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Uncorrelated Through COVID

Three years ago, we argued that, at a high level, the liquid hedge fund universe could be bifurcated into two camps.¹ Directionally biased approaches seek alpha, but may be correlated to traditional equity, credit or other market risk premia. Uncorrelated strategies seek alpha, but are more agnostic as to direction and have not exhibited any meaningful correlation to traditional asset markets.

There have been ups and downs since then, but the COVID-19 crisis of 2020 presented this concept with one of the toughest challenges imaginable.

Did the uncorrelated strategies we identified live up to their promise?

More precisely, we define uncorrelated liquid alternative strategies as those exhibiting a correlation of no more than +/- 0.25 to equity or fixed income markets over a full business cycle. Alongside a few other niche strategies, we identify six major categories. Unlike long-biased equity or credit long/short strategies, which have exhibited market correlation of between 0.60 and 0.90 over the past 20 years, these strategies have tended to derive virtually all their returns from market-agnostic trades.

¹ Fred Ingham and Ian Haas, "Beta Blockers" (July 2017), at <https://www.nb.com/transfer?URL=insights/beta-blockers>

Uncorrelated Strategies: The Six Major Categories

Equity market neutral aims to express fundamental views on idiosyncratic stock risks whilst removing overall market risk by building a portfolio with an equal amount of long and short market exposure.

Statistical arbitrage uses statistical analysis to trade technical short-term mis-pricings between related stocks, within highly diversified portfolios of long and short positions with no residual market exposure.

Trend following seeks to benefit from medium- to long-term positive and negative trends in equity, fixed income, interest rate, currency and commodity futures markets; the strategy can be directionally biased over the short term to the long or short side depending on the market environment, but over the long term tends toward a minimal correlation.

Short-term trading seeks returns from technical trading of long and short positions in equity, fixed income, interest rate, currency and commodity futures markets over periods ranging from intra-day to around four weeks.

Global macro seeks returns from long and short positions in a range of markets, over a range of time horizons, based on macroeconomic themes and discretionary or systematic analysis.

Volatility relative value seeks out opportunities by comparing the implied volatilities of different options contracts, typically building portfolios that are balanced in their exposure to the movement of the underlying market.

The crisis in the first quarter of 2020 provided a good test of the uncorrelated-strategies principle. How did these strategies fare?

Overall, they performed broadly in line with our expectations. However, the real stand-out performers during the crisis period itself tended to be in two particular categories: short-term trading and volatility relative value.

In this article we will look at how these two strategies work and why we believe they were able to deliver so well in the first part of this year. But we also explain why short-term trading and volatility relative value are not a “silver bullet” for long-term portfolio diversification, and why we still believe in the benefits of our four other types of uncorrelated strategy, where performance during the COVID-19 crisis was more widely dispersed.

Why Short-Term Trading and Volatility Relative Value Had An Advantage

There are many varieties of volatility traders, all with different pay-off profiles. In the relative value space, we focus on strategies that buy and sell options contracts but seek to maintain “positively convex” pay-off profiles; in other words, they generally benefit from sudden large moves.

These are differentiated from outright “tail-risk” managers, who are structurally biased toward buying options, because relative value players seek to trade actively on both sides of the market. Outright tail-risk strategies are often viewed as akin to buying insurance against a market crash or period of high volatility and, like insurance, the option premia an investor pays to do that can be costly and exact a heavy drag on performance over time.² Trading on both sides—if executed skillfully—can make it possible to target “positive convexity” overall while offsetting some of those costs.

During the first quarter, opportunities arose for volatility relative-value traders because of general panic and forced selling by market participants who were structurally short volatility (that is, structurally biased toward selling options). Examples included anomalies in the relationship between the CBOE Volatility Index (VIX) and the S&P 500 option contracts on which it is based, mis-pricing between options in different regions and countries, and simple cheapness in implied volatility versus realized market movement at certain points in time.

² See Derek Devens, “Chasing Your Tail” (May 2018) at <https://www.nb.com/transfer?URL=insights/chasing-your-tail>

Already on the front foot due to their structural positioning, some sophisticated volatility traders were able rapidly to assimilate and analyze price action, monetize these often short-lived anomalies—and then move on to the next trade. One of the characteristics we look for in volatility traders is evidence of this kind of dynamic approach to recycling and renewing portfolio ideas. It is notable that we saw some managers who define themselves as relative value, but in fact express trades in a more negatively convex way suffer heavily in Q1; so careful manager selection and trade profile analysis were critical within the volatility sphere. Additionally, we saw some of the tail-risk players who also benefitted from the early market dislocations give back a lot of their gains as equity markets recovered in the second quarter, as they maintained their outright long-volatility exposure.

Just as faster traders in options markets generally navigated confidently through the sharp up-down-up of February, March and April, so did the faster traders who look for opportunities in the broader futures markets across equities, currencies and fixed income.

Short-term futures trading involves holding positions over horizons of weeks, days or even hours. Based on rapid systematic analysis of futures price movements, often with no view on economic fundamentals, they seek to identify very short-term momentum and breaks in markets, as well as situations where markets temporarily lose their coordination with one other.

The ability of these strategies to change their market exposure rapidly, which sets them apart from trend followers, is one reason short-term trading has the ability to perform well during market shocks, and did so again this year. The focus on market movements rather than fundamentals, which differentiates them from most global macro strategies, can also be an advantage. We believe both characteristics give these strategies an edge when markets become very “technical” and waves of forced or panicked selling and buying set in. The period of February, March and April 2020 is now a textbook example of these conditions.

Diversification Remains Critical

This doesn't mean one can build an uncorrelated portfolio from only short-term trading and volatility strategies. Diversification remains critical.

When market volatility is within normal ranges, strategies such as equity market neutral or statistical arbitrage may have a better chance of potentially generating steady, uncorrelated return profiles. Diversification therefore helps to maintain acceptable returns over a cycle.

Moreover, every bear market is different. When shocks and crises amplify rather than reverse recent conditions, strategies such as trend-following or global macro could potentially make bigger returns than short-term trading: it was they who led the pack during the more drawn-out crisis of 2008 – 09, for example.

Even during the first quarter of this year, the best-performing uncorrelated strategies were not exclusively volatility and short-term traders. Within global macro, we observed great results from managers with a bias toward fixed income trading, as well as those who happened to be long the dollar rather than long global carry trades coming into the crisis. Within equity market neutral, we found that discretionary pair trading tended to hold up better than model-based strategies and statistical arbitrage.

Predicting the next regime can be extremely challenging, especially when the market environment can change very rapidly. The current environment of unprecedented levels of stimulus and accumulation debt upon debt has increased the risk of lurching from one regime into the next in unpredictable patterns.

That is why we would always recommend allocating to a diverse portfolio by strategy and manager rather than trying to bet on one kind of environment or another. It is also why we think any investors in liquid alternatives should seriously consider the many ways in which diversification can be achieved between managers within strategy groups, and indeed within individual managers' portfolios (figure 1).

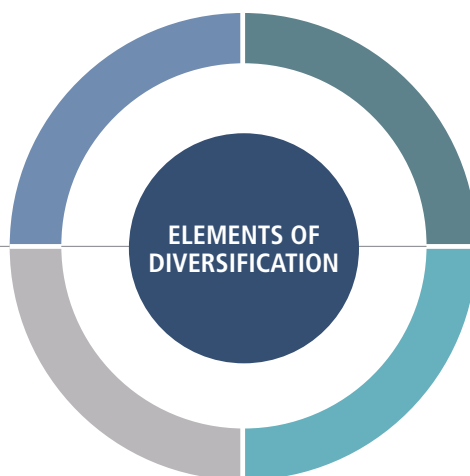
FIGURE 1. INVESTORS CAN DIVERSIFY WITHIN LIQUID ALTERNATIVE STRATEGIES, AS WELL AS AMONG THEM

Time Horizon

- Short-term (intra-day to days), medium-term (multiple days to weeks), and long-term (multiple weeks to multiple months)

Asset Class/Instrument Type

- Single-name equities
- Futures contracts across equity indices, fixed income and currencies
- Options contracts



Style

- Technical data (e.g., price and volume information)
- Fundamental data (e.g., econometric forecasts, valuation)
- Sentiment data (e.g., analyst recommendations, trend signals)

Implementation

- Systematic (model-driven) strategies
- Discretionary strategies

Source: Neuberger Berman. For illustrative purposes only.

We believe the importance of diversification and the required transparency to monitor the spread of risk within a portfolio also makes a strong case for building a portfolio of uncorrelated strategies via managed accounts rather than pooled vehicles. In our view, managed accounts facilitate the level of transparency and the control of capital required to view risk through multiple lenses at both individual strategy and overall portfolio level, and then adjust positioning as required. This makes it easier to maintain the portfolio balance that can generate through-cycle performance combined with downside mitigation. It also allows for greater efficiencies around factors such as cash management, funding, margin and control around costs.

Conclusion: Skewing the Odds

We believe it is possible to build a genuinely diversifying book of uncorrelated strategies. But we also argue that there is no silver bullet: we do not believe one can build a cheap index of uncorrelated strategies and get the same results, simply because every market shock is unique and every strategy group features wide underlying dispersion of performance.

Instead, we argue that investors need to skew the odds of success in their favor by thinking carefully about all possibilities for diversification, using managed accounts for transparency and control, and being forensic about manager selection.

Following these principles, we believe that the experience of the first half of 2020—an extraordinary rollercoaster ride in a range of markets over a remarkably short period—has given strong support to the uncorrelated strategies concept.

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