Global Equity Market Neutral Strategy

A unique approach to style-based absolute return investing
Having developed his first style strategy in 2003, Erik Rubingh has been leading our Systematic Strategies team since 2007. Extending and enhancing our capabilities over time the team has developed an innovative True Styles approach that has been successfully employed within a range of strategies, both long and long / short.
Global Equity Market Neutral Strategy

A systematic equity market neutral investment strategy focusing on style premia and aiming to deliver attractive absolute returns with low correlation to traditional asset classes.

Absolute return strategy

- The strategy aims to deliver positive absolute returns regardless of market conditions.
- The strategy targets a return of 7% over the risk free rate with 10% target volatility.
- Rationale for style based approach supported by academia and empirical evidence.
- Low correlation is achieved with traditional asset classes including bonds, equities and hedge fund indices.

Understanding portfolio returns

- Typical portfolio returns are comprised of two elements – beta (the market return) and alpha (outperformance of the market).
- Outperformance is often a result of persistent exposure to certain styles; the remainder may be attributable to stock picking.
- Style-based investing aims to add value through focused exposure to defined styles and the ‘premia’ they generate whilst reducing exposure to stock-specific risk.

Correlation of Global Equity Market Neutral Strategy to key traditional asset classes


Source: BMO Global Asset Management. For illustrative purposes only.

*The strategy aims to deliver a positive return regardless of market conditions but such a positive return is not guaranteed. Capital is at risk and an investor may receive back less than the original investment.
What is an equity style?

Styles are quantifiable characteristics of securities that determine the return and volatility of those securities. It has been shown academically that a significant amount of investment returns can be explained by styles. These styles have demonstrated persistent positive returns associated with them over time.

These style premia can either be used to improve the risk adjusted returns of equity portfolios or, as we do in this market neutral strategy, captured to provide positive absolute returns independent from equity markets.

What styles do we target within the strategy?

We have carefully selected a combination of styles that have been recognised for positive returns, in academic and empirical research, over a sustained period (size, low volatility, momentum, value and growth at a reasonable price: GARP). We believe that this combination of styles is an effective way to capture excess returns available in equity markets.

<table>
<thead>
<tr>
<th>Style</th>
<th>Description</th>
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<tbody>
<tr>
<td>Growth at a reasonable price</td>
<td>Stocks with good growth, moderate valuations and good quality financial statements represent ‘the best of all worlds’</td>
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<tr>
<td>Low volatility</td>
<td>Aversion to leverage and the ‘lottery effect’ lead to low risk stocks performing better than expected under traditional finance theory</td>
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<tr>
<td>Momentum</td>
<td>Under reaction to news and extrapolation of past trends lead to past winners continuing to win and past losers continuing to lose</td>
</tr>
<tr>
<td>Size*</td>
<td>Higher (diversifiable) risk of smaller companies leads to better returns of smaller companies as a group</td>
</tr>
<tr>
<td>Value</td>
<td>Excessive pessimism about the prospects of ‘dull’ companies and optimism about ‘glamour’ companies leads to mispricing</td>
</tr>
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*Size is implemented on a periodic basis in the market neutral strategy
“We employ a systematic approach that intelligently combines exposure to a range of styles extracted from the MSCI World Index universe.”

Erik Rubingh, Head of Systematic Strategies.

Observed returns to selected styles

Source: BMO Global Asset Management, Factset. January 1988 to 30 September 2016. The returns represent the outcome of buying the top 20% of stocks with each particular attribute and selling the bottom 20%, rebalanced monthly, and do not include any transaction costs. This information is not a representative investment strategy but an indication of the efficacy of each style. A logarithmic scale shows two equal percent changes plotted as the same vertical distance on the scale.

Buying rising stocks and selling falling stocks leads to excess outperformance of about 1% per month (1965-1989)

- “the momentum factor”
  Jegadeesh & Titman (1993)

Small cap stocks outperform large cap stocks over the long term (1962-1989)

- “the size factor”
  Cheap stocks (based on fundamental ratios such as price-to-book or price-to-earnings) outperform “expensive” stocks
  - “the value factor”
  Fama & French (1992)

Over the past 40 years, high volatility and high beta stocks in U.S. markets have substantially underperformed low volatility and low beta stocks.

- “low volatility factor”
  Baker, Bradley, Wurgler (2009)
The importance of our ‘True Styles’ approach

While exploitation of styles alone is an attractive concept, using only the ‘raw’ styles (e.g. book-to-price for value) may not be the best approach. What we need to consider is that the various styles can be driven by shared components.

For example
A small Italian retailer may look cheap from its book-to-price ratio, but if all Italian stocks are cheap, does it really represent value? Before we can come to a conclusion, we need to remove the shared elements that contribute to the valuation to discover the ‘True Styles’.

From Styles... ... to ‘True Styles’

Raw styles are attractive but not necessarily independent. This can lead to:
- Lower return characteristics
- Lower diversification benefits

Our unique ‘True Styles’ approach:
- Isolates the desired style
- Aims to improve long-term return
- Lowers correlation between styles
- Greatly improves predictive power

‘True Styles’ example: Value

Step one:
We take a list of the stocks that make up the MSCI World Total Return Index and their book-to-price ratios, where a high value indicates a stock is cheap and a low value indicates a stock is expensive.

Step two:
We adjust the book-to-price ratios to remove the effect of other styles as well as country and sector effects. We now have a list of stocks in the MSCI World Total Return Index and their ‘true’ book-to-price ratio. The true book-to-price ratio indicates the cheapness of a stock relative to other similar stocks. This is also how active managers like to compare stocks – they will buy a stock that is cheap relative to its peers.

Step three:
We create a portfolio which maximises the exposure to the book-to-price ratio. This value portfolio is now less likely to include stocks that have negative momentum for example.

Over a number of years we have developed and refined a methodology that extracts the ‘True Styles’. Our methodology removes the shared components from the raw variables, simultaneously, to come to an improved metric of the desired style.

Not only does the ‘True Styles’ methodology greatly improve the predictive power of the styles; by removing the shared components it also lowers the correlations significantly, thereby improving the diversification benefits.

The following is an example, utilising true value style, of how we create our portfolios to neutralise other influencing styles.
‘True Styles’ in focus

Taking the value style as an example, the ‘True Styles’ methodology increases the risk-adjusted returns generated by book-to-price, with a significant enhancement to the Sharpe Ratio.

Benefits of diversification – low correlation between styles

Reducing absolute correlation between styles

In this bar chart, we show how our refined individual True Style exposures demonstrate lower correlations with other styles than their raw style counterparts do.

Market neutral construction

We minimise operational complexity in the strategy by taking exposure to our selected ‘True Styles’ through a repeatable systematic process, operating within a robust risk framework. We outline the key stages below.

1. Individual market neutral ‘True Styles’ portfolios
   Custom optimisation tool maximises desired styles within strict country/sector/stock limits and minimises stock specific risk.

2. Multi-style portfolio
   The style portfolios are combined into one multi-style portfolio using an (active) Equal Risk Contribution methodology.

3. Define risk level
   Small positions are trimmed and portfolio is adjusted to get to desired risk level.

4. Ongoing monitoring and rebalancing
   Model run monthly, although not every portfolio transacts each month with turnover capped to limit transaction costs.

Equity Market Neutral® - An investment strategy that seeks to exploit differences in stock prices by being long and short in stocks within markets, sectors, industries or countries. This strategy is intended to create returns that, over an extended period of time, are uncorrelated with general equity market performance, however this cannot be guaranteed and over discrete periods there may be a high degree of positive or negative correlation.