Long short, hedging and market neutrality under unruly markets

In times of unruly markets, even long short, hedged or market neutral portfolios can behave in unexpected ways. This may be because of factor biases or technical reasons.

Factor biases are the most obvious reason for unexpected behaviour. If you’re net long or short a sector, size, valuation, country, or cyclical v defensive factor, your portfolio is not robust against rotation.

What’s not so obvious is that a properly hedged or balanced portfolio can still misbehave. Technical factors may be responsible.

Crowding. If the market is long some names and short others, this creates instability. Now the market is always in balance so what do we mean by the market being long or short? We refer to the length of the dynamic, actively managed portfolios. Long term, passive investors don’t contribute to this type of volatility. When markets fall, sometimes, hedge fund deleveraging can lead to crowded longs being sold and crowded shorts being covered (bought). This makes the longs fall faster than the shorts, which, incidentally, may even rise. Crowding is sometimes a sign of groupthink and a lack of imagination. I

Too much leverage. When a portfolio is too leveraged, a small loss at gross asset level can lead to a big loss at net asset level which can trigger margin calls. Here the trigger puller is not the investor but the provider of leverage. When the gross leverage rises due to an erosion of the NAV, your prime broker may ask that you reduce your longs and shorts.

Leverage and liquidity. Your broker will mark your longs to the bid and shorts to the offer. When markets get unruly and bid offer spreads widen, the portfolio NAV can shrink even if mid prices haven't moved much. Now consider what happens when you have large gross exposures. The NAV shrinkage increases the leverage and triggers margin calls.

An over leveraged prime broker. This is unlikely to happen these days with Basel 3 and additional capital requirements but never say never. Through no fault of your own, because some other client has overcooked their book, a prime broker facing financial stress can require you to deleverage.

When markets get weird, there is no better way to stabilise your portfolio than to reduce exposure on both longs and shorts. Correlations can change quickly, dependencies can arise, or evaporate.

Well hedged long short, hedged or market neutral portfolios are very well in theory but may not work in practice when markets get gappy.