Equity investors have faced a difficult start to the year. All major equity markets are down, and volatility has continued to rise. A convergence of investor concerns is likely to dominate markets for the near term—with consequences for strategies seeking to generate alpha through stock picking.

The same economic and policy issues continue to dominate markets. Emerging market weakness is spilling over to developed markets, and China and oil are dominating sentiment. Uncertainty over the impact of the recent hike in U.S. rates, and the likely path for future monetary policy, does not help matters. A notable development in the new year has been an apparent shift in the significance of central bank rhetoric: monetary policy has been a clear driver behind investor sentiment since the global financial crisis.

However, while many central bankers issued dovish statements as markets fell in January, their impact on market performance has been muted thus far. Even the Bank of Japan’s historic decision to introduce negative interest rates only briefly led to a rally in Japanese stocks, as concerns over the longer-term impact of negative rates took hold. It appears that the markets’ faith in the ability of central banks to generate growth and return inflation to targeted levels might be fading.

The impact of these macro factors is worse for some areas than others. As China continues to slow, global GDP growth is reducing, but this has limited immediate implications for economic growth in the UK and Europe. The profit impact for companies is likely to be worse, but depends on their exposure to slowing markets and is mainly felt through weaker currencies. While earnings will likely remain under pressure, the outlook for Main Street could be more benign. The role of banks will be pivotal, and at the moment we take comfort from their stronger balance sheets, set against the likelihood of events that are unlikely to match the global financial crisis for size.

In the UK, the debate over the potential departure from the European Union is dominating headlines and will only encourage investors to be cautious. The consumer could hardly be described as exuberant. It has been somewhat disappointing that fuel price weakness has not led to better conditions thus far, but it should continue to provide a cushion against a further erosion in consumer confidence. For now, it appears there will be little reason for corporations and consumers to change their behaviour unless they run out of financing.

Aside from the implications of broad macro issues, technical factors are also having an impact. Elevated volatility and outflows have led hedge funds and other active managers to reduce or close positions, causing some unusual stock price movements which appear at odds with fundamentals. Investors are also using equities to hedge exposures in other asset classes such as credit. The falling oil price is squeezing investors who have historically depended on oil to fund expenditures, such as sovereign wealth funds, leading to asset sales elsewhere—including equity markets.
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It is possible for long/short strategies to profit in volatile environments, but in the face of the current short-term uncertainty we have adopted an increasingly defensive stance. In our portfolios we generally have two ways to control exposure: namely, adjusting hedges and position sizes/gross exposure.

The ability to adjust hedges is a result of our investment approach, which depends on pair trades. After identifying a lead long or short investment, we select a hedge to isolate the specific risks that we wish to target, while seeking to minimize market direction and other unwanted risks. Typical hedges include a broad market index, an index that tracks a specific sector, or specific stocks. We have the flexibility to “tighten” or “loosen” a hedge within a pair trade as market conditions evolve: for example, an index hedge can be “tightened” to a sector instrument, or similar stocks, with an aim to reducing industry risks as well as broad market direction risk.

As macro uncertainty picked up over 2015, we tightened the hedges within our portfolios, generally opting for sector instruments (such as a retail stock index rather than a broad stock index) and stock-specific hedges to limit market exposure.

More recently, heightened volatility and uncertainty have also led us to reduce overall gross exposure in our portfolios. Gross exposure is currently at the bottom of the historical range, post-financial crisis, in our portfolios.

We are currently in the eye of the storm. We believe volatility is likely to continue until the outlook for China and global growth stabilises. It is also possible that further developments, such as another shift in central bank policy, could serve to either dampen volatility or sustain it.

Periods of market stress typically throw up opportunities as some prices move too far, or anomalies are created. Having reduced gross exposure in our portfolios, we have capital to deploy as the environment stabilises.

**Figure 1:** Equity investors have faced a difficult period

![Equity investors have faced a difficult period](image)

**Source:** Insight Investment, as of February 18, 2016. For illustrative purposes only.
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