J.P.Morgan
Asset Management

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stay positive

No-one would argue that the last two years since the beginning of the credit crunch have been easy for equity investors. But the JPM Highbridge Statistical Market Neutral Fund has managed to produce a positive return while global stock markets have nosedived.

So what's its secret? Catherine Vaughn, Head of European Business Development at Highbridge Capital Management, provides the answers.

What is a 'statistical arbitrage' strategy?

Statistical arbitrage is a trading strategy that aims to identify and profit from stock mispricings using an automated, quantitative approach. The strategy relies on mathematical models to identify stocks that are temporarily mispriced and exploit resulting trade opportunities. Statistical arbitrage managers believe that movements in stock prices that result from stock-specific characteristics are predictable and can serve as a sustained source of excess returns over time.

The strategy is focused on the US stock market and emphasises stock selection as the primary means of generating returns and providing diversification. Stocks are evaluated using similar valuation techniques to those of traditional investment managers. However, the Fund's powerful automated trading system is able to continually analyse the whole market to identify over and undervalued stocks. This automated process can trade every five minutes, maintaining a highly-diversified portfolio of on average approximately 900 US equity positions across all sectors, market capitalisations and investment styles.

In order to minimise market risk, the Fund maintains a market neutral stance. How do you do this?

A market neutral stance is generally achieved by investing in stocks that are identified as being undervalued (buying long), while also holding equal and opposite short exposure to similar stocks that appear overvalued. Maintaining short exposure to these stocks allows fund managers to profit when a stock price falls in value.

By combining equal long and short exposure in similar stocks (for example in the same sector), the portfolio overall has minimal exposure to market movements. If you are long in an attractively valued car maker and short in an expensive car maker, it doesn't matter if the market rises or falls. It only matters what happens to these two similar stocks. For example, any event that causes the whole auto industry to fall in value will cause a loss for your long position, but this will be mitigated by the profit from your equal and opposite short exposure in the sector. Similarly, if all auto stocks rise in value due to general market optimism, you will be shielded from losses on the short position by your equal and opposite long position.

Investors should bear in mind that there is no guarantee that the use of long and short positions will succeed in limiting the Fund's exposure to domestic stock market movements, capitalisation, sector swings or other risk factors. However, market neutral funds use this technique with the aim of eliminating market risk (or beta). In practice our JPM Highbridge Statistical Market Neutral Fund has maintained a beta of -0.01 to the S&P 500 Index since its launch.

Instead of beta risk, the Fund aims to profit from its stock picking. In our example, if the attractive car maker outperforms the expensive car maker, the Fund will make money, and it will make a loss if the expensive car maker outperforms. The end result is a portfolio whose returns are driven by Highbridge's ability to consistently identify attractive companies from unattractive companies, rather than the direction of the market itself. Please note that an investment process that employs short exposures involves certain risks, including additional costs associated with covering short positions and a possibility of unlimited loss on certain short sale positions.

What are the key benefits of a market neutral strategy?

Investing in a statistical market neutral strategy may bring both diversification benefits and an added source of returns to a portfolio. Because of its focus on total returns rather than beating a stock market index, and because the fund seeks to eliminate market risk and maintain a beta close to zero, it can potentially perform very differently to traditional investment funds.

Therefore, including a fund that employs a market neutral strategy may help improve portfolio diversification. In addition, since a market neutral strategy aims to minimise exposure to overall market risk it may have the potential to perform better in volatile and falling markets than long-only equity funds.

Over the last two years the Fund has navigated its way through exceptionally difficult and volatile market conditions to produce positive returns for investors even when stock markets fall sharply.

How has the Fund performed over the last two years?

The MSCI World Index fell steeply by 42.86% in euro terms between 31 May 2007 and 31 May 2009. Yet within this same period, the J.P.Morgan Highbridge Statistical Market Neutral Fund has produced a positive return of 7.73% in euro terms*. It has also been remarkably stable since its launch back in November 2006, maintaining a realised volatility of just 4.64% since inception. Investors in the Fund have benefited from relatively stable monthly returns even while volatility on global stock markets surged to record levels.

The Fund uses an innovative market neutral strategy, and stock selection is driven by a statistical arbitrage model developed by alternative asset management group Highbridge Capital Management. The Fund invests in the US stock market, but is designed to provide total annual returns in excess of cash**, with a relatively low target annual volatility of 4-6%.

Why is the Fund managed by Highbridge Capital Management?

Managing a statistical market neutral fund requires experience and a proven investment process. That's why J.P.Morgan Asset Management uses the expertise of Highbridge Capital Management, a leading global alternative asset management firm which (as of 1 July 2009) is fully owned by J.P.Morgan Asset Management.

Highbridge's statistical arbitrage team consists of broadly talented mathematicians, statisticians, computer scientists, investment analysts and traders. The group has access to all of Highbridge's analysis and research capabilities throughout the world to help them identify investment opportunities.

*Source: J.P.Morgan Asset Management, NAV, net of fees on an offer-to-offer basis.

**The Fund aims to deliver returns of 4-5% above its cash benchmark over a full market cycle (3-5 years). Please note that the Fund's investment approach is speculative and entails risks. There can be no assurance that the investment objective of the Fund will be realised. Past performance is not a guide to future performance.

The Skandia fund will not mirror the performance of the underlying fund because of Skandia fund charges, taxation adjustments (if appropriate) and the Skandia investment.

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The JPM Highbridge Statistical Market Neutral Fund is now available through Skandia's Selestia Investment Solutions platform.