

# INVESTMENT INSIGHTS

## Spotlight on: Market neutral investing

### A brief history of market neutral investing

Market neutral strategies were first applied to stocks in 1949, when Alfred Winslow Jones popularized short selling, a technique that enables investors to profit from declining stock prices. Jones theorized that portfolios holding both long and short positions could yield positive results regardless of general market movements.

Jones' innovative investment technique did not garner significant interest as a mutual fund vehicle for nearly 50 years. In 1997, the Internal Revenue Service lifted certain restrictions on short selling, opening the door to market neutral mutual funds.

### A focus on positive returns regardless of market direction

Today, many investors remain reluctant to invest in stocks given market uncertainty. While bonds offer an alternative, their values may start to decline if interest rates begin to rise. Market neutral strategies provide another viable option. These portfolios combine offsetting long/short positions, seeking to offer consistent positive returns whether markets rise or fall.

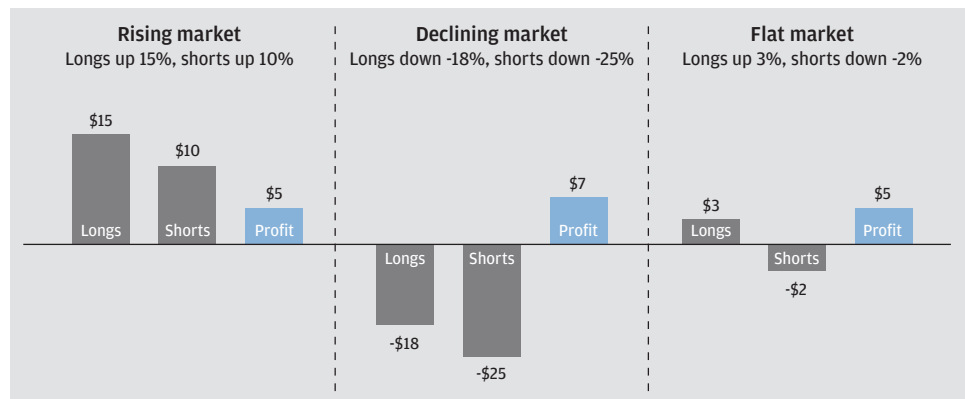
### Positive return potential in any market environment

Market neutral strategies and other absolute return investments pursue positive returns no matter what happens to the economy, interest rates or financial markets. This approach to capturing non-correlated performance has the potential to increase returns, reduce risk and expand diversification when added to a portfolio of traditional assets.

Professionally managed market neutral portfolios implement short and long positions in an effort to eliminate market risk exposure. This can produce positive returns independent of the broad market if the portfolio's long positions outperform its short positions. For example, returns would be positive in rising markets if longs rise more than shorts. In declining markets, returns would be positive if longs fall less than shorts [see Exhibit 1].

The return difference between long and short holdings is known as the "spread," and a market neutral strategy's total return is created by this spread plus any interest earned from cash holdings. Consequently, a portfolio that combines equal long and short positions relies purely on manager stock selection skill to generate returns.

### Exhibit 1: Positive returns when longs outperform shorts (hypothetical \$100 investment in various markets)



These charts are shown for illustrative purposes only and are not indicative of any particular investment.

Shorts down refers to a depreciation in the price of the security resulting in a gain on the short position. For more information please see our *Spotlight on: Short selling*

### Comparing different long/short strategies

There are three different types of long/short portfolios, all of which focus on various degrees of reducing volatility and enhancing return potential. Each may play a unique role within a diversified portfolio.

#### Market neutral

- Seeks to neutralize market risk and generate positive results regardless of market direction
- Uses shorting to reduce long exposure (typically 100% long and 100% short)
- Little or no exposure to overall market risk

#### Long/short hedged

- Seeks equity-like returns with less risk
- Uses net long exposure with long/short position ranges
- Reduced exposure to overall market risk

#### 130/30

- Seeks to increase returns relative to a market or benchmark
- Uses shorting to pursue additional performance while controlling risk (typically 130% long and 30% short)
- Similar risk as overall market

For more information about these strategies, please see the *Investment Insights* overview on *Short selling: Removing long-only constraints to add portfolio value*

### How market neutral longs and shorts work together

One of the most common market neutral strategies involves investing equal dollars in long (buy) and short (sell) positions. In a typical market neutral portfolio, the goal is for total returns to exceed prevailing money market rates by anywhere from 2% to 5%. Compared to long-only stock investing, these strategies have the potential to generate relatively attractive returns with significantly less volatility, since they can benefit from both rising and declining stock positions.

Generally speaking, market neutral strategies include three sources of return: the actively managed long and short positions and the cash component.

- The **long portfolio** houses the manager's best "buy" decisions. These are attractive stocks the manager believes will appreciate in value over time. As such, the long portfolio realizes positive results when its stocks rise in value and negative results when prices decline.
- The **short portfolio** contains stocks the manager considers unattractive or trading at higher prices than their true worth. To capitalize on these likely underperformers, the manager borrows stocks, sells them immediately and invests the proceeds in cash. If a shorted stock declines in value, the manager can buy it back for less than the original sales price, thus earning a profit when borrowed shares are returned to the lender. Conversely, if a shorted stock rises in value, the manager pays a higher price and suffers a loss.
- The **cash component** is funded primarily with the proceeds from short sales. It is invested in Treasury bills or other cash equivalents earning prevailing interest rates. It also serves as the margin account for the short portfolio.

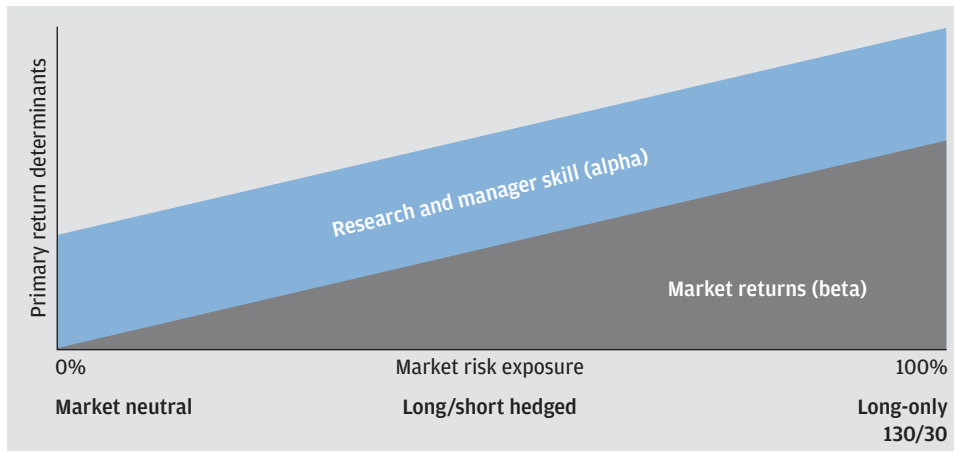
### Skilled stock selection is key

When a portfolio combines equal long and short positions, stock selection becomes the driving force behind performance. Success depends on selecting longs likely to appreciate more rapidly in rising markets and shorts likely to decline faster in falling markets. As a result, market neutral managers rely heavily on an intensive research effort to gather insights into stocks and generate sound investment ideas. In a falling market, for example, strong stock selection should help limit losses from long positions, while maximizing gains from short positions to earn a positive net spread.

Using long buys and short sells to take offsetting positions in a specific sector or industry is known as "hedging." For example, a manager may hedge exposure to the health care sector by purchasing (long) health care stocks expected to perform well and selling (short) health care stocks expected to perform poorly. This strategy seeks to reduce overall portfolio risk and enhance return potential by neutralizing exposure to broad market movements, which are also known as "beta."

In a market neutral strategy, the manager needs to maintain zero beta exposure to the overall market to avoid introducing any added risk or volatility into the portfolio. Market neutral strategies often also seek to maintain dollar and sector neutrality as part of a disciplined portfolio implementation process. The net spread between long and short performance drives returns when the strategy is truly market neutral and directly reflects the manager's stock-picking skills [see **Exhibit 2**].

## Exhibit 2: Comparing alpha and beta exposure



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## Low correlations, high diversification potential

Performance correlations are a critical factor to consider when building a diversified portfolio. Some investments are positively correlated to each other, meaning they tend to react similarly to market or economic trends. For example, small and mid cap value stocks generally rise and fall at the same times, in similar patterns.

In contrast, negative correlations can be found among securities from different asset classes (stocks vs. bonds) or with different characteristics (government bonds vs. high-yield bonds). Non-correlated securities make excellent diversification tools by allowing investors to pursue increased returns from assets that respond differently to changing conditions. This may expand return potential while helping to protect against downside risk, because gains in one investment may offset losses in another.

Market neutral strategies have had little or no correlation to stocks and bonds, meaning they generally have moved independently of traditional asset classes often found in investors' portfolios [see Exhibit 3]. At J.P. Morgan, we believe non-correlated assets like market neutral strategies, real estate and high-yield bonds can play important roles in any portfolio, from the most conservative to the most aggressive. Adding these alternative assets may help investors reduce downside risk without sacrificing upside return potential.

**Exhibit 3: Market neutral strategies have exhibited low correlations to traditional investments**  
(January 1, 2000 – September 30, 2011)

	1	2	3	4	5	6	7	8	9	10	11
Large Cap (1)	1.00	0.94	0.92	0.87	-0.32	0.79	0.65	0.43	0.74	0.79	0.49
Small Cap (2)		1.00	0.88	0.83	-0.37	0.73	0.56	0.36	0.79	0.74	0.46
EAFE (3)			1.00	0.91	-0.22	0.75	0.63	0.51	0.73	0.85	0.66
EME (4)				1.00	-0.20	0.80	0.70	0.54	0.64	0.86	0.53
Core Bonds (5)					1.00	-0.11	0.16	-0.23	-0.04	-0.22	-0.02
Corp. HY (6)						1.00	0.85	0.51	0.68	0.78	0.40
EMD (7)							1.00	0.42	0.59	0.64	0.34
Commodities (8)								1.00	0.39	0.69	0.49
Real Estate (9)									1.00	0.60	0.50
Hedge Funds (10)										1.00	0.58
Equity MN (11)											1.00

Source: Source: Standard & Poor's, Russell, Barclays Capital Inc., MSCI Inc., Credit Suisse/Tremont, NCREIF, DJ UBS, J.P.Morgan Asset Management Indexes used - Large Cap: S&P500 Index; Small Cap: Russell 2000; EAFE: MSCI EAFE; EME: MSCI Emerging Markets; Bonds: Barclays Capital Aggregate; Corp HY: Barclays Capital Corporate High Yield; EMD: Barclays Capital Emerging Market; Comdty: DJ UBS Commodity Index; Real Estate: NCREIF Property Index; Hedge Funds: CS/Tremont Multi-Strategy Index; Equity Market Neutral: CS/Tremont Equity Market Neutral Index. \*Market Neutral returns include estimates found in disclosures.

This chart is shown for illustrative purposes only.

**A compelling fixed income alternative**

Investors frequently use market neutral strategies to diversify equity allocations. This makes sense because, compared to stocks, market neutral investing has shown less volatility, low correlations and little or no exposure to broad market risks. For many of these same reasons, market neutral strategies can also help diversify fixed income allocations.

- Risk/reward characteristics similar to bonds: Market neutral strategies generally seek total returns of 2% to 5% over prevailing money market rates with standard deviations in the 3% to 5% range, similar to many bond holdings.
- Low correlations: Market neutral strategies historically have not moved in tandem with fixed income markets.
- Potential benefits from rising short-term interest rates: Higher rates typically decrease the value of existing bond holdings, but they increase the yields earned by market neutral cash portfolios.

With short-term interest rates currently at zero, it appears highly likely that rates will rise over the next two to five years. This poses a threat to investors who are now overweighting bonds in response to high volatility and disappointing stock performance over the past decade. As interest rates rise, bonds may generate negative returns. Adding a market neutral strategy offers one possible solution to help mitigate this risk by hedging fixed income exposure and potentially profiting from a rising-rate environment.

**Adding a market neutral strategy to a diversified portfolio**

Investment role	Who may benefit
Capture positive return opportunities regardless of market movements	Investors unsure where to invest or who have reduced risk tolerance in the wake of extreme market volatility
Expand diversification	Investors who want to lower overall portfolio risk by adding non-correlated assets
Earn higher return potential than cash with less interest-rate risk than bonds	Investors with excess cash frustrated by historically low returns or overexposed to bonds at a time when interest rates may rise