

PRESCIENT

VOLATILITY AND THE CASE FOR MARKET-NEUTRAL INVESTING

Markets look set to revert to the 'old normal' as QE-fueled liquidity dries up

Several growth-supportive factors that equity and other markets have grown accustomed to over recent years are now reversing, with the result that the dynamics in play during the pre-quantitative easing regime are likely to return to favour.

That's the view of Nafees Hossain, Fund Manager at Prescient Investment Management who said "markets are likely to revert to the old normal".

"We see risks from the end of the quantitative easing era and rising protectionism that are conducive to higher volatility for financial markets. In addition, downside risks to global growth have risen with protectionist rhetoric and trade tensions a key challenge to the world economy.

"Other factors that could slow growth include European politics, China's tough balancing act, and oil price volatility," he commented.

With the US Federal Reserve hiking interest rates and actively shrinking its balance sheet, the European Central Bank is set to join in with the Bank of Japan not too far behind, Prescient Investment Management expects that declining liquidity will have an impact by way of increased market volatility.

"While consensus is for global economic growth to slow but to remain at decent levels, ongoing trade tensions, monetary tightening and uncertainty regarding growth will keep volatility high. With risk assets more sensitive to macroeconomic factors, and political uncertainty playing an increasing role, there is a strong case to be made for market-neutral investing, Hossain said.

Market-neutral investing is an investment style that seeks to gain whether markets are up or down, while avoiding some form of market risk entirely, typically by hedging. The term refers to a group of investment strategies that try to neutralise certain market risks by taking offsetting long and short positions in related instruments.

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The idea is to limit exposure to asset price changes prompted by macroeconomic shifts or changes to market sentiment. Market-neutral investing is likely to find favour when markets are making investors nervous.

Hossain said interesting literature exists where it is argued that market neutral/statistical arbitrage strategies are implicitly “long volatility”.

According to the analysis, pair trading strategies seem to have a positive and statistically significant exposure to market volatility. A pick-up in volatility typically has a positive impact on the returns of the strategy. As volatility increases, more pairs tend to diverge from their equilibrium relationship, but they also tend to revert to their historical mean levels quicker.

“A pick-up in volatility would therefore also be associated with more pair trade opportunities and with a lower holding period for these trades. With the QE regime coming to an end, credit spreads widening, economic and political uncertainty increasing, we believe that this will result in more earnings and balance sheet volatility.

“Hence it is not surprising to see the strategy having come back to profitability in 2018. We are confident that systematic statistical pairs trading will keep rewarding investors this year as volatility increases and arbitrage opportunities reappear,” said Hossain.

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About Prescient

- Prescient Investment Management (Pty) Ltd (Prescient Investment Management), is an authorised financial services provider (FSP 612).
- For any additional information, including our services, fund prices, fees, brochures, minimum disclosure documents and application forms please go to www.prescient.co.za

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