WEALTH MANAGER

Alternatively Speaking

By Robert A. Isbitts

There are many investing solutions in tough times. Hedge funds don't have to be among them.

It's hardly surprising that many advisors are new to the world of hedged investing. Back in the 1980s and 90s, when the stock and bond markets made everyone look like a genius, they didn't have to bother with it. And while stocks suffered from 2000 to 2002, as they have done many times in the past two decades, bonds bailed them out. Rates dropped as stocks fell, so bond prices rose. This allowed so-called "asset allocators" to survive by shifting money from stocks to bonds and lulled many investors and their advisors into a dangerous complacency.

Merely implementing a so-called bear market strategy is not the answer. What's called for is really a different approach to "lifestyle" investing—one that takes your clients' human emotions into account in a way that many traditional approaches ignore.

Rydex publishes a wonderful chart showing the Efficient Frontier—risk/return tradeoffs of various stock and bond allocations—by decade going back to the 1950s. What is striking in that data is that during both the 1960s and 1970s, there was no combination of stocks and bonds that produced a positive return through either decade! And with the high inflation that existed, their real return was even less.

Bond rates have fallen for a quarter-century, but now the world seems to be catching a whiff of inflation again. Stocks have spent years just to get back to where they were at the height of the Internet bubble (and many are still miles away). Volatility is up, and your clients are noticing. If you are not investigating strategies with low expected correlation to the stock and bond markets, you are taking an unnecessary risk in your practice.

The Hype of Alternative Strategies

Certainly hedge funds and hedge funds of funds have garnered much attention as a potential solution. Realistically, though, the benefits of the hedge fund are more than offset for most clients by the "box" in which the hedge fund is wrapped—the Limited Partnership. This means that even if your clients qualify to invest in hedge funds, they must grapple with what we call the TLC of hedge funds: Transparency (not enough of it); Liquidity (not enough of it) and Cost (too high). Add to this the fact that many hedge LPs invest in private securities not registered with or regulated by the Securities and Exchange Commission, and you get the picture. You need to find other ways to get the "good stuff" hedge funds can provide, such as low market correlation and more consistent returns.

Some point at so-called "130/30" strategies as a solution, but investing 130 percent of your capital long and 30 percent of it short still adds up to 100 percent exposure to the stock market. In the long run, that tells me that most 130/30 funds will behave like index funds at best. And—fancy strategy aside—that does not spare your clients the agony of a bear market. I have heard hedge funds referred to as a "compensation scheme masquerading as an asset class;" 130/30 may just fit that definition.

With so many "mainstream" strategies producing mediocre risk-adjusted results over long periods of time, why aren't more advisors furiously researching alternatives? Put another way, why haven't advisors embraced low-correlation alternatives to the overwhelming number of high-correlation strategies out there? The answer is twofold: Advisors have been disappointed with the alternative strategies they have encountered, and they have not been properly introduced to the alternative mutual fund space.

Alternative mutual funds—the forgotten "alternative"

The loosening of the short-short rule in 1997 allowed mutual funds greater flexibility in shorting stock and opened the door for new products. However, when the stock bear market hit in 2000, the number of registered mutual funds that pursue alternative strategies was very small, and ETFs barely existed. Since that time there has been an explosion of product. At my firm, we have identified 12 different sub-categories of alternative mutual funds and ETFs (see Guide on page 4) that we use to construct portfolios.

It's great that the world of low-correlation investing is now at the fingertips of any advisor and any-sized investor. The biggest hurdle is conducting the research to develop a portfolio mix that satisfies the goal. While the process is similar to that which you would follow in the traditional stock and bond world, it still takes a lot of time to create a process, get comfortable with what you created, and actively monitor the portfolio.

Yes, some hedged mutual funds stink, while others have consistently delivered returns that rival or exceed their peers in the hedge fund world. This is no different from traditional mutual funds. There are well-constructed funds with a great chance for long-term success, and there are others whose success is likely to be fleeting, or based more on luck than on skill and ingenuity. Your job is to identify those in the former category, construct portfolios (or find someone to do that for you), and communicate all this in a way your clients can understand.

> Since 2000, there has been an explosion in the number of registered mutual funds that pursue alternative strategies.

Look particularly at long-short mutual funds. Using the Open End Mutual Fund Category Averages provided by Morningstar, and analyzing the 10-year period ended 12/31/07, we see that while most growth-oriented mutual fund styles and popular diversification methods—like Target Date and Allocation Funds—tend to exhibit high correlation, the category containing long-short mutual funds does not correlate with any of the other groups. Here is the first major point to remember about long-short mutual funds: When you add the concept of short-selling to a mutual fund, it tends to lower long-term correlation of your portfolio.

We can also compare long-short mutual funds to various types of bond funds. Again, the bond fixed-income styles are highly correlated to each other, but long-short is not highly correlated to any of them. Remember that long-short mutual funds, if used correctly, can be an ideal substitute for bond exposure in a portfolio. In fact, we have been making this substitution for our clients gradually for several years now.

Finally, we can compare long-short mutual funds to the asset allocation-oriented fund categories and the S&P 500 Index over the same 10-year period. The long-short mutual fund category had a higher annual return than all of the peers in this comparison. The formula is simple: If you experience ups and downs in the markets over a 10-year period, the ability to short stocks or market indices is a key driver of success. This 10-year period contained strong, weak and flat stock markets. The one thing we did not see was sustained increases in bond rates.

Define your purpose

Keep in mind that this style of investing can serve many purposes. But before you can engage in analysis of individual funds, you must determine for a given client or your clients in the aggregate what the role of alternative investing is. Your choices include, but are not limited to:

- » Substitute for fixed-income funds
- » Substitute for individual bonds
- » Substitute for Target Date or Lifestyle approaches
- » Complement to traditional portfolio strategies

Your answer will affect whether you "tilt" your alternative asset allocation toward or away from the following four subcategories:

1. LONG-SHORT: this includes many of the funds that reside in Morningstar's long-short mutual fund index. Some of these funds take a classic approach, buying long positions with some of their assets and shorting stocks perceived as weaker. Other funds use a market-neutral approach, in which long and short exposure is kept close to equal. Still other funds are long-oriented, but have the ability to short when market conditions are perceived to be very dangerous. Funds that conduct arbitrage on merger transactions also fit into this group. The best approach is a combination of all of the above, with a focus on what the managers are trying to achieve and how confident you are that they can deliver. Advisors who recommend hedge funds often direct clients to hedge funds-of-funds for diversification benefits. The logic is the same here.

While many long-short mutual funds have been around for only a few years or even less, there are plenty of candidates with established track records. For instance, Gateway Fund, which recently celebrated its 30th birthday, is the oldest fund in the category. As is the case with many funds in this group, Gateway's approach is unlike any other of its peers. They simply buy the stocks in the S&P 500 and actively manage an option collar position around it. The goal is to control downside risk while capturing much of the returns from the net option premiums received. This is not long-short in the classic sense, but rather represents substance over style, so to speak.

The problem is that too many people stop here. They find a fund that seems to capture the idea of alternative or hedged investing, add it to their otherwise traditional portfolio, and get back to the important work of servicing their clients and growing their practices. This does not work any better in the hedged space than it does in the traditional space. There is manager risk and style risk in any fund, so building a portfolio of these oddball funds works much better than what I would call the "one and out" research process commonly used.

2. INCOME-RELATED: This sub-sector includes high yield bonds (U.S. and Non-U.S.), convertibles and REITs. These are more familiar to many advisors than long-short funds, and they serve a supporting role in a "hybrid" portfolio. Yet all funds in each of these styles are not equal. As an example, many REIT funds have become more growth-oriented over the years and their stabilizing force— the dividend yield—has declined. For this reason, we keep ourselves open not only to buying REIT funds or ETFs, but also to buying one of the ETFs that short a REIT index. There are funds that short high yield bonds as well. So, even in the categories that are not themselves long-short, you can short them anyway with some additional ingenuity.

3. COMMODITIES: the development of ETFs that target commodity indices or segments thereof has been rapid, and now you don't need to resort to learning how to be a futures trader to participate here. Warning: This is the most volatile area of Hybrid investing, so positions here are best kept smaller than the other categories most of the time. You may also find it necessary to be more active in managing this segment of the portfolio. This is where a noticeable chunk of our transaction turnover comes from.

4. DEDICATED SHORT: otherwise known as the "secret weapon" against bear markets. Conventional wisdom says that in a prolonged bear market, there's no way to make money. That's wrong. Remember that nothing bruises client confidence like defending a losing position for years under the guise of being a long-term investor. There are times when loss-avoidance should be given greater emphasis. For instance, in 2002, there was a major bull market…in shorting the Nasdaq— not with 50 percent of your portfolio, as that would be gambling, but with a modest allocation. This of course, means you will need to get yourself in the habit of being a macro-thinker when it comes to portfolio strategy. Many advisors already think that way, but don't realize how big their macro toolbox has become.

Analysis and allocation

Once you have identified the variety of alternative funds that make sense to you, we can use many of the techniques we apply to the analysis of traditional funds. Look at past performance, but not in isolation. Look hard at the fund's ability to preserve capital or even profit during down markets. Use statistics such as Capture Ratio, R-Squared, Beta, and Sharpe Ratio to compare funds and to see if the funds you include in your portfolio have been battle-tested.

Look at expense ratios, but not too closely. In the alternative mutual fund world, you often get what you pay for. These funds are not being paid to beat the S&P 500; they are being paid to make money and minimize losses when they occur. In my opinion, that skill is worth more than a relative-return manager's. Of course, they have to deliver on the promise to continue to justify the cost. That's another reason to get excited about the possibilities that alternative mutual fund investing brings to your practice. You are paying for skill, not for "closet-indexing." Clients feel much better about paying for Alpha than paying for Beta.

The world is changing around us—it's not the 1990s anymore. Going forward, investors will demand more than the "meat and potatoes" approach to investing.

When you are all done and have allocated and invested, the process has only begun. Now you need to follow the funds closely. Read everything your fund managers put out, and meet them or talk to them if you can. Some of the most insightful strategy commentaries come from long-short managers. The reason is obvious: They don't have to be cheerleaders for the stock and bond markets; if they see trouble, they can short it and make money.

Make no mistake—this is a labor-intensive strategy. For some advisors, this will be an extension of their current investment process; they will climb the learning curve required for alternative funds the same way they pursued their knowledge of stock and bond funds. For others, outsourcing this function will be the best approach.

Either way, what is clear is this: The world is changing around us—it's not the 1990s anymore. Going forward, investors will demand more than the "meat and potatoes" approach to investing. Of course, many alternative mutual funds and ETFs fail to deliver what they aim for, and several are untested. But creating an effective portfolio mix of low-correlation mutual funds is very do-able, and provides the advisor with a valuable tool to both meet existing client needs and differentiate their practice.

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A Guide to the **Alternative Dozen**

Equity Market Neutral
Exploits equity market inefficiencies and usually involves being simultaneously long and short matched equity portfolios of the same size within a country. Market neutral portfolios are designed to be either beta or currency neutral, or both.

Long-Short Equity and Hedged Equity
Involves equity-oriented investing on both the long and short sides of the market. The objective is not to be market neutral. The difference between the two is that a long-short fund typically shorts more than a hedged equity fund.

Dedicated Short
Maintains net short as opposed to pure short exposure. Short bias managers take short positions mostly in equities and derivatives.

Bond Hedge
Shorts bonds. As interest rates rise, bond prices fall, and these funds appreciate in value.

High Yield Bonds
Often called junk bonds, this subset refers to investing in low-graded, fixed-income securities of companies that show significant upside potential.

Distressed Debt
Invests in the debt, equity or trade claims of companies in financial distress and (generally) bankruptcy.

Convertibles
Invests in bonds and preferred stock issues that are convertible into the stock of the same issuer if the stock reaches a certain price level.

REITs
Invests in publicly traded REITs.

Merger Arbitrage
Invests simultaneously in long and short positions in both companies involved in a merger or acquisition. Risk arbitrageurs are typically long the stock of the company being acquired and short the stock of the acquirer.

Asset Allocation
Carries long and short positions in any of the world's major capital or derivative markets. These positions reflect their views on overall market direction as influenced by major economic trends or events.

Commodities
Uses derivatives or stocks to gain exposure to the performance of a basket of commodities such as energy, metals and grains.