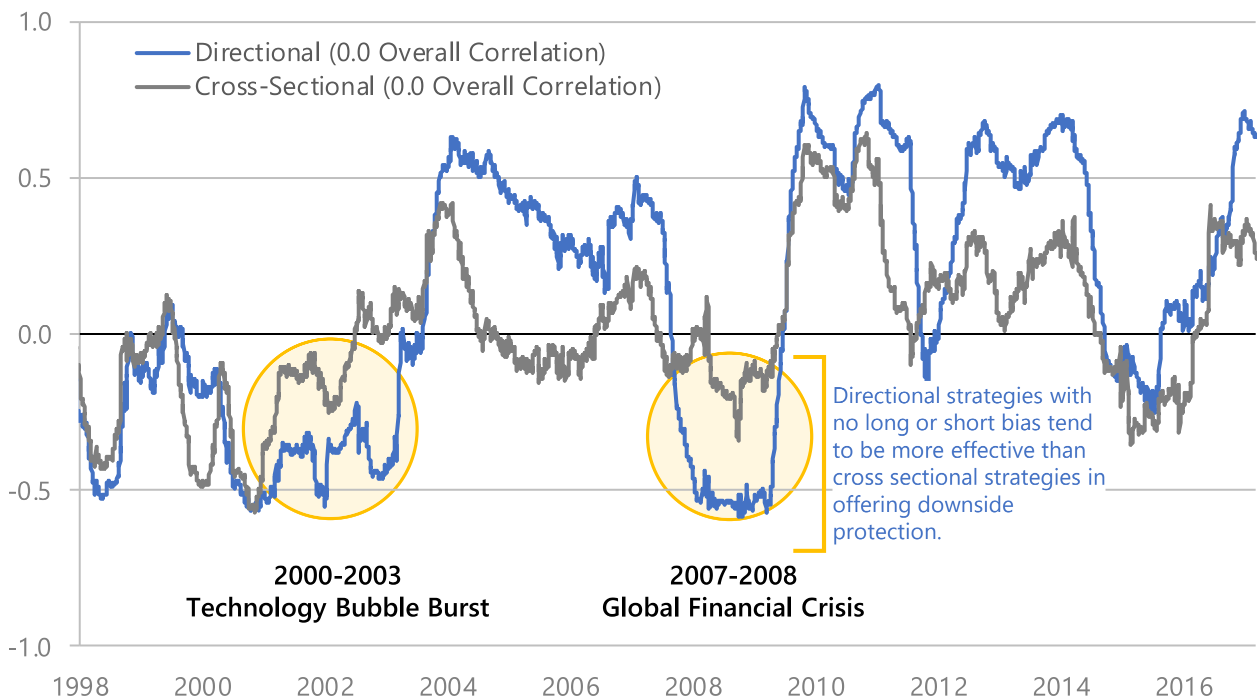
Directional versus Cross-Sectional Market Neutrality

It is tempting to argue that an investor with a large existing equity allocation should prefer a cross-sectional strategy because of its perceived market neutrality – at least in theory – to global equities. But here we see that the market-neutral nature of cross sectional portfolio construction may in some instances be undesirable for such an investor. While a well-developed cross-sectional strategy might in theory be less likely to add to the portfolio's equity exposure (because it is long some equities and short others), it would also be less likely to subtract from exposure when it might be advantageous to do so. Both cross sectional and directional strategies demonstrate strong diversification and performance benefits when added to a traditional portfolio of stocks and bonds. However, each approach has unique performance characteristics that should be taken into consideration.

Correlation to S&P 500 (6 Month Rolling Window)



THE BOTTOM LINE

- Both directional and cross-sectional strategies can have low average correlation to market risk (e.g., equities), but they earn these correlations differently.
- Cross sectional is often perceived to be beta-neutral at any given point in time, whereas directional has periods of positive and negative beta.
- Directional strategies have the ability to have large net long or short positions which can be a key differentiator during periods of equity weakness.

NEED MORE INFO?

Access the full Research Note:
Directional and Cross-Sectional Strategies

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CROSS SECTIONAL AND DIRECTIONAL PERFORMANCE: The data reflects the hypothetical gross performance of cross sectional and directional alternative risk premia strategies based on a backtest of simple momentum, value and carry signals as defined in the accompanying Research Note, Directional and Cross-Sectional Strategies. The backtests of the momentum, value and carry signals were performed on 46 markets across four sectors, including commodities, equities, fixed income and foreign exchange, using futures or forwards for each of these markets. The resulting momentum, value, and carry signals were combined into an over-arching cross-sectional or directional strategy using inverse volatility weighting, rebalanced daily. These strategies were then leveraged to achieve 10% targeted volatility. The performance information is provided on a gross basis and does not reflect reductions for fees or expenses. Including fees and expenses would reduce the returns.

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