Pairs trading

Business, Company

Pairs trading: It generally involves purchase and sale of two similar securities in combination, which were equally valued at a certain point of time; but have now drifted away (one gets over-valued and the other under-valued) due to occurrence of a pricing irregularity not relating to company fundamentals (Connor et al, 2005). It results in a positive pay-off as and when the market contracts and corrects itself, resulting in both the stocks to converge themselves irrespective of the movements in the market.

This kind of trading strategy is not limited to only the equities market, but can deal in any type of securities. Dedicated Short Bias: Another variant of this kind of strategy is the dedicated Short bias. This works very well when markets show a declining trend, since in this kind of strategy the managers concentrate on the short more (Connor et al, 2005). This results in sacrificing the market neutrality feature.

GENERATION OF RETURNS & COSTS INVOLVED:

Long-short equity hedge funds have historically been known to generate equity –like returns with lower volatility and shallower high to low declines. Returns generated on long-short equity hedge strategies come from directional or spread bets on the market. Other factors influencing returns are price momentum, market activity, etc. In this kind of long-short equity hedge strategy, the manager targets to make returns from falling stock prices too. He re-purchases the sold stock at a price which is ideally lesser than the price that he sold the stock for, thus generating profits on it. This method is commonly referred to as Short Selling. Thus, in this type of strategy, the manager generates returns when the stock prices of under-

valued long positions rise and when the stock prices of over-valued short positions fall.

Per Eurekahedge (2004), there could be three types of potential outcomes or returns by investing in a long-short equity hedge. In the first case, if the long positioned stock rises in terms of value and the short positioned one declines, it is called the most favourable outcome termed as “ double alpha”. In the second case, only one side of the portfolio moves favourable and generates a net positive return. This is called ‘ single alpha’. The third type is when neither occur called “ double splat”.

Horejs (2011) explains the returns derived from employing these kinds of strategies. He finds that the return from these kind of strategies is the sum of return from exposure to market (beta) and any addition in value resulting from timing the market or stock-picking. Further, fees for management eat into the share of returns for investors. Thus, sources of returns in these kind of strategies include the alpha on long and short position, dividend income on long position, rebate on short position i. e. the interest earned on short sale proceeds minus brokerage & lender fees and expenses, interest earned on liquidity buffer, etc.

Further, the costs of borrowing shares, margin costs on short positions taken would be deducted to obtain the net returns from these funds. Hedge fund Management fee structures are famously termed as “ 2 and 20” i. e. 2% annual management fee on Assets under management (AUM) and 20% of profits along with operational expenses. Expenses may include legal fees, organizational costs, marketing and distribution costs, etc apart from the

management fees. However, in a test conducted by Morning Star to see how overall portfolio can undergo a change by inclusion of long/short hedging strategies, results showed that a greater allocation of long/short equity perked up the portfolio's returns adjusted for risk in the last 10 years.

1. RISKS INVOLVED

The degree of assumed risk of a hedge fund is closely related to the type of strategy adopted by its fund managers. The risks involved in the Long-short equity hedge strategy are related to the following occurrences: Risks in Short -sales: Some of the risks that could be incurred are unlimited loss potential, stock loan difficulties, " call-in" of stock, call for more margin due to sudden rise in prices, short squeezing due to sudden sharp increase in prices, etc. Due to market stability conditions, some of the countries have imposed a ban on short-selling or naked short-selling for e. g. France, Italy, Spain, Belgium, etc.

Rarely market-neutral: Since these strategies are rarely market neutral, they typically are either long-bias or short-bias. Thus, they are prone to having either a positive or negative market exposure risk (Connor et al, 2005). Style risk: Long-short strategy type funds are mainly affected by specific equity price risk, if dealt with the equity class of assets. The investment is subject to precipitous losses (Blackstone, 2013). For eg. If an investment of $ 1000 loses 50%, its value would decline to $500. Subsequently, on a rise by 50%, the value would go only to $750, which would look to be a gain, but is actually $250 short of the actual cost. The investor would need to have a 100% gain to actually break-even.

Industry Factors Risk: Equity trading type may increase the correlation with broad indices, thus making the fund more susceptible to risks in particular industry sectors or global regions. Past performance may not be an indicative of future results. High Dependency on Managers' skills: This type of strategy completely focuses on stock selection and hence investors tend to depend a lot on skills of experienced and talented managers. In times of stressed markets or highly volatile markets, investors are subject to a lot of risk due to this factor. Liquidity Risk: Hedge funds normally face a liquidity risk than mutual funds, since in their case, shares are not easily saleable. High Losses: Since they are susceptible to high level of risks, they also could incur high losses due to uncontrollable market movements.