Equity Market Neutral Prospects. Stoxx Dispersion Chart

In 2009, the HFRI Equity Market Neutral Index was up 1.69%. The HFRI Index of all strategies was up over 20% and the equity long short index was up over 26%. Equity long short hides a multitude of sins, like a chronic long bias and market timing. Equity market neutral, however, is fairly specific. (We have to assume away the self classification bias in the HFRI database.)

Here is a chart of equity dispersions in the European equity markets. Each line in the chart represents the dispersion of returns across the different stocks in each sector. The chart therefore demonstrates the relative level of idiosyncratic risk in the market.

The dispersion also represents the opportunity set available to the long short manager. Dispersion spiked in 2008 despite the system wide nature of the crisis as volatility levels surged and companies were assessed on their balance sheet strength rather than cash flow or profitability. Since then, dispersion has fallen sharply through the recovery in equity markets, evidence of the systemic nature of the recovery. Market neutral stock picking funds have struggled to generate returns in this environment, as one would expect.

Dispersion levels have dipped to levels seen in the years 2003 – 2007, years when equity market neutral funds did moderately but not outstandingly well. Bear in mind that in those years, leverage available and deployed was significantly higher than what was available and deployed in 2008 and 2009.

It is well worth monitoring the dispersion of equity returns and correlating them to the dispersion of financial results of companies as well as to historical levels of volatility and correlation. If markets continue to display subdued idiosyncratic risk relative to systemic risk, the prospects for market neutral strategies for a given level of leverage will remain muted. Dispersion of returns is the oxygen which market neutral stock picking strategies require to prosper.