VIEWPOINT

MARKET-NEUTRAL FUNDS

Buying and Selling Stocks in One Sector Isn't Market-Neutral

Stocks in market-neutral funds should have a provable interrelationship

Market-neutral funds are designed to deliver low double-digit annual returns, regardless of market volatility. However, many of them have been falling short of that mandate, largely because they're not using traditional strategies.

Like hedge funds, market-neutral funds exploit price discrepancies between related securities, the key being the correlation between the securities. However, the new trend among these funds is to buy undervalued stocks and sell those that are seemingly overvalued—and in most cases there's no real relationship. They may be companies in the same industry or that share some attributes, but essentially, they're merely a collection of stocks that a fund manager believes may go up or down.

THE CONVERGENCE OF TWO SECURITIES FORMS THE BASIS OF MARKET NEUTRALITY

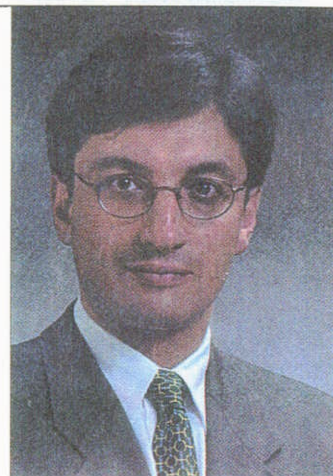
A true market-neutral fund contains securities with a provable interrelationship—for example an equity derivative, such as a convertible security, and its underlying equity. The two securities are related via the contract between them, which assures that at a future time, the two will become fairly priced in relation to each other. This convergence creates the basis for true market-neutral performance.

Risk arbitrage is another market-neutral strategy. In this case, two merging companies establish a relative price for their securities at the time the deal closes. The fund manager, betting that the deal will close and the prices will converge, buys the cheaper security while shorting the more expensive one.

Corporate-structure arbitrage is another example of true convergence. The fund manager simultaneously buys and sells different classes of a company's securities in cases where the two classes represent different investor groups, and thus may be mispriced in relation to each other. This strategy is completely different, say, from betting long IBM stock and short Microsoft stock, in hopes that, because the two stocks have had some sort of historic correlation, they may once again interconnect. This doesn't shield investors from adverse market movement; it merely amounts to two independent bets on companies in the same industry.

Convergence strategies such as convertible-bond arbitrage, fixed-income arbitrage, and corporate-structure arbitrage carry risk, and may experience interim losses. However, investors with a time horizon that mirrors that of the fund's convergence—typically three years or more—can easily estimate the expected return-to-convergence. An appropriate investment horizon and the financial stability to withstand interim market movements can eliminate the danger of being forced to sell at an inopportune time—that is, before convergence occurs.

Perhaps the biggest risk faced by true market-neutral funds is a mismatch between the timing of position convergence and investors' horizons. In most instances, positions are established with an expected convergence of three to five years. The liquidity provided to investors is generally quarterly or monthly. However, if jittery investors begin redeeming their holdings, the fund may be forced to sell positions in the middle of a dip in market valuations, which can imperil the portfolio. It's vital that investors choose a fund with an appropriate convergence period. It's equally important that the fund manager accept only sophisticated, financially enabled investors who thoroughly understand the strategy.



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