A MARKET-NEUTRAL SECURITIES PORTFOLIO UTILIZING THE S&P 1500, OPTIONABLE STOCKS, AND THE ARTE MODEL

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ABSTRACT

This paper explores the creation of a market-neutral hedged portfolio. The portfolio consists of only optionable stocks contained within the S&P 1500. The portfolio constructed consisted of ten long and ten short stock positions for the 105 monthly periods from 12/31/1995 through 8/30/2004. The selection of the securities was based on the investment statistic called ARTE or Accelerated Relative Trend of Earnings. The positive results of the study were beyond the expectation of the authors. The return of the market-neutral portfolio shows a 1.82% monthly total return. This compares favorably with the 1.22% monthly return of the S&P 1500. The coefficient of variation was used to examine the risk of the portfolio. The CV of the portfolio was 3.61 compared to 4.48 for the S&P 1500. Moreover, the correlation of the monthly-hedged returns was –0.24 to the S&P 1500. This clearly indicates the market-neutral character of the portfolio. The ARTE model and S&P 1500 optionable stocks are indeed a formidable addition to hedged portfolio construction.

INTRODUCTION

Fair is Foul and Foul is Fair." "Nothing is but what is not." Sayth Shakespeare's MacBeth during the 16th century's turbulent times. History is repetitive, continuously returning to the past. Among the lessons of the 21st century's post 9/11 lies the stark reality of the fragility of stability. This insight is most applicable to the investment arena. Traditionally Wall Street and Main Street alike coveted the stable: competent, ethical management, rewarding positive corporate earnings and their reliability, and taking for granted, understandable risk/reward matrixes regarding choices made based on betas and other mathematical modeling.

The exponential application of technology to the investment decision making process has further exaggerated the post 9/11 fragile investment environment. When uncertainty reigns—and today it does—the rational man, here the investor for the purposes of this inquiry, searches for mitigating and safe havens. It is to satisfy this search that the authors of the current study address mitigation of investment uncertainties. The present quest seeks mitigation of risk for the equity investor. The authors proffered that investments must be hedged for protection, performance, and propriety. Given that the most compelling reality of today is the uncertain tomorrow, to mitigate, the investor must hedge. Investment sanity is somewhat restored with the knowledge that risk will have limitations.

The United States and the Global Financial Markets are in economic transition and at War as well. The fragile political and financial arenas seek stability during these tenuous times. Following a sixteen-year cycle of boom, it is understandable not to foresee an imminent readjustment. Investment hedging with a market-neutral portfolio might provide increased investor comfort and continue to expand as a pragmatic investment strategy. This would seem to correspond to the negative outlooks of signal investors who indicate that there is no end to possible financial crises. There is also the underlying fear of yet another 9-11 type event incident.