source is the SEC filings of managers with a reported market value of $100MM or above. These filings mainly capture long positions, so our analysis is limited to the alpha generation of the long book across the four selected Market Value ranges. Managers with smaller asset bases (i.e., <$100mm) may be more smaller cap intensive, but we have no insight into this sleeve of managers.

When we then look at alpha by these sleeves of managers, the results are surprising: in the last 10 years, with the exception of 2009 and 2010, smaller managers have generated less alpha in comparison to bigger managers.



Managers reporting >$1B of market value from the long side have performed better overall during this time frame.



The million–or billion–dollar questions:

For managers: How do you navigate growth: are you an alpha generator or an asset gatherer?

For investors: Do you believe smaller managers perform better than larger managers? Is this one of your core marketing and investing strategies?

This destroys the second of the arguments: smaller managers do not necessarily outperform bigger managers.

What's the Explanation?

Although some strands of academic literature support our findings, there are several potential explanations for our results, among others:

1. We are capturing long positions for the most part. Smaller managers may have better opportunities in the short side, which would not be accounted for in the above results.
2. Managers with Market Value less than $100MM may perform better than all other Market Value ranges but are absent from this study.
3. Other non-equity strategies may be more suitable for smaller managers. The mandatory SEC disclosures capture most equity and equity-like instruments, but not all security types.
4. There may be other style drifts that explain better historical performance.

Conclusion

As always, before investing in a new manager one should look into a broad spectrum of metrics and factors. In this article we try to demystify a common belief in the financial markets: smaller managers do not always outperform bigger managers, at least in the long book.

Melina Sanchez
Analyst, Client Analytics
Novus, Inc.

Andrea Gentilini, Ph.D.
Head of Europe
Novus, Inc.

Novus was founded in 2007 by a group of investors, data scientists and engineers to build a foundation that helps the world's top investors generate higher returns. Simply stated, we believe investors need to innovate, adapt and increase the value they deliver. Today, almost 100 of the world's top investment managers and investors managing approximately $2 trillion are using a single foundation that leverages all of their ideas and produces innovative technology on a regular, iterative cycle. At its essence, Novus is a platform for the industry's top investors to collectively innovate.

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The German language seems to have expressions which describe complex concepts so clearly and concisely in a single word that they are hard if not impossible to translate. "Zeitgeist", or "Angst" are two examples where the English language reaches for the German to describe something. When interviewing Harald Sporleder (in English - though both of us speak German as our mother tongue) we came across another such word, "Königsdisziplin". Königsdizplin (literally "competing at the level of a king", but of course being German one must emphasize the discipline over the competition) describes a situation in which one competes at the highest, most competitive and challenging level in a given sphere. It is often used in context of sport where, for example, Formula 1 is referred to as the "Königsdisziplin" of motor racing.

KÖNIGSDISZIPLIN

by Kamran Ghalitschi

The Art of being Market Neutral

It is more than ten years ago that Allianz Global Investors, the European Asset Management giant that today has in excess of 450 billion Euros under management, set out to do something different. With vast internal resources in research, trading and other areas, the ambition was to offer a product that would fit the more conservative DNA of the group and client base, but would be driven by equity Alpha. The challenge was to develop a new strategy whilst leveraging off the depth of the existing long only platform that would allow participation in both rising and falling markets. Harald Sporleder, who has managed this project since its paper trading days and is today the lead portfolio manager for Allianz Discovery Europe Strategy, provides his views on the art of running a true market neutral portfolio.

No pairs, no derivatives

Where many strategies rely on hedging out market risk with futures and options (typically being: short an index to protect a long book of single stocks), Harald has never used derivatives in the fund's eight-year track record. "We believe in hedging the portfolio by picking single stock names of good and bad companies."

Harald observes large parts of the industry relying on protecting downside risk with derivatives with some concern. "These products may not perform when markets come under stress, as the derivative will not always deliver the returns modelled out on an Excel sheet. When markets are in real trouble, correlations shift and protection fades away. The way you expected your portfolio to behave likely goes out the window."

Harald is not a believer in pair trading either but rather relies on deep, fundamental research. "Being long Daimler and short BMW or vice versa does not allow you to get the returns right to justify the fee structure." He does see some value in pair trading as implemented under some quantitative approaches. However, these strategies typically require entering into several hundred pair trades with the expectation of small returns on each position and a high turnover of the portfolio. Often these strategies need to take on leverage, which is limited in UCITS structures, and returns come from many different sources. "That is the complete opposite of what we do. It may be less complicated and more arduous but we pick our investments as a result of research on individual stocks and thematic views on sectors and countries."

Active country or sector bets are a substantial part of portfolio construction, yet the fund remains strictly market neutral. Harald sees three core parameters that characterize a market neutral strategy: (1) The strategy must be Beta neutral (ideally with a Beta very close to zero); (2) the net equity exposure should be in a restricted range (in this case +/- 15%); and, (3) the volatility of the fund must remain low.

Picking your Shorts - The Königsdisziplin

"It is a daily challenge to build a portfolio which remains market neutral, capturing upside with the long positions whilst maintaining the necessary focus on the short positions. The biggest challenge - the Königsdisziplin - is to identify and manage these shorts. I spend 70% of my time generating and analysing short ideas," Harald says.

Due to the depth of research available within the group, Harald has the opportunity to challenge the other investment teams' and analysts' understanding of a particular business model, and to leverage the global research platform to identify and understand the structural changes facing countries, industries, sectors and individual companies.

Structural changes within a sector can be very long lasting and may be triggered by a variety of factors including changes in regulation, legislation or by disruptive product innovation. Harald points to the utility space for an example; he believes that French and German energy providers whose revenues are based on nuclear power provision are structurally at risk and are therefore likely to fall out of favour. "I am always on the lookout for the long term losers. We do not come up with structural short ideas overnight. Our shorts undergo an extended research process often involving a number of parties across the groups business". Another internal tool the team is utilizing is "Grassroots Research" - a global network of market researchers which has been in use since 1984. It employs investigative journalism, supply chain surveys and analytical techniques to identify stock and sector trends, and serves as a "fact check" on long / short ideas.

An advantage Harald also sees in the AllianzGI organisation is that all senior portfolio managers are located on the same floor. "Sometimes we get trading ideas from other teams, for example those who specialise in areas like small caps or growth stocks."

The portfolio's turnover is around 12-15 times a year. The turnover tends to be lower in directional markets and unsurprisingly, higher in volatile markets. Short-term trades, which make up about half of all trades, typically have a profit target or stop loss of 10% before positions are closed. For structural long ideas, those targets can be much wider. "These long term trades have a different return profile, there we try to identify a fixed catalyst prior to adding a position." Once this catalyst is reached the position is closed, or at least re-evaluated for other factors. Harald mentions he has three names in the portfolio that the team has held for at least six years. "These stocks have reached their catalyst and performance targets several times, but the companies' management teams always came up with new ways to enhance the earnings streams supporting our fundamental investment thesis."

Harald Sporleder, Portfolio manager at Allianz Global Investors

Know your Game

Manager skill is undoubtedly a crucial factor when selecting a hedge fund, and ability to generate Alpha may provide the supporting evidence of such skills. Alpha therefore often refers to the "skill based" returns of a manager. "Market Neutral and Global Macro strategies are trading styles where the portfolio manager has to demonstrate that he or she is able to capture Alpha in all market environments and periods. They are likely to be the most complicated setups as they require a dedicated team with the right combination of experience and skill sets," Harald believes. Manager risk may also play a more crucial role in these strategies. "It is almost a form of art to build a portfolio which is Market Neutral, and crucially Beta neutral. It all comes down to experience in understanding your markets and structuring the product well."

Directional strategies, like classic long / short funds or even CTAs, are more Beta driven and rely more on managing exposures and Betas. Market Neutral and Macro strategies are fully focused on Alpha. "After all," Harald is convinced, "the Alpha is what the client truly wants to be paying you for!"

Market Neutral Strategies are becoming Fashionable - that´s a Risk

After years of equity bull markets and historically low interest rates, more investors are looking for other sources of Alpha, and are focusing more on the alternatives space. With so many good, well established products on the market such as Lansdowne and GLG Partners with five, ten or more years of successful track record, Harald is doubtful whether new managers who base their merits only on backtesting and papertrading can satisfy investor expectations.

"So many good funds are already closed due to capacity restrictions, and we are not far off either," Harald notes, concerned about limited space. "Market Neutral strategies are becoming fashionable, creating a pull-factor for new products and players - and that´s a risk for investors and the industry. One has to ask, where are all these extraordinary new managers coming from, and what is their track record?"

Harald argues for hedge fund investors to turn to managers that have proven themselves to be deliverers of Alpha in times of severe market distress. "If you were not involved in managing assets in the 2008 or 2011 hedge fund crisis, you may not be able to convince investors that you are capable of delivering Alpha in a complicated market under difficult conditions". Harald closed by saying: "In a nutshell, the industry is not scalable to an unlimited extent."

Harald Sporleder is a portfolio manager at Allianz Global Investors, heading the asset manager's European Long / Short Equity team. He joined Allianz in 1996 as a junior fund manager for German equities and in 2002 took responsibility for the management of high Alpha portfolios with a focus on Germany and Europe. Harald now manages the Allianz Discovery Europe Strategy, adopting a market neutral approach and using various fundamental criteria as valuation metrics on his funds.

Sporleder is based in Frankfurt, holds a Master's degree in Economics from the University of Halle in Wittenberg, and is a member of the HFSB organization.

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BENEFITING FROM CORPORATE EVENTS WHILE MITIGATING MARKET RISK

BY JONATHAN FURELID

Carl Anderén is the portfolio manager of Coeli Norrsken, a niche player in the event driven hedge fund space. The fund looks to profit from the price action that follows when a company announces a new share offering. At the same time, the strategy aims to be indifferent to market risk by holding a dollar neutral portfolio.

The strategy behind the Coeli Norrsken fund was set up already in 2001. In a nutshell, it seeks to benefit from the risk premium that develops when a listed company goes to the market to seek new capital. This premium is the result of the overreaction and discounting that often follows when a company announces its ambition to raise capital.

”We only trade in companies that are raising capital from the equity markets. Our universe consists primarily of companies listed in the U.S. that either issue new shares or sell out shares from existing owners of the company.” Anderén says.

”The way it works is that a company announces a share issue. Then they need to tell the market what they plan to do with the funds. When this takes place you introduce a new uncertainty and this uncertainty is discounted by the market. The goal of the fund is to capture this “uncertainty premium” and profit as the discount dissipates,” Carl Anderén explains.

The time it takes for the stock to converge varies says Carl, but as the effects of the transaction dissipates, i.e. when the transaction is priced and uncertainty is no longer present, the company’s stock price goes from being somewhat decoupled from the overall market to being more aligned or more correlated with the market again. Because of this realignment, over time, it is important to have a market neutral approach.

”We are only interested in capturing the premium, not having unwanted overall market risk, as a result, a market neutral strategy comes naturally, Anderén says.

The way the strategy hedges out market exposure is through holding a dollar neutral portfolio of using broad equity indices, Carl emphasizes that the dollar neutral approach is much more stable than a beta neutral approach for a strategy such as that employed by Norrsken.

”We are religious when it comes to hedging. Given that we hold a fairly concentrated portfolio, the dollar neutral approach is our choice to maintain market neutrality. Beta neutral strategies tend to work less well in transition periods when markets become more volatile. It is harder to forecast how the portfolio will behave in these scenarios.”

Our research that we have done over the last decade is fairly clear, predicting future correlation is extremely difficult. This is especially important when you have relatively narrow portfolios. Given that you cannot predict future correlations a beta neutral portfolio will either become over or under hedged in transition periods, which are typically when you need the market hedge the most.

In any given year, Carl and his team participates in around 150 transactions, the investment process is systematic on the initial screening process with a discretionary overlay on final decisions. The execution has evolved over time into what today is a systematized way of detecting opportunities in what is referred to the market for secondary offerings.

Carl highlights that the process is very strict as to which transactions the fund enters into.

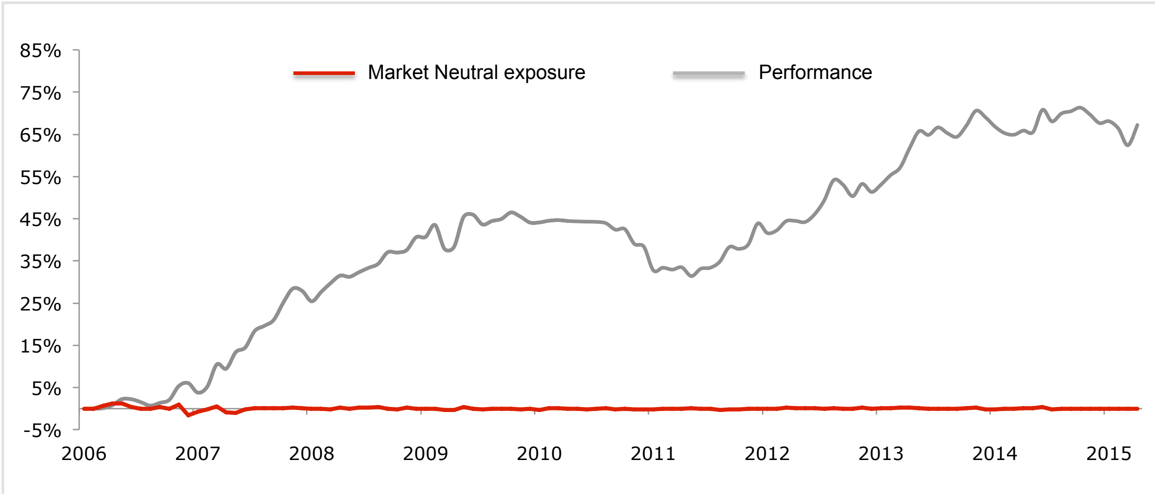
”First of all, we limit the universe to companies that have a market cap of above 500 million USD. We try to distinguish between companies that ”want” to raise capital as opposed to companies that ”must” raise capital, Anderén says and continues:

”We do not participate in transactions where the value of the company is based solely on future events, for example most biotech’s and commodity prospecting companies. We are also very cautious when a company is raising equity to survive, which in general has a much higher risk profile and we believe needs to be viewed with a very specific skill set.”

The performance of the strategy has been soft during 2014 and 2015 after a strong run in 2012 and 2013. Carl says that one of the reasons for this is the strong stock market during this period has tended to push the premium, which he tries to capture, lower. However since the correction in the stock market during August Norrsken has witnessed a better environment, with better pricing of transactions due to the heightened risk awareness.

Looking forward, Carl is optimistic and says that the current heightened risk awareness will lead to increased risk premium introduced to the raising of new equity capital, which will benefit the strategy.

”This strategy offers punchy returns, with periods of sideways action to be followed by bursts of strong numbers as the opportunity-set for the strategy improves. We look to generate around 5% - 10% annually with a very limited risk profile.”



Market Neutral exposure vs. performance for Coeli Norrsken since inception

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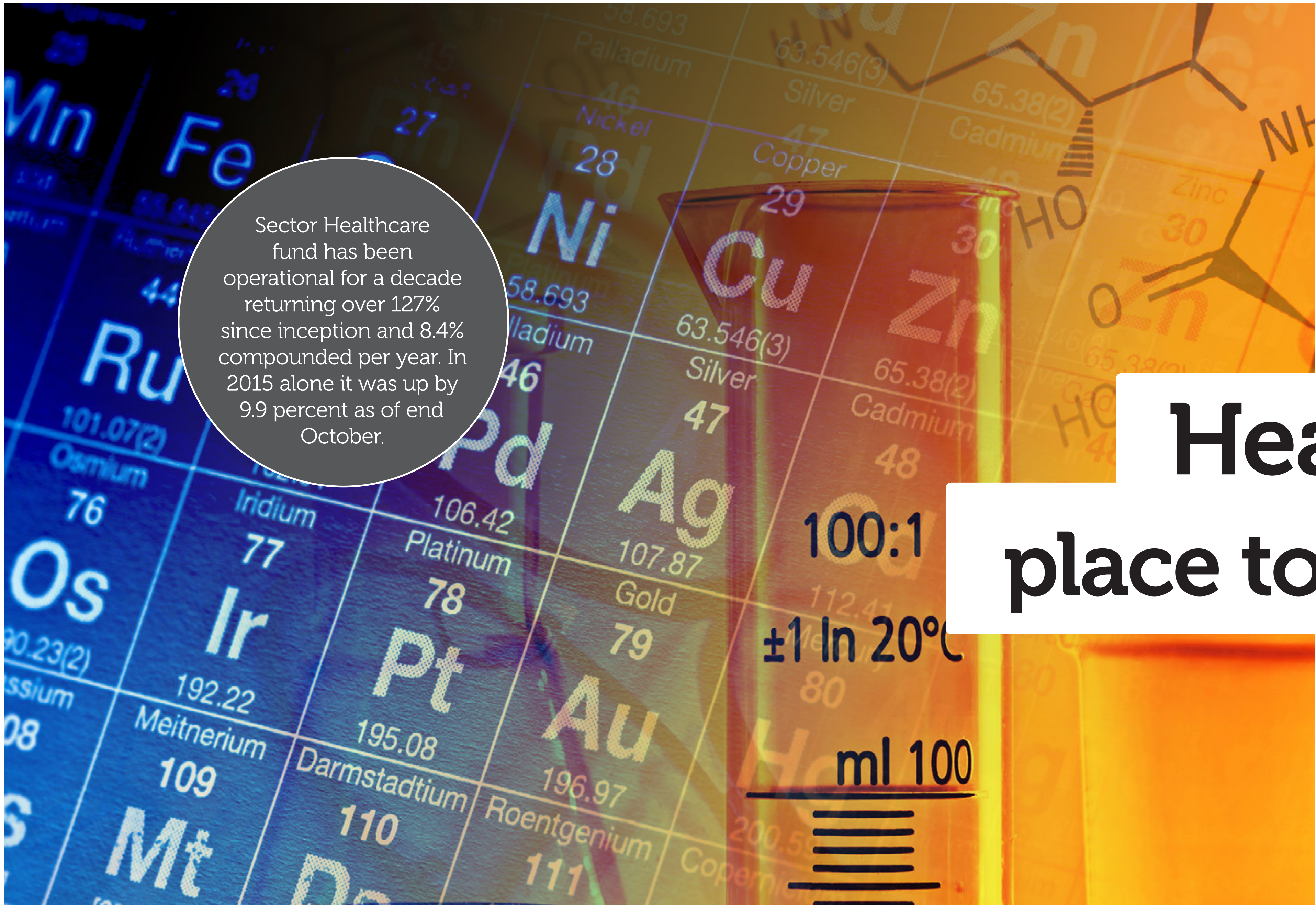


Sector Healthcare fund has been operational for a decade returning over 127% since inception and 8.4% compounded per year. In 2015 alone it was up by 9.9 percent as of end October.

by Pirkko Juntunen

Health Care - a great place to be market neutral

For the Norwegian based management team of the Sector Health Care fund, the idea to launch a product with a market neutral strategy in the healthcare space was born on the back of some rather simple considerations.

"We loved the fact that the returns would be generated by picking the right stocks rather than determined by systematic market factors."

While the team had all the confidence in being good stock pickers, they did not want to be relying on beta or timing skills. There would be plenty company specific risk factors and dispersion in the healthcare space to make attractive returns in a market neutral setup with limited exposure towards systematic market risk factors.

Trond Horneland, co-portfolio manager of the $660 mill. healthcare strategy, said the healthcare sector is particularly well-suited for a Market Neutral strategy. "The healthcare sector is dominated by company-specific factors, such as new product launches, as well as the inherent cyclicality caused by individual patent expirations. Given the dynamic nature of the industry, it has historically been an attractive universe for active stock selection strategies". The healthcare sector consists of large and liquid companies with high historic return dispersion and low correlations. Currently there are well over 3000 listed healthcare companies in developed markets, with an aggregated market value of well over 6 trillion Dollars - about 27 times the value of the Norwegian stock market. The large, liquid and de-risked portion of this healthcare universe, consists of roughly 350 companies with an aggregated market value of well over 5 trillion Dollars. "When we first launched our fund 10 years ago, we had about 220 companies in our core investment universe. This has now expanded to well over 350 companies despite a very active mergers and acquisitions environment during the last ten years. This is a good illustration of how dynamic the overall healthcare universe has been historically.

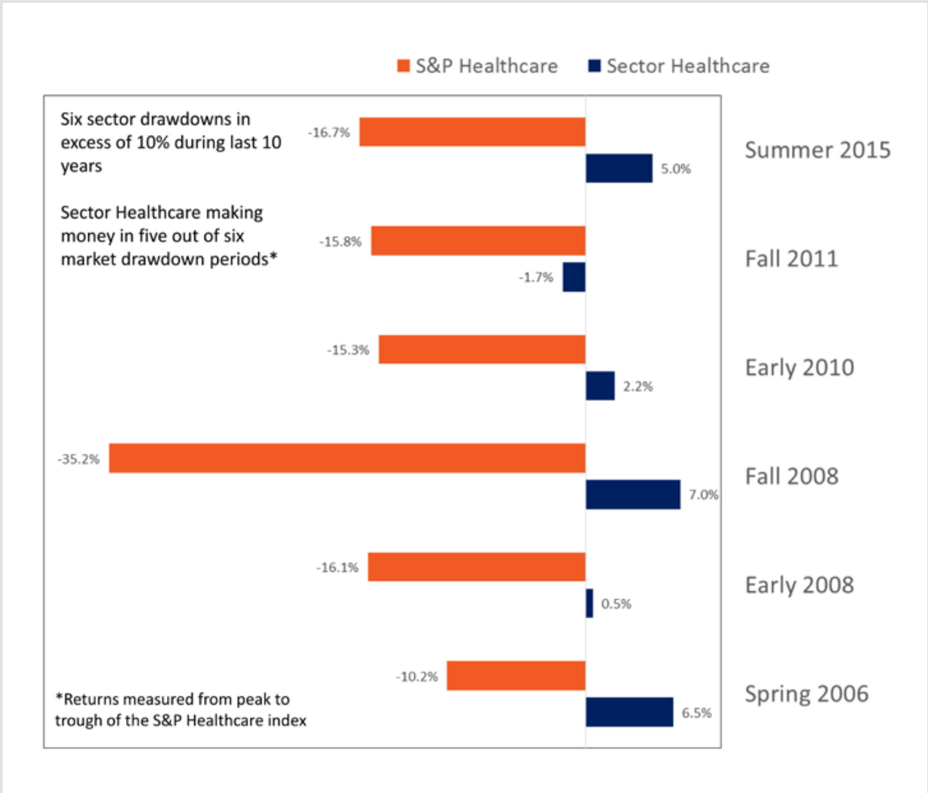
Market neutrality is achieved by trading on the long or short side of bottom up, fundamentally driven single stock ideas and no options or futures are used. "On a few occasions we have turned to liquid ETFs when we found no suitable short right way, but that has historically not been more than around 5% gross exposure of the short book."

Merger and acquisition activities are a big topic in the industry, and the fund has historically benefited from being on the right side of M&A situations. However, the team tends to avoid merger arbitrage situations, as Horneland does not like the risk reward pattern of these deals having a fixed upside but open downside risk. "We have not been too keen on those arbitrage situations and tend to stay away from them. In general, Sector Health Care does not enter into pair trades, but likes each position to stand on its own merits."

The team historically has been able to extract alpha from both the long as well as the short book. Alpha from shorting has proved more challenging in the healthcare bull market experienced during the last five years, but this year Horneland estimates that 30% of the fund's alpha has come from the short side. Since the inception of the fund, the short book explains nearly 40% of the historic alpha.

The fund has proven its claim to have an uncorrelated return profile and more than stands its ground in periods of significant market stress. In 2008, the fund returned 11 percent. The fund has also had a good period during the last 3-4 months at the same time as the broader healthcare sector had a correction of over 15 percent from peak. "We think our history of doing well in periods of market stress is due to a disciplined risk construction framework as well as an active management of all systematic risk elements. Our contrarian tilt has also proven valuable in these periods since crowded positions often take outsized losses in flow driven market selloffs"

Sector Healthcare´s two founding investment managers, ,Trond Horneland and Trond Tviberg, launched the fund in 2005. Currently, the investment team consists of 5 experienced healthcare investment



professionals that invest globally in developed markets and across most sub–sectors of healthcare, including pharmaceuticals, medical technology, healthcare services and developed biotech. The team manages the market neutral Sector Healthcare Fund as well as the long only UCITS fund, Sector Healthcare Value Fund. The latter was launched five years ago, and is largely a replication of the long book of the market neutral hedge fund.

Even with the pedigree of a hedge fund manager, Hornelund insists there is nothing wrong per se with being exposed to Beta. Especially with the privilege of looking at the last years of returns of the healthcare space in the rear view mirror, the sector was a great place to be exposed to Beta."You can also have a very active portfolio and be a good or bad stock picker in a long only setup. The return and risk factors are likely to be different and much more determined by the performance of the general market or sector and of course one must monitor how the strategy performs in situations of severe market stress and be able to stomach potentially hefty draw downs. That is clearly not the mandate of a market neutral setup. We don't start at plus ten or minus ten dictated by market Beta or other systematic risk factors. We start at zero, and then from there onward it is our skills that will determine the results." he says.

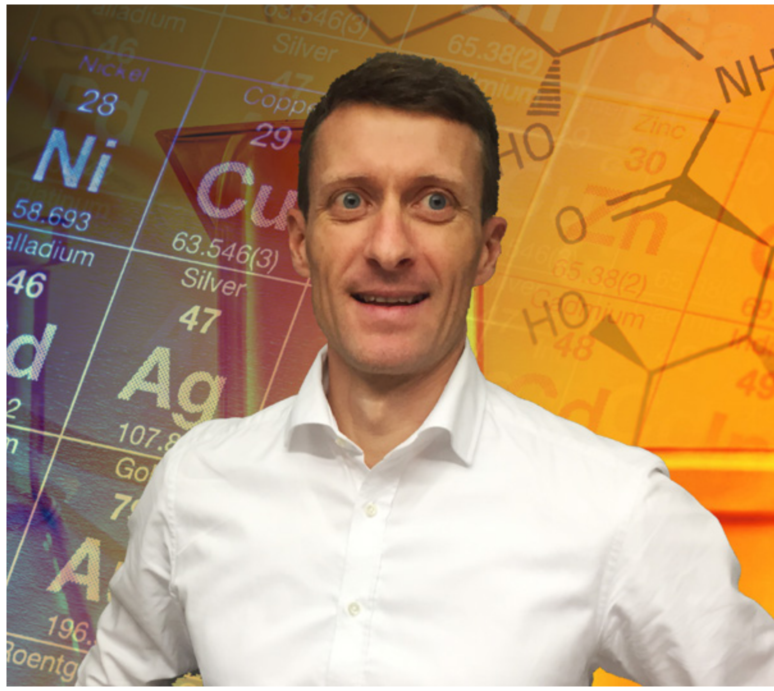
The team aspire to add value through fundamental research, a rigorous investment process and an adaptive portfolio construction process. As a bottom-up value-based investor, the portfolios often have a contrarian tilt and early-stage biotech investments are largely avoided due to risk considerations.

Horneland said trading is an integral part of the fund's success, contributing 20% to its historical performance. "Our position taking is long term in nature but we are very active in sizing our positions around changes in risk, price levels and fundamental news flow. The majority of our trading is not in and out of names but rather up and down in the sizing of the position. Our timing in making these changes to the portfolio has historically been profitable"The team is financially oriented with a value approach to stock pricking. Horneland also emphasized that their valuation focus is not the same thing as being a traditional value investor. The team is looking beyond the P/E ratios to determine if a stock is over- or under-valued. "Many of our most profitable positions have been undervalued high P/E stocks on the long side and overvalued low P/E stocks on the short side. Sustainability, quality and duration of earnings is a key variable for us when looking at stocks. Being valuation oriented most often leads to having a contrarian tilt to the portfolio"

The investment process is based on a scorecard model for stock selection. This model is built to improve the timing in the investment decision by accounting for shorter-term factors such as earnings momentum and sentiment, Horneland said. "The input into the model is based on bottom-up fundamental analysis by the analyst and portfolio manager, and is not a quant model," he said.

The portfolio typically consists of 30-50 long and 35-50 short positions. Position sizes are determined by the alpha estimate relative to the non-systematic risk of the security, and option implied volatility is used to estimate company-specific risk. At the same time unintended factor exposure is actively monitored and managed. Risk is based on the commercial and financial outlook rather than pipelines, and unintended systematic risk is minimized.

Mr. Horneland believes the health care sector continues to offer great opportunities for stock picking. The investable universe of stocks has grown, dispersion has picked up and their core style (valuation and mean reversion driven) is more in favour. One needs talent, or skill to pick the stocks, but there also has to be the right investment universe to offer those possibilities, combined with the



Trond Horneland, Portfolio Manager

opportunities that allow to execute on those ideas. The healthcare space offers all these prerogatives for a market neutral strategy."

On the issue of capacity Horneland said all active portfolio management strategies have capacity constraints. "Given the growth in our investable universe, improved liquidity in the underlying positions and an uptick in dispersion, we think a conservative capacity limit for our fund is around US$750 million," he said. The team manages a total of $660 mill. out of which US$420 mill. is in the fund and the rest in managed accounts. The fund has had several soft-closures already and does not foresee problems reaching capacity restrictions in the coming years.

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QQM: Systematic Market Neutrality with ESG principles

By Kamran Ghalitschi

Stockholm domiciled QQM Equity Hedge is a systematic, equity-market-neutral absolute return fund based on proprietary quantitative models. The fund's partners Ola Björkmo and Jonas Sandefeldt have been managing the fund since July 2010, refining the investment model and successively expanding the investment universe. The result has been reduced volatility and a significant performance improvement. **QQM Equity Hedge** has continuously posted strong performances over the last three years and is ranked as top 10 in the world in its category (Equity Market Neutral) by BarclayHedge over a rolling 3 years period from Q4 2012- Q3 2015. QQM Equity Hedge was also ranked top 10 for the single years 2013 and 2014.

ONE INVESTOR'S MISTAKES CAN BECOME ANOTHER INVESTOR'S PROFITS

The fund's strategy is based on behavioural finance theory and its findings in terms of how investors make mistakes because of cognitive and emotional biases, resulting in the mispricing of assets. "The idea is to benefit from an understanding of what drives investor behaviour. Irrational behaviour by many individual investors causes mispricing and creates opportunities for others," says Ola Björkmo, Partner and Managing Director at QQM Fund Management.

There are several drivers behind mispricing. Overconfidence is one of the more common failings that many individuals suffer from when making investments. Overconfidence often leads to trading too frequently. Confirmation bias is another, where investors use a form of selective thinking, seeking out information that supports their original ideas about an investment, and ignoring information that contradicts it. Anchoring is a third effect, where people tend to attach or anchor their thoughts around a reference point despite the fact that it may not have any logical relevance to the situation.

"The costs of implementation can exceed the size of the pricing errors. Therefore, diligence is required and the costs weighed against any possible revenue," says Jonas Sandefeldt.

THE FUND STRATEGY

QQM is managed in line with two cornerstones – market neutrality and systematic management. By market neutrality, the fund managers mean that the fund never engages in any form of market timing. Instead, the fund's expected beta coefficient to the stock market is maintained as close to zero in all circumstances. "Equity trades are also executed in a completely market-neutral manner to eliminate the occurrence of unwanted market risk in the fund," says Jonas Sandefeldt. "Beta is abundant, but Alpha is in short supply."

"QQM Equity Hedge's historical correlation to global equities is 0.13. The bottom line is that the fund will not track the stock markets over time. Accordingly, the fund's contribution will be in the form of diversification," says Ola Björkmo.

The fund's systematic investment process implies that quantitative models are used to screen a large investment universe and to rank stocks based on specific criteria. Examples of effects that the models analyse include earnings momentum and earnings surprise.

A Kelly criterion using a constant risk level is applied in the management of the fund. "Given that our models provide us with a statistical advantage, it is crucial to take positions in many different securities and to maintain a constant level of risk," say the fund managers. At present, the fund comprises about 180 long and 230 short positions, with a typical gross exposure of between 260 and 300 per cent.

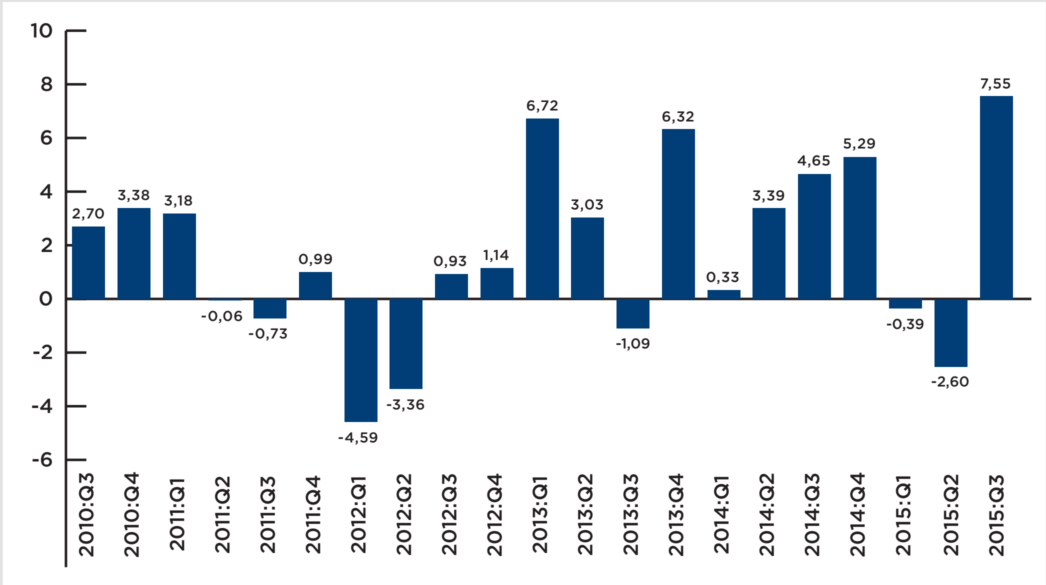
ETHICAL AND NORM-BASED SCREENING MAKES QQM EQUITY HEDGE UNIQUE

All investments are subject to ethical and norm-based screening by ISS-Ethix. The screening identifies investments in breach of the UN Global Compact principles and ethical criteria, and is used as a basis for QQM's investment decisions. Very few hedge funds encompass an ESG component, making QQM Equity Hedge a rare bread in the space and attractive for investors with ESG and SRI guidelines in their investment policies. Partner and Fund Manager Ola Björkmo comments:

An experienced team that has worked closely together for more than ten years

The partners and fund managers Ola Björkmo and Jonas Sandefeldt have managed the fund since 1 July 2010. Mr Björkmo has a degree from the Stockholm School of Economics and previously served as Managing Director of Öhman Asset Management and held senior positions at Brummer & Partners and the Öhman Group. Mr Sandefeldt has an MSc in Physics from the Royal Institute of Technology in Stockholm and also studied Economics and Business at Stockholm University. Mr Sandefeldt served as a quantitative analyst at AP1-3 and Brummer & Partners, before joining Öhman Asset Management as a portfolio manager and analyst focusing on quantitative investment strategies.

"The market-neutral strategy is particularly attractive in the current low-rate environment. We are noting demand for the fund from institutional clients as well as high-net-worth individuals, who appreciate the strong returns generated by the market-neutral strategy while adhering to ESG principles."



HISTORICAL RETURN, QUARTERLY DATA

The image shows the fund's quarterly return for the 21 quarters since 1 July 2010. In two-thirds of these quarters, the fund generated a positive return. The four best quarters were significantly stronger than the fund's weakest quarters. The average return for the positive quarters is 3.54 per cent, compared with an average of negative 1.83 per cent for the negative quarters.

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Merrant: The Market Neutral Multi-Manager

Navigating Difficult Market Environments

by Jonathan Furelid

Merrant Alpha Select is a Swedish fund of hedge funds co-managed by Ulf Sedig and Rolf Hagekrans. The fund focuses entirely on identifying and allocating to market neutral hedge fund strategies with the objective of generating consistent returns that are uncorrelated to other asset classes, including hedge funds. So far, the approach has been highly successful!

”We have been running this strategy for more than six years now and managed to navigate all sorts of difficult market environments. Since inception, the fund has only had five negative months, with risk-adjusted returns that have consistently beaten benchmarks. To me this is evidence enough that our approach works,” as Rolf Hagekrans summarizes the strong pedigree of Merrant Alpha Select.

Merrant Alpha Select was launched in August 2009 and has shown an exceptional consistency in returns ever since. The fund is yet to report a losing year, and has generated annualized returns of 5.8 %. Volatility levels have been subdued, and the fund’s annualized volatility amounts to 1.6%. Not only has the fund performed well, it has also shown low correlation to equities, which Hagekrans sees as one of the main reasons to consider a market neutral strategy.

”One of the main advantages of the market neutral strategy is that it has a greater emphasis on acting as a true hedge to market volatility and therefore shows resilience in times of equity market distress”, Hagekrans explains, continuing:

”Market neutral funds seek to earn a positive total return over a full market cycle regardless of market conditions or general market direction. A diversified portfolio that holds a market neutral component is better equipped to provide diversified returns and improve risk-adjusted returns.”

Merrant´s concentrated portfolio currently consists of 10 different single manager market neutral funds, with the bulk of the risk being in market neutral equity strategies, the most widely used strategy in the market neutral space. As of late, Merrant has reduced the risk to fixed income relative value strategies, as the manager believes the market opportunities are simply not there.

”We have cut back significantly on fixed income allocations. The current market environment makes it hard for these strategies to generate any meaningful returns, and we believe the risk to the downside is higher than it used to be,” Hagekrans explains.

The active management of the portfolio is an important aspect in Merrant´s approach. The fact that the portfolio consists of multiple funds with inherently different styles and characteristics is a way to diversify risk, he says.

Merrants fund selection process is highly structured and lives by a number of core beliefs that the portfolio managers believe explain why the funds have been recognized as having some of the highest risk adjusted returns in the industry.

“When selecting managers and strategies to the Merrant multi-strategy funds, we always have a very clear understanding of what to expect from the trading approach and how it should add value to our portfolio. We also strive to find managers that have a well defined edge, at least 5 years of live track record and that have proven themselves in difficult market environments, such as that experienced in 2008. One way of finding unique edges is to look at the market or sector traded by the manager and to pinpoint why the manager should be able to have a comparative advantage in this respect.“ Ulf Sedig explains.

Merrant have a number of quantitative and qualitative criteria in their filtering process that ultimately leaves the multi-manager with an investable universe that is 5 % of the total universe scanned. Among the quantitative criteria Merrant use are: the level of consistency of the strategy, low downside risk, low volatility, significant alpha, low level of correlation to equities and fixed income markets and low correlation to other strategies in the current portfolio. “In addition, there are a number of qualitative factors that we considered prior to an allocation. For example, we only consider managers where investment decisions and risk control are a function of a team effort rather than the strategy being dependent on a single person. Furthermore, we only look at managers who can show relevant and extensive experience managing the particular strategy. Merrrant also expects the manager to have a solid infrastructure, including relationships with well regarded custodians, auditors and administrators.”

”Our investment philosophy is built on constructing a diversified portfolio of market neutral hedge funds. These should be mutually uncorrelated, and uncorrelated to broad stock market indices. We believe, if we are successful in our selection of managers, we can reduce the risk in the portfolio and generate high-risk adjusted returns, compared to having only one single manager”.

Although Merrant has so far been trading successfully through many different market scenarios, Hagekrans points out that market neutral strategies are subject to specific risks that one is not exposed to in the long-only space. Of particular importance is the risk of not being truly market neutral.

”One of the risks is the practical ability of managers to maintain a beta of zero. It is very difficult to achieve a truly market-neutral positioning at all times. When historical correlation patterns in the market break, that is the time to be particularly observant,” Hagekrans is aware.

Despite cutting back on fixed income strategies, Hagekrans believes that market neutral strategies overall are in for a period of competitive returns.

”With high uncertainty about the outlook for the global economy, monetary policy and political risk, there is a high possibility that volatility returns to global financial markets, resulting in sharp falls in equity, bond and commodity prices, and an increase in volatility indexes. This is an environment where market neutral strategies excel,” Hagekrans concludes.

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Deutsche AWM Sticks to Strategy Biases – Positive on Equity Market Neutral

BY SIMON KERR / PUBLISHER AT HEDGE FUND INSIGHT

At the beginning of the last quarter Deutsche Asset & Wealth Management's Hedge Fund Advisory Team advised an overweight in equity market-neutral and an underweight in distressed investing strategies. Both have been good calls in the short period since. Here we catch up with Tim Gascoigne, Head of Liquid Alternatives – Hedge Funds, and ask for updates on views on both investment strategies

Is equity market-neutral likely to continue to outperform?

We will probably see continued equity-market volatility in the United States, as investors worry about the timing and magnitude of an interest-rate increase, a potentially stronger U.S. dollar and its impact on corporate earnings. We expect this will maintain a low level of correlation across equities. We continue to hold a positive view on equity market-neutral as the trading environment remains favorable for arbitrage -orientated equity strategies, with dispersion between stocks, sectors and style factors likely to remain a key performance driver. Equity-market liquidity is also healthy after reduced levels over the summer period.

Furthermore, the third-quarter earnings season should provide further reasons for differentiation between individual stocks and market sectors. The increased focus on fundamentals as a determinant of equity valuations, combined with currency and commodity trends, should provide many opportunities for managers to find profitable trades within equity-market-neutral strategies.

Tim Gascoigne, Managing Director
Head of Hedge Fund Advisory
Deutsche Asset & Wealth Management

Are there ways to manage a long-biased approach in the current environment?

We would suggest a close monitoring of equity long/short allocations and prefer approaches with a low net exposure. With regard to geography we feel comfortable with current levels of risk in Europe but would continue to avoid long-biased emerging-market strategies.

Within event-driven strategies, we suggest avoiding the more directional equity-special-situations funds, which can be concentrated on a few events and exposed to any unwinding of risk. Within credit, we would focus on managers that risk manage their overall allocations effectively, focusing on high-quality credits on the long side and keeping smaller positions on the short side.

Will market volatility create opportunities?

For discretionary macro managers, investors' preoccupation with the Chinese growth slowdown represents an opportunity. As market participants reassess its implications for both consumer demand and global inflation, this impacts valuations across yield curves, exchange rates and relative equity sector preferences. For Commodity Trading Advisors (CTA), while we still await the re-emergence of significant asset-class trends that drive the majority of their returns, elevated volatility sets the scene for gains. With regard to the short-term approaches that feed off healthy intraday volatility, their mean-reversion and break-out models are expected to be well-positioned to generate strong returns.

Could there also be good returns in the distressed sector?

Our view is that the current low default-rate environment provides very little opportunity to earn substantial risk premia here. We believe that default rates are likely to stay low for the foreseeable future as companies continue to have access to capital markets to refinance or roll-over maturing debt. However, we expect to see more opportunities within the energy sector due to oil-price volatility forcing companies to restructure their debt.

Can a core portfolio benefit from auxiliary strategies within equity and credit markets?

We suggest a core portfolio built on the three pillars of liquidity, a positive correlation to higher volatility and an ability to perform whether the market is going up or down. This would be comprised of equity-market-neutral, global-macro and CTA strategies. Around this, we would have strategies operating within equity and credit markets where the underling liquidity profile of their assets and the tendency of this to change is an important determinant of strategy selection.

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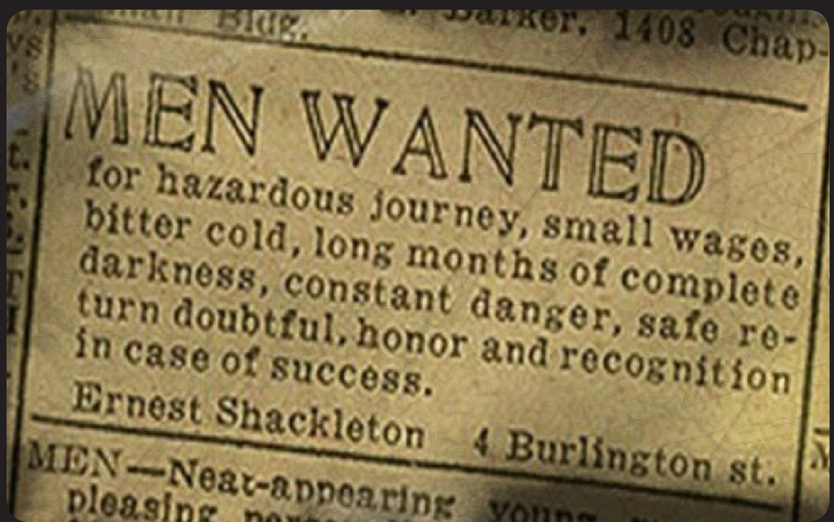

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