

Equity Market Neutral

A Key Component of Asset Allocation in Varying Market Conditions

Market-neutral strategies have been around for roughly two decades. But the more volatile conditions of recent years have increased interest among consulting firms, investment banks and money managers in how this relatively lower-risk investing method may be used to generate competitive returns.

The attraction of market-neutral investing

As the name implies, market-neutral strategies work by seeking to neutralize as many risk factors as possible, including beta, currencies, market caps, sectors, regions and investing styles. For example, in a well-constructed market-neutral fund, if you're long one dollar, you'll be short one dollar, leaving no dollars exposed to the market. With all factors neutralized, the only issue that

should remain is whether the portfolio manager is good at picking stocks, both long and short.

Market-neutral strategies may also have the advantage of being relatively liquid, as they use exchange-traded equities to implement the strategy and avoid less liquid instruments like bank loans, credit default swaps, distressed debt or high yield. Nor is there a need for much leverage.

As the exhibit below indicates, the correlation characteristics of market-neutral strategies are appealing, compared not only with traditional long-only equities and fixed income, private equity and real estate, but also with non-traditional approaches, such as other hedge fund strategies.

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EXHIBIT I: LOW CORRELATIONS TO TRADITIONAL AND ALTERNATIVE ASSET CLASSES

Traditional Asset Classes	Equity Market-Neutral
Equity Market-Neutral*	1.00
S&P/TSX Composite	0.58
S&P 500	0.26
MSCI EAFE (N)	0.39
FTSE EPRA/NAREIT GIB (G)	0.10
ML High Yield	0.17
DEX Universe	(0.19)
DEX 91-Day T-Bill	(0.10)

Alternative Asset Classes	Equity Market-Neutral
Equity Market-Neutral**	1.00
Convertible Arbitrage	0.18
Dedicated Short Bias	(0.15)
Emerging Markets	0.22
Event-Driven	0.38
Fixed-Income Arbitrage	0.36
Global Macro	0.03
Long-Short Equity	0.22
Managed Futures	(0.09)
Multi-Strategy	0.42

Source: Pyramis Global Advisors and Credit Suisse/Tremont Hedge Funds. Correlation is based on monthly returns (local currency) for the period from December 31, 2006, to December 31, 2009.

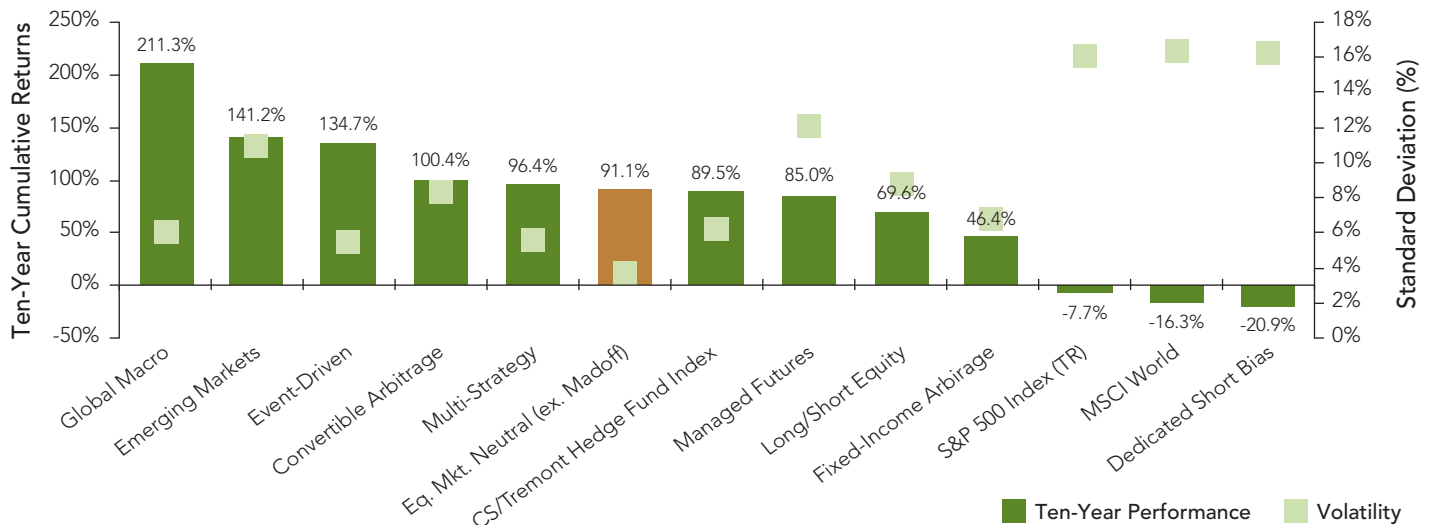
* Represented by HFRI EH: Equity Market Neutral Index.

** Based on Credit Suisse/Tremont Hedge Fund Index.

As seen in the graph below, market-neutral strategies can also provide solid risk-adjusted returns. In the past decade, they have provided returns similar to those of most hedge fund strategies, but without the high volatility associated with hedge funds.

EXHIBIT II: MARKET-NEUTRAL STRATEGIES MAY PROVIDE STABILITY RELATIVE TO OTHER HEDGE FUND STRATEGIES

Ten-year performance and volatility for strategies in the Credit Suisse/Tremont Hedge Fund Index and equity markets



Source: Credit Suisse/Tremont Hedge Fund Index and Bloomberg. Excludes the Kingate-related November 2008 writedown. January 2000 – December 2009 (USD).

Index or benchmark performance shown in the bar graph above does not reflect the deduction of advisory fees, transaction charges and other expenses, which would reduce performance. Investing directly in an index is not possible. Past performance is no guarantee of future results.

Quantitative or fundamental?

There are two basic ways to manage a market-neutral strategy. The quantitative method, used by the majority of investors, looks at historical information, including earnings, valuation, share buy-back activities and insider trading activities, to try to predict the best companies to buy and to short in a portfolio. The other, or fundamental approach, looks at more fundamental research that might or might not be captured by quantitative tools. This approach tends to be more forward-looking.

In general, quantitatively based market-neutral strategies have not fared as well as fundamentally based strategies since 2007. In part, this may be because quantitative managers have tended to use the same algorithms and models, in effect chasing

¹ Source: Credit Suisse/Tremont Hedge Funds Index, Bloomberg.

Important Information

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the same cheap growth opportunities and overcrowding the marketplace. Managers would be better advised to tweak their models and look in different areas for growth.

Putting market-neutral into practice

Despite this caveat, market-neutral strategies produce results that compare favourably with traditional asset classes. Using various index data, market-neutral strategies have, over the past four years, shown low to negative correlations with several traditional hedge fund strategies, including the convertible arbitrage, short-biased and event-driven strategies found in many clients' portfolios. Similarly, market-neutral compares favourably in terms of risk-adjusted returns or Sharpe ratios over longer periods.¹