REDUCE INVESTMENT RISK WITH

MARKET NEUTRAL STRATEGIES

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Introduction

Market-neutral investment strategies are not about investing in financial products that are safe from the fluctuations affecting the market. ***A market-neutral strategy is about creating a hedge against the factors affecting the market by adopting different positions.***

This approach is focused on generating absolute returns on the long-term instead of relative returns or immediate profits. Using market-neutral investment strategies is ideal for investors who have some experience with stock picking or who can benefit from the recommendations of a qualified investment advisor or fund manager.

There are a few concepts you should be familiar with to gain a better understanding of market-neutral investment strategies:

1. A long position refers to the purchase of a commodity motivated by the belief it will gain value.

2. A short position refers to the sale of a commodity motivated by the belief it will lose value.

3. ***A market-neutral investment involves a long and a short position so that gains and losses can offset each other regardless of how the market moves.***

> ***"An active investor is someone who actually lives off their investments as opposed to wages from a job".***
>
> ***- Robert Kiyosaki***

How Do Market-Neutral Investment Strategies Work?

A market-neutral strategy is created by adopting different positions that allow you to generate a profit regardless of how the market moves.

Carefully selecting stocks or other products that move in opposite directions and balancing your positions so that you have equal interests in each position enables you to yield a profit without relying on market fluctuations.

Pros and Cons of Market-Neutral Investment Strategies

Be aware of these downsides before looking for market-neutral positions:

1. **Two portfolios.** You cannot generate a market-neutral position unless you have two portfolios (one for your long position and one for the short one). There is a risk of losing both positions if they're not effectively picked and managed.

2. **Higher fees.** ***Managing two portfolios means there are higher fees associated with this type of investment strategy.*** Most fund managers will charge you regular management fees as well as a percentage of the profit, and managing your portfolios yourself means you will have to pay transaction fees for two portfolios.

3. **Finding the right position requires time and expertise.** You might have a hard time coming across positions with enough flows to generate a profit that makes this strategy worth your while.

4. **Be realistic.** Some fund managers present market-neutral strategies as quick and easy ways to make money. Be realistic when adopting market-neutral positions and you won't be disappointed.

On the other hand, with a good risk management strategy, market-neutral investments allow you to:

1. **Reduce risks.** You can reduce the risks associated with investing since your yield will not depend on market fluctuations.

2. **Diversify.** Diversify your portfolio by adopting a long and a short position.

3. **Leverage an existing position.** You may be able to get more out of a long position by adding a short position to your portfolio.

4. **Generate profits.** ***You can expect profits as long as you benefit from the advice of a qualified fund manager or have the skills to manage your portfolios yourself.***

When Should You Consider a Market-Neutral Investment Strategy?

There are a few things to consider before adopting market-neutral positions:

1. **Long-term investment.** A market-neutral investment strategy is ideal if you are ready to invest for the long term.

2. **Market conditions.** You should consider this approach if there are no other opportunities on the market, since you

can generate a profit regardless of how the market fluctuates. ***If the market is not in great shape and there are no signs of a possible recovery, adopting market-neutral positions could be your best choice.***

3. **Lower the risks of an aggressive portfolio.** This is a great strategy if you currently have a fairly aggressive portfolio and need a diversification strategy that will lower your risks.

4. **Market-neutral investment strategies require some management.** You will not get the results you were hoping for unless you keep an eye on your positions or hire someone to do it for you.

How Should You Manage Your Positions?

Apply these simple principles to optimize your decision-making process when managing your market-neutral positions:

1. **Bull market. *Your long position is going to generate a profit.*** Sell the short position. You will generate a return on your investment, thanks to the sale of the short position and the profits generated by your long position.

2. **Bear market.** If the market is performing poorly, your long position will lose some of its value. ***Conversely, your short position will become more valuable*** and you should be able to generate an interesting profit by selling this position.

3. **Maintain your balance between long and short positions.** Failing to sell your short position on time or to strengthen it to maintain a balance with your long position could ruin your entire strategy.

What Kind of Products are Best for this Approach?

Stocks are often used to create market-neutral positions, since it's fairly easy to find long and short positions. However, stock picking can be challenging if you lack experience.

It is possible to find market-neutral positions with other products, including bonds, indexes, currencies, and commodities. Contracts such as futures and options are often used to create a hedge against market fluctuations.

"Where you want to be is always in control, never wishing, always trading, and always, first and foremost protecting your butt. After a while size means nothing. It gets back to whether you're making 100% rate of return on $10,000 or $100 million dollars. It doesn't make any difference".

– Paul Tudor Jones

Creating a Market-Neutral Investment Strategy

Pair trading and delta hedging are the two most common strategies used to adopt a market-neutral position.

Pair Trading

Pair trading is about finding two financial products with a correlation. Traditionally, stocks are used for this strategy, but ***it's possible to follow this same principle with any two correlated products.*** Historical data on the two products is used to calculate the standard deviations between the values of the two products and to adopt a market-neutral position.

Follow these steps to create a market-neutral position with pair trading:

1. **Find two products with a correlated value.** These are some examples of the financial products that fund managers and investors use for this strategy:

- ***Two stocks from companies in the same industry.*** The value of stock A will increase if company A does more business than company B, and the value of stock A will drop if company B does better than company A.

- ***Two correlated indexes.*** The S&P 500 and the Dow Jones Utilities Average are popular products for this strategy.

- ***Two currencies.*** Any of the popular currency pairs traded on Forex can be used for this strategy (USD and Euros, Yen and USD, GBP and Euros, GPB and USD, and so on)

- ***An index or a commodity and its future contracts.*** Use the index or the commodity as a long position and adopt a short position with a future contract that is gaining value.

- ***Let's take an example:*** Companies A and B sell a similar product and the daily charts for both stocks look like they have very similar ups and downs.

2. **Look at the price history of the two products you selected.**

    - Price charts should be acquired for stocks A and B (from either financial sites or trading tools). Ideally, price charts should go back a few months to establish an accurate estimation of the correlation between the two stocks.

3. **Calculate a price ratio by dividing the price of product A by product B.**

    - Calculate the correlation between stock A and stock B. If stock A is currently trading at $12 and stock B at $16, the current correlation ratio is roughly 0.8. Use software to calculate the correlation at several points in time and get an idea of how stable this ratio is.

    - ***If the correlation ratio varies a lot, the two stocks are not good candidates for this strategy.***

4. **Look at the deviations.** The first or the second deviation is usually a good indication of how the products perform.

- The average correlation ratio between stock A and B is 0.8. Use trading software to create a price chart that shows the price ratio and its deviations. For instance, the price ratio between stock A and B recently reached 1.6 (due to stock B gaining value up to $18 and stock A dropping to $28). The price ratio is well over the standard deviation and it is time to enter the trade.

5. **Purchase your positions.** ***Establish a long position with the product that underperforms and a short one with the product that performs well.***

    - With stock B reaching $18 (well above the usual $12 trading value), adopt a short position with this stock and use the underperforming stock A as a long position.

6. **Ensure your two positions have an equal dollar value.**

    - Perhaps you have a little over $200 to invest in this strategy. Purchase 4 shares of stock A and 6 shares of stock B. ***Maintain this equal dollar value by purchasing more of stock A or B as needed.***

7. **Establish a stop-loss point. *This point is important in case both investments fall through.***

    - Your stop-loss point depends on the risks you're willing to take. For example, if you don't wish to take the risk of losing more than 40% of your initial investment, sell everything if the combined value of your shares of stocks A and B drops below $112.

8. **Use the price ratio history to determine the best time to sell and generate a profit.**

    - Look at the price ratio history of stocks A and B. Since you adopted a short position with stock B, you should see whenever the price ratio goes above its average of 0.8.

    - If you notice that one deviation is usually followed by another larger one, wait for the first deviation to occur and sell when the second one starts.

Delta Hedging

Greek letters are used to refer to the different factors that influence the price of an option. Delta is the letter used to

refer to how the value of an underlying position influences the price of an option.

It's possible to adopt a market-neutral position known as a delta neutral position, for instance by adopting a short position on an underlying stock and a long position on the corresponding call or put option. ***Delta is used to calculate the ideal investment to keep these two positions in balance.***

Follow these steps to adopt a delta neutral position:

1. **Use a calculator or a simulator to calculate delta on the two products you are interested in.** There are free online calculators available but you can achieve the same result by using Excel.

    - For instance, a stock is currently trading at $25. Delta is estimated at 0.5 and the call option is worth $1.5.

2. **Look at how the underlying stock influences the value of the option.** For instance, a delta of -.3 means the value of the option is reduced by 30 cents for every dollar the underlying stock gains.

    - With our example, a delta of 0.5 means the call option will lose $0.50 whenever the stock gains a dollar and

will gain $0.50 if the value of the stock is reduced by a dollar.

3. **Use the underlying stock as a short position and the corresponding option as a long position.**

   - With this example, one call option equals 100 shares. ***Establish a long position by purchasing shares.*** You could, for instance, purchase four shares for a total of $100.

4. **Multiply the value of your current long position by delta.** If delta was -.3 and your current position is worth $100, you would obtain -30.

   - You invested $100 and bought four shares of the stock that was trading at $25. Delta equals 0.5. You need to multiply your long position by delta to establish the value of your short position. In this case, you should invest $50 on the call options.

   - ***Once you've established a long position worth $100 and a short one worth $50, your portfolio is delta neutral.***

5. **Adjust your short position accordingly.** With this example, you would need to purchase $30 worth of the underlying stock to achieve a delta neutral position.

    - ***Delta will change before the call options expire.*** You'll have to re-balance your portfolio. For instance, if delta jumps to 0.7, you would have to purchase an additional $20 worth of call options to maintain a delta neutral portfolio. If delta goes down to 0.3, you can either sell $20 worth of call options or decide to consolidate your long position.

> ***"The time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell".***
>
> ***– John Templeton***

Hedge Funds

Creating a market-neutral investment strategy with pair trading or delta hedging requires some degree of experience with investing. ***If you would like to diversify your investment portfolio with some market-neutral positions without picking and managing these positions, your best option is to invest in a hedge fund.***

There are hedge fund databases available through a number of financial institutions. These databases allow you to get a better idea of the securities used for each fund and give you access to information on how a fund is performing. Take the time to review this information before selecting a hedge fund for your portfolio.

How Are Hedge Funds Different From Other Funds?

- A hedge fund is a collection of underlying securities. A hedge fund can include a selection of stocks, bonds, commodities, contracts such as futures, and options or real estate.

- ***Unlike other funds, hedge funds are not regulated by the Securities and Exchange Commission.*** This allows for more leeway in how securities are selected and combined.

- Most hedge funds investors use leverage. This means that money is borrowed to invest, usually to strengthen a short position.

What are the Downsides to Investing in a Hedge Fund?

1. **Hedge funds are traditionally not very liquid.** These funds are designed for investors who are interested in adopting long-term positions. Some products may be added to the fund on the short-term to create a market-neutral strategy, but you shouldn't choose a hedge fund unless you're ready to invest for at least a few months.

    - A hedge fund that includes shares in startup companies could keep your money tied up for years.

2. **You have no control over results or risks.** ***The results you get from this investment depend entirely on the skills of your fund manager and on the financial institution behind the fund you selected.***

    - It's important to choose a transparently-managed hedge fund so you have a good idea of how much exposure to risks you have.

3. **Hedge funds are not available to all investors.** You'll probably have to prove that you have a certain amount of capital available before getting access to a hedge fund.

How Are Hedge Funds Managed?

1. **Fund managers usually earn a fixed fee as well as a percentage of the profit generated.** This motivates managers to produce greater profits.

    - ***The shortcoming of this payment strategy is that some managers are tempted to take unnecessary risks in an effort to perform better.***

2. **Managers rely on a number of strategies to create a market-neutral position.** Some funds are based on long and short strategies similar to the ones described in this guide, while other managers create a market-neutral position by investing in emerging markets or using options.

> ***"Investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas".***
>
> ***- Paul Samuelson***

Conclusion

A market-neutral investment can be a great addition to your portfolio if you get help from a professional or are confident about your own stock picking and management skills.

Just like with any other investment strategy, a detailed plan that includes risk management, expected profits, and an efficient monitoring and management strategy will enable you to adjust your positions as needed.

Remember that the best way to protect your portfolio from the vicissitudes of the market is to diversify your positions as much as possible. Even though market-neutral positions are about reducing risks, ***these positions should not account for the entirety of your portfolio.***

It's important to have realistic expectations regarding the returns on your market-neutral investments before you decide to consolidate your portfolio with one of these strategies.

> ***"If investing is entertaining, if you're having fun, you're probably not making any money. Good investing is boring."***
>
> ***– George Soros***