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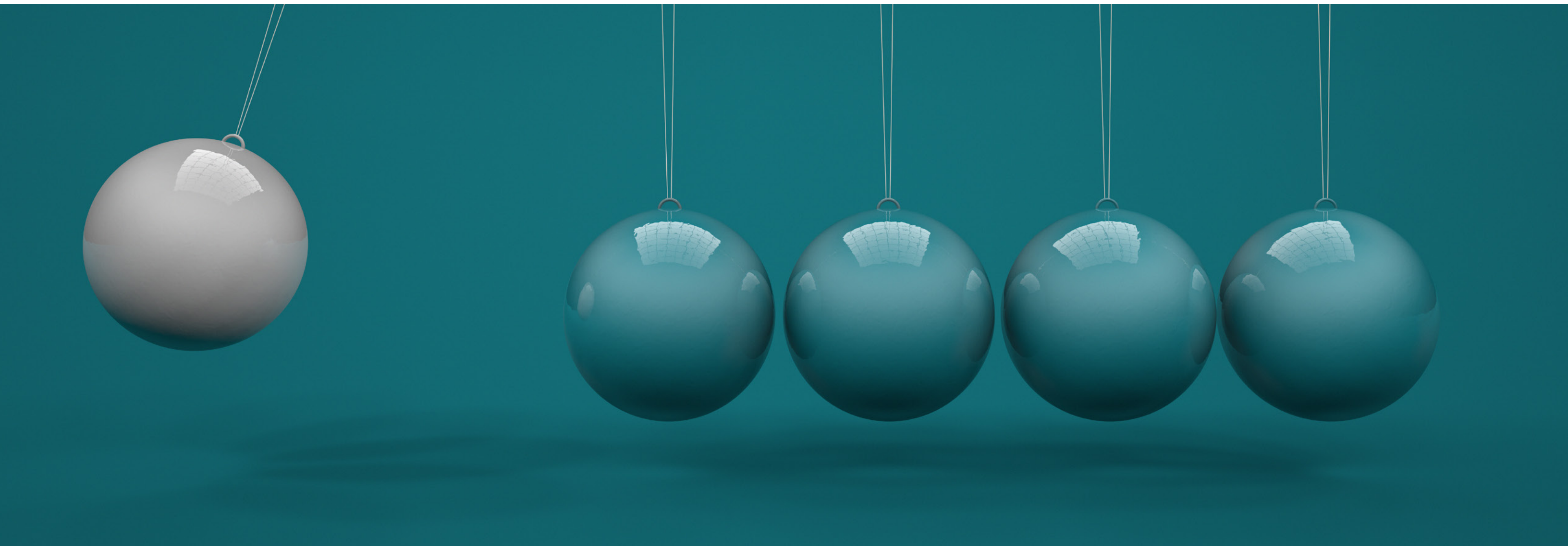

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Equity Market-Neutral Investing: More Than One Type of Catalyst

Equity market-neutral investing involves taking both long and short exposures in an attempt to isolate the alpha from an idiosyncratic investment thesis while hedging out market beta and style factor risks. In theory, the performance of a market-neutral strategy should depend on the strength of the practitioner's ideas and the care with which they are implemented rather than the direction or level of markets.

One of the more prominent equity market-neutral trading strategies is catalyst or event-driven investing. This involves investing in companies that are undergoing some form of transformative change that the investor believes will result in a rerating of the shares. Those events can be announced ("hard") or anticipated ("soft") catalysts.

In this article, we outline the principles of market-neutral catalyst investing, explain the difference between "hard" and "soft" catalysts, and argue that meticulous hedging is just as important for successful outcomes as the robustness of the catalyst thesis itself.

Executive Summary

- Investments around publicly announced "hard catalyst" events tend to be relatively crowded, making it harder for the investor to develop any meaningful analytical edge, and leading to challenging trading dynamics given the amount of short-term, and like-minded, event-driven positioning.
- "Soft catalysts" are not publicly announced: Investors are trying to identify a series of probable events that are likely to materially impact a company's prospects—a process that involves both assessing the magnitude of a value-creation opportunity and the probability of it occurring.
- Soft-catalyst investing involves more diligence, research resources and creativity than hard-catalyst investing, but the reward is less-crowded positions that express differentiated views and allow for more efficient hedging.
- While the probability of soft catalysts not materializing can be higher, the ability to hedge them more effectively means returns can be determined solely by the success or failure of the idea and trade construction rather than the direction and level of the market.

The more common version of catalyst investing attempts to exploit hard catalysts. These are events, such as mergers, spin-offs, restructurings, tender offers, exchange offers and complex litigation, that have been publicly announced. They have a defined plan and timeframe, providing a clear roadmap for investors to follow.

When this strategy evolved, decades ago, the market was less efficient and such catalysts attracted far fewer participants. It was therefore much easier to profit from them despite their relative predictability. Certain hard catalyst events, headlined by merger arbitrage, can still offer attractive risk-reward opportunities for a seasoned investor. In general, however, the sheer number of analysts and amount of capital circling these hard catalyst trades today limits the ability to develop a truly differentiated view on every event. In addition, crowding of capital into these investments, including by passive strategies that participate in every event, amplifies position volatility and increases gap risk (for example, the potential for the stock price to move immediately lower when the anticipated positive event doesn't materialize). Both are difficult to hedge effectively.

The Challenge of Hedging a Hard Catalyst

Hard catalysts, by definition, flow from public announcements around very specific corporate events. They are known to all market participants and attract a large group of similar-minded investors to a narrow field of opportunities. This potentially creates an unfavorable negative skew profile for these strategies. Given the narrow opportunity set and the large number of participants in the space, situations often become "fairly" priced quite quickly as the crowding effect serves to limit upside and increase downside. This groupthink means that security prices can often gap lower on any hint of doubt or perceived disappointment around the outcome of the catalyst.

That combination makes building robust hedges for hard-catalyst positions a challenge. The discontinuous price gap risk in the target security that is subject to the catalyst is very unlikely to be replicated in the hedging positions, resulting in potentially large "basis risk"—the potential for meaningful divergence between the prices of a hedge and the asset being hedged.

Less Crowding Makes Soft-Catalyst Risk More Manageable

This does not mean that we think investing in hard catalysts is impossible, or that no attractive hard catalyst opportunities exist, but we do believe investors can generate a differentiated stream of positive returns if they can identify potential catalysts much earlier—that is, when they are soft catalysts that have yet to become widely known or publicly announced. Identifying situations earlier than the crowd, with a broader event path, and before those events have been publicly announced, can provide a more favorable risk-reward profile.

The skill here, of course, is in identifying potential catalysts ahead of the broader market, and being right more often than wrong in idea generation and security selection. In our view, that comes down to an investor's fundamental research capabilities. When an investor gets it right, the investment often transitions to a hard catalyst, making it more valuable as the anticipated events become announced and recognized by the broader market. At that point the soft-catalyst investor will often take profits and hand the opportunity over to the hard-catalyst, event-driven investors.

Soft catalysts can have an investment horizon spanning a few weeks to 18 months, but the common characteristic is that the path to value creation has not yet been identified by the market. Sourcing investments where a series of potential events likely to impact a security's prospects and future earnings power can be anticipated requires more diligence, but allows the investor to form a more differentiated view and establish more effective hedges. This approach leads to a less-crowded portfolio with more bespoke ideas that can be hedged more efficiently, with potentially less downside gap risk.

Constructing Effective Hedges

In our view, constructing effective hedges for a soft-catalyst position is both a science and an art.

The science is the simpler part, as it involves using quantitative tools to identify the "betas" and "factors" of individual securities or the portfolio as a whole.

A common approach in the event space is to invest in a number of catalyst names, evaluate the portfolio beta using these tools and determine a level of hedging to decrease the overall portfolio beta to an acceptable level. However, we think finding hedges at a position level is more optimal to isolate the "alpha" of an event—and this is where the "art" comes into play. Using index options to construct a hedge, or even a tailored basket of companies that are apparently comparable to a soft-catalyst position, can appear effective through the lens of a risk model based on historical returns. However, seasoned investors have been doing this long enough to know that the best models ever built will be of little use when correlations converge to one; liquidity exists only at much lower prices; and historical betas are simply numbers on a chart.

In our view, a prudent approach to hedging requires two things: first, a long memory and an imagination vivid enough to encompass all the things that can conceivably go wrong with each individual position and the portfolio overall; second, a lot of time spent digging for relative value and alpha shorts that have fundamental economic, rather than merely statistical, relationships with the portfolio's investment ideas.

As such, we believe any investor considering a market-neutral catalyst allocation should concern itself not only with managers' modelling capabilities, but with the depth and breadth of its fundamental equity research resources.

An Uncorrelated, Alpha-Centric Approach to Equities

Executed well, we believe market-neutral catalyst investing can deliver an attractive return profile that can be uncorrelated with the market and style factors.

Hard catalyst investing has its place, but these crowded trades tend to come with higher volatility, more market and factor exposure and more potential for basis risk in its hedges. Although soft catalyst investing demands more research resources, both for identifying and assessing opportunities and for constructing effective hedges, we think it provides for less-crowded, more differentiated investment ideas that allow for more effective hedging, which is critical to removing significant unwanted market and factor exposures. Where that remains impossible for a given idea, we believe investors should move on; research-driven managers should always be able to find other opportunities where risks can be prudently managed and hedged.

The trade-off can be a relatively lumpy month-to-month return profile, punctuated by sudden spikes when catalysts are realized. The lumpiness is caused by the fact that soft catalysts are, by definition, less well known than hard catalysts, not necessarily a consensus view, and subject to greater probability of not materializing. The soft-catalyst investor's aim is not to be right with 100% of their ideas, but to prudently manage the risk of being wrong, and to have returns be determined solely by the success or failure of the ideas rather than the direction and level of the market, unintended factor exposures or ineffective hedges.

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