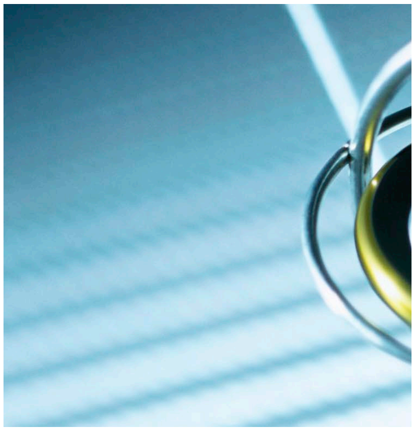
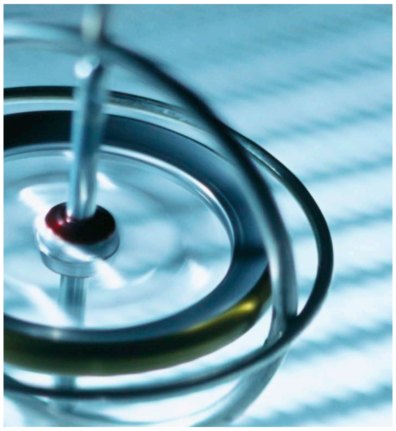
Equity Market Neutral:
Diversifier Across Market Cycles

September 2009

Equity Market Neutral funds take both long and short positions in stocks while seeking to minimize exposure to the systemic risk of the market (i.e., a beta of zero is desired) with the aim of being uncorrelated to market movements and delivering pure alpha. These funds aim to exploit investment opportunities presented by a specific group of stocks, while maintaining a neutral exposure to broad groups of stocks such as sector, industry, market capitalization, country, or region. The strategy's market neutrality essentially seeks to eliminate the problem of timing the investment from the investor's perspective. Statistical arbitrage and traditional quantitative long/short are the two main sub-sectors in the strategy.

Jordan Low, CFA
Director
Quantitative Equities Group





Executive Summary

One of the lessons investors may have learned from the financial crisis of 2007-2009 is the degree to which different hedge fund strategies vary in their adaptability to changes in market cycles. Many investors were unpleasantly surprised to find that a large number of hedge funds ended 2008 in negative territory, particularly since hedge funds posted overall positive returns for the previous ten years; the Credit Suisse/Tremont Hedge Fund Index finished 2008 down 19.07% and has had a 9.1% annualized average return since 1994 as of July 31, 2009. Certain strategies such as Long/Short Equity or Fixed Income Arbitrage that generated returns in the growth part of the economic cycle, i.e., March 2003 - October 2007, were significantly challenged in a stressed market environment such as 2008.

This variance in performance among hedge fund strategies highlights the importance of diversification, not just across asset classes but also across hedge fund strategies. There is a growing awareness, however, that achieving a diversification that will hold up in volatile market environments is more difficult than had been previously assumed. This is because correlations between asset classes and hedge fund strategies began to change dynamically and converged when the recent financial crisis reached peak levels in 4Q 2008. The Equity Market Neutral strategy (EMN) was one of a few strategies that were less affected by the market forces that drove the synchronized moves of the previously uncorrelated asset classes. Thus, we believe that EMN stands out as potential diversifier given the low beta it showed to the 2008 equity markets in what was a historically volatile year (See Figure 1). Figure 2 suggests that EMN also has lower annualized volatility than other hedge fund strategies over the long term, indicating that the strategy has avoided the downside risk of markets over time and provided generally positive risk-adjusted returns over the last ten years.

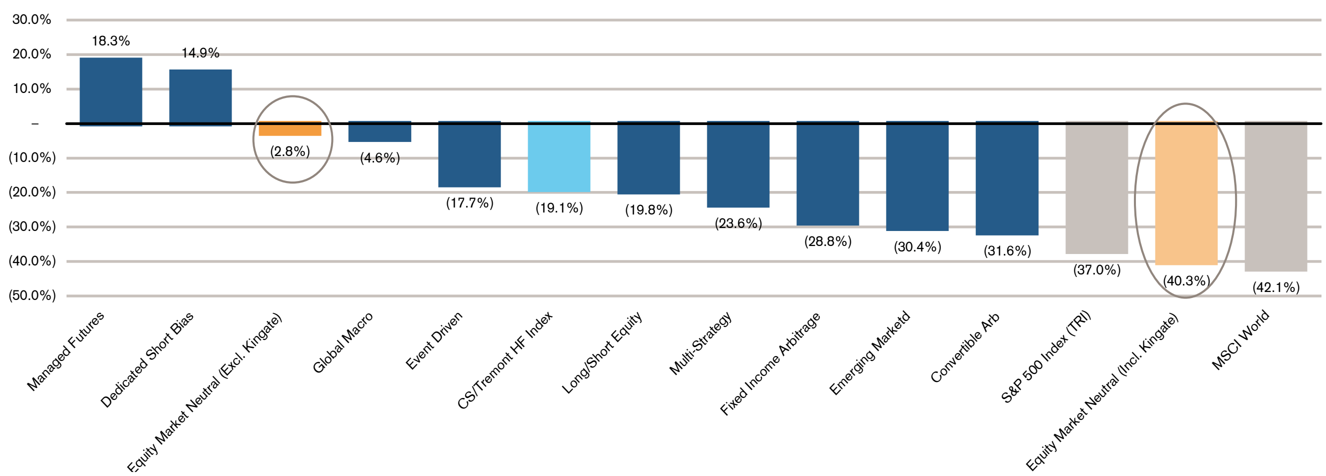
Another important consideration when analyzing quantitative strategies such as EMN is that of diversification of managers' factors and models. Quantitative funds experienced heavy declines in August 2007 (which rebounded later in the month) due to the heavy unwinding of crowded trades, significantly beyond the historical range of the strategy's volatility. Certain managers have used that singular event as a learning experience, implementing new risk controls and creating proprietary factors and models to seek to avoid crowded trading situations. Diversification of factors and models within the strategy was a key element in 2008 for the strategy's ability to weather market volatility and will likely remain the cornerstone of alpha generation for the strategy going forward.

The Diversification Challenge of Shifting Correlations

Because correlations have converged toward one during severe market drops such as that which followed the Lehman Brothers bankruptcy in September 2008, one of the biggest challenges facing investors is achieving a true diversification of asset classes that will resist the shifting correlations during times of market stress. As can be seen in Figure 1, EMN was one of the top three performers in 2008, having lower net exposures to the market beta in a year that saw the Chicago Board Options Exchange Volatility Index (VIX) hit its all-time intraday high of 89.5 in October 2008; as a point of reference, the VIX average from January 1990 to October 2008 was 19.0. Thus, EMN has shown that its multi-factor approach has enabled it to profit from a variety of environments and has provided an effective counterbalance in diversified portfolios during periods of market volatility.

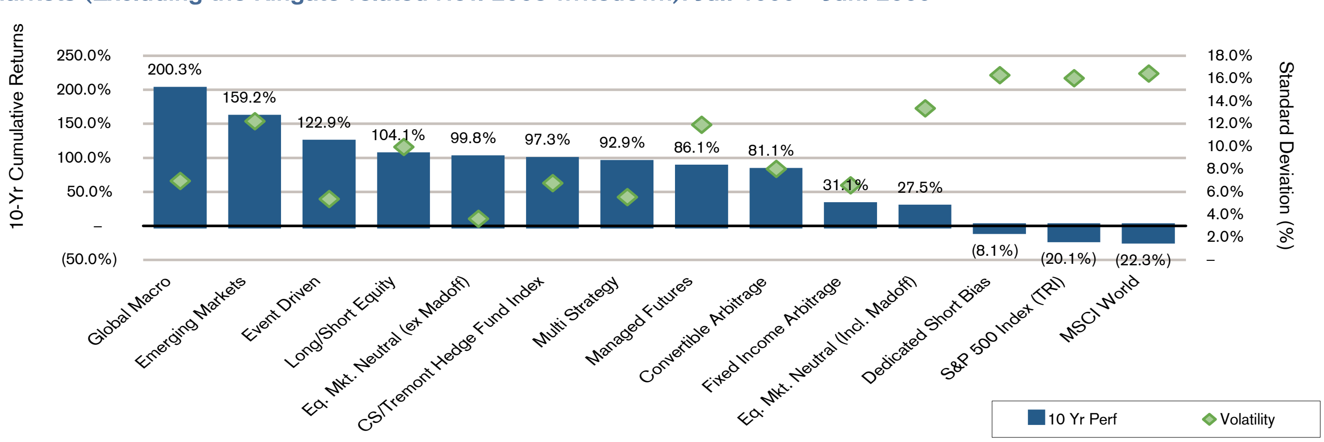
Managers point out that an investor seeking to improve the efficient frontier in their portfolio by using EMN as a diversifier might start with a couple of considerations: first, at the portfolio level EMN has low beta to other hedge fund strategies and equity markets on a longer range basis as well (Table 1); second, within the EMN strategy investors need to be aware that some managers are more diversified in their range of factors and signals than others, making them less vulnerable to undesirable market beta exposures.

Figure 1: 2008 Performance for Strategies in the Credit Suisse/Tremont Hedge Fund Index and Equity Markets[1]



Source: Credit Suisse/Tremont Hedge Fund Index, Bloomberg.

Figure 2: 10-Year Performance and Volatility for Strategies in the Credit Suisse/Tremont Hedge Fund Index and Equity Markets (Excluding the Kingate-related Nov. 2008 writedown): Jul. 1999 – Jun. 2009



Source: Credit Suisse/Tremont Hedge Fund Index, Bloomberg.

[1] This performance chart shows the Credit Suisse/Tremont Equity Market Neutral Sector's performance in two ways: A) The performance number excluding the writedown taken by the Credit Suisse/Tremont Hedge Fund Index in November 2008 for the investment in the Kingate Fund which had a substantial allocation to the Madoff Fund which was discovered to be fraudulent and B) The performance number including the Madoff-related writedown.

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