Institutional Investor's alpha

Making Do in a Zero-Interest-Rate World

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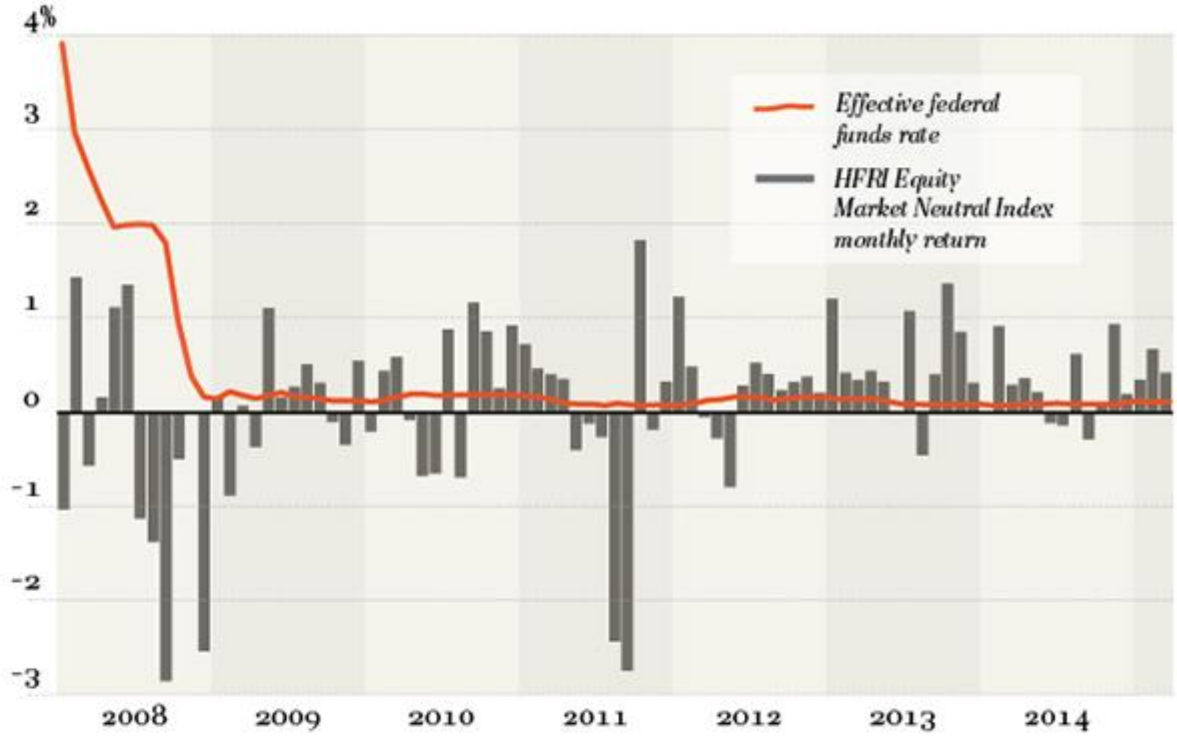
A rise in short-term interest rates would be "good for the investor, but it shouldn't be a free ride for managers."

A lot of investors are keeping a close eye on the Federal Reserve, but few are as eager to see a hike in short-term interest rates as U.S.-based market-neutral equity managers. "No one ever talks about the impact of short-term interest rates on market-neutral strategies," says Jason Cross, global head of equity strategies at Minneapolis-based Whitebox Advisors, which manages about $4.2 billion and runs its market-neutral strategy in both hedge funds and mutual funds. "Short-term rates are a very important consideration. If, say, three years from now short-term interest rates are at 2 percent, my expectation is that the returns of these strategies should go up by 2 percentage points."

Rising interest rates could provide a much-needed boost for a strategy that has been posting average returns in the low single digits while cash balances are earning almost nothing with short-term interest rates near zero. Hedge Fund Research's HFRI Equity Market Neutral Index was up 0.96 percent this year through April and rose 3.08 percent in 2014.

Market-neutral equity funds tend to have significantly more capital in cash than other hedge fund strategies. In a traditional market-neutral strategy, the fund makes a balanced number of long and short bets, often thousands at a time, to try to produce a positive return uncorrelated to overall market movements. By shorting — selling borrowed securities — the fund generates cash and typically winds up holding an amount about equal to the original invested assets that can earn interest.

At Man Numeric, a Boston-based quantitative equity manager with $16.7 billion under management and a strong emphasis on market-neutral strategies, Gregory Bond agrees that a rise in short-term rates would help market-neutral bottom lines. "It is good for the investor," says Bond, the firm's co-head of hedge fund strategies. "But it shouldn't be a free ride for managers."



Sources: Hedge Fund Research; Federal Reserve Bank of St. Louis.

Instead, Bond asserts, market-neutral managers should get credit for navigating choppy markets to produce steady, uncorrelated returns. According to filings by Numeric's parent, London-based Man Group, the Numeric US Market Neutral strategy was up 1.8 percent in 2014 and the firm's World Market Neutral strategy rose 3.6 percent.

Interest rates, and the central bank policies behind them, aren't merely a factor in how much managers can earn on cash. Central bank stimulus policies have been credited with spawning several years of a U.S. equity market with one direction: up. When equities rise in unison, dispersion in performance among individual stocks and sectors drops, making the task of finding good short bets challenging.

"It has been difficult for [market-neutral equity] managers to make money on the short book," says Robert Christian, head of research at K2 Advisors, a Stamford, Connecticut–based fund-of-hedge-funds firm that is part of Franklin Templeton Investments.

With the Fed having signaled the end of quantitative easing, U.S. markets have begun to adjust in anticipation of higher interest rates, leading to greater dispersion and more opportunity for shorting. "Clearly, the environment is getting better in the U.S. for market-neutral players," says Philippe Ferreira, head of research at Lyxor Asset Management in Paris. Lyxor manages about $21 billion in alternative assets. "They should continue to perform well."

Ferreira says newly aggressive central bank stimulus policies in Europe have cut into short positions there, while Japan has seen some similar challenges for shorting: "In Europe and Asia dispersion is going down, and market-neutral strategies exposed to those regions are suffering somewhat."

Despite the challenges, market-neutral equity managers continue to attract new investors looking for a way to shield their portfolios from setback, particularly if U.S. markets turn. "A lot of people are nervous about the level of equity beta in their portfolios," says Yung-Shin Kung, head of portfolio management in the Americas for Credit Suisse Asset Management's alternative funds strategies business.

For those investors market-neutral equity might be the antidote at a time of rising interest rates and falling equity performance. And rising interest rates could also provide a bonus to market-neutral returns.