Registered Rep.
The Source for Investment Professionals

THE DIY HEDGE FUND

The hedge fund backlash has begun. Tired of the hassles of investing in hedge fund limited partnerships, more advisors are creating their own "hedge fund"-like strategies with new hybrid mutual funds. You can do it, too. By David A. Geracioti

In Search of a Hedge: Financial advisor Rob Isbitts creates his own hedged portfolios.

Some years ago, during the Great Buying Panic of the 1990s, it occurred to Rob Isbitts that the traditional idea of diversification might not provide the downside protection it was advertised to deliver. As an investment advisor with Emerald Asset Advisors, an RIA in Weston, Fla., Isbitts saw new clients who had assets spread all over the place; it was as if the prior "advisor [was] trying to fill all the boxes in the famous Morningstar Style Box, then convincing the client that they [could] weather any storm," Isbitts says. "I think this is very 1990s thinking, and it is potentially very dangerous to you as an advisor. Style-box investing does not reduce your risk as much as you think it does."

His hunch was later confirmed in the bear market that struck in 2001. It turns out that "stocks plus stocks equals stocks," says Isbitts.

Just look back at the past decade: In the worst three years over the last 10 years (ending 2005), according to Isbitts, who used Morningstar data, a 100 percent long portfolio in the S&P 500 would have lost, on average, a little over 16 percent. If you added a 25 percent exposure to the Russell 2500 and 25 percent to the MSCI ex-U.S. and reduced your stake in the S&P accordingly in those three worst years, your losses would have decreased to an average annual 15 percent. (Feel better, Mister Client?)

That's why financial advisors and their wealthy clients seek out hedge funds: to produce positive returns—eye-popping big, if you please—no matter the weather. But the list of gripes against hedge funds and funds of funds is long, from high fees and illiquidity to a decidedly we-don't-need-you attitude some hedge funds put on for retail advisors. And, besides, since the bear market came to an end, hedge fund performance, in general, has been getting worse each year as money and new offerings flood the market. (There are now an estimated 8,000 hedge funds managing around $1.3 trillion in assets)

But who needs them anyway? "Fortunately," says Isbitts, "there are a growing number of mutual funds that transcend the style-box approach." Indeed, the securities industry, never slow to roll out products to fill a perceived market void, have trotted out a slew of "regular," open-end mutual funds that go long and short, use leverage and other complex strategies. These funds, which are registered with the SEC under the Investment Company Act of 1940, like other open-end funds, can avail themselves of various strategies to help produce low-correlated, low-volatility returns for retail advisors and their regular Joe clients. And more advisors are using them to build their own hedged portfolios. In general, says Isbitts, these hedged portfolios aim for returns that rival those of common stock benchmarks but enjoy volatility that is more like bonds (low) than stocks (high). Oh, and during down stock markets, these strategies should eke out returns (or lose little).

Advisors, such as Isbitts, are gobbling them up. In other words, by packaging these funds around any core index fund, you too can create a portfolio modeled on the endowments of a Yale or Harvard. (Assuming they haven't moved on to something else.)

The Next Big Thing

Morningstar now tracks 48 long/short mutual funds, that's double the offerings it tracked at the start of 2003 (although some advisors say the number out there is actually higher, since do-anything funds, such as Leuthold Core Investment,

> "It's a leap of faith that we know what's going on [with their hedge fund]. It makes me nervous as an advisor if I can't look them in the eye and tell them what's going on with their money. That's not a confidence builder."

aren't included in the group). The growth in offerings is not surprising given the amount of money that has been flowing their way. Through November 2006, long/short and market-neutral mutual funds gathered about $4.8 billion in net new cash, according to Strategic Insight, a mutual fund research and consulting firm. That's up from about $1 billion in new money in 2005. And you can thank the bulk of that new cash to the handiwork of financial advisors, says Avi Nachmany of Strategic Insight, a mutual fund research and consulting firm. Why? Nachmany says, "Maybe [advisors] are trying to bring the mystique of hedged strategies to traditional fund investors, or maybe it reflects the FAs' never-ending search for interesting investment strategies and discoveries of such—but ones still within the transparency and oversight of mutual funds, which offer comfort zones and protective regulation, unlike nonregistered alternatives."

Another reason why cash should continue to flow to 1940 Act hedged funds: The SEC has proposed raising the minimums for investing directly in hedge funds to $2.5 million in liquid assets from $1 million. That excludes most U.S. households. That's one reason why so-called 130/30 funds (where the fund goes 130 percent long, and 30 percent short for a net exposure of 100 percent long) are being brought to the retail market, according to Todd Trubey of Morningstar. And baby boomers who are approaching retirement will definitely see the beauty that long/short mutual funds wrapped around various indexes or ETFs provide: more consistently positive returns than they get from the stock market, but higher returns than they can get from bonds.

For these reasons, among others, hybrid funds, as Isbitts calls them, may indeed prove to be growing competitors to traditional hedge funds. That's certainly the case for Isbitts, whose firm caters to the wealthy; it has $250 million in assets under management. He increasingly uses them in place of hedge funds or funds of funds for his accredited investors. In essence, he'd rather make his own than deal with all the "headaches" that nonregistered funds bring with them. Hybrids are much cheaper for the client (costing a total of 2.5 percent or so, after the advisor's fees and fund expense ratios, on average). They also offer daily liquidity, yet can be used to achieve the kind of uncorrelated, absolute returns that the the big boys do. (Hedge funds typically charge 1 percent in annual management fees—and sometimes more—and then keep 20 percent of any profits—and sometimes more. Funds of funds have another layer of fees. As Isbitts says, hedge funds are a "compensation scheme masquerading as an asset class.")

Carl Zuckerberg, a partner at Relyea Zuckerberg Hanson, a dually registered RIA and registered rep (affiliated with Commonwealth Financial Network) in Stamford, Conn., says his firm, with about $500 million in assets, also caters to wealthy retail investors: He has a $3 million minimum and an average account size of around $6 million. "We do use hedge funds for certain clients," Zuckerberg says, "but we have a some older clients who want to touch [their investments] and feel [them]." He adds, even with the most prestigious funds, "It's a leap of faith that we know what's going on. It makes me nervous as an advisor if I can't look them in the

HEDGING BUILDING BLOCKS

Morningstar follows 48 different funds in its long/short category. While it's difficult to compare long/short mutual funds with each other because of their different strategies, *Registered Rep.* screened for best performance.

Fund	ticker	1-year Return	3-year return	5-year return	Sharpe ratio	Maxi front load
Analytic Global Long/Short	ANGLX	13.4%	10.3%	9.6%	0.90	0%
Calamos Market Neutral A	CVSIX	8.4	3.7	5.5	0.12	4.75
Diamond Hill Long-Short A	DIAMX	16.9	18.4	12.8	1.82	5.00
Gateway	GATEX	10.1	7.2	5.5	1.42	0
Hussman Strategic Growth	HSGFX	3.5	4.8	9.7	0.37	0
James Market Neutral	JAMNX	-0.4	5.3	4.1	0.35	0
Laudus Rosenberg Global Long/Short	MSMNX	3.2	3.9	5.7	0.15	0
Laudus Rosenberg US Large/Mid Long/Short	SSMNX	6.8	7.0	5.6	0.67	0
Merger	MERFX	11.0	4.7	3.8	0.45	0
Templeton Global Long Short A	TLSAX	14.4	7.3	6.2	0.72	5.75

Returns through 12/31/06 *Source: Morningstar*

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In addition to the long bill of particulars against hedge funds is another added problem: Now that reporting and accounting requirements have increased, clients who invest in limited partnerships may not get their K-1s until October or November (by comparison, 1099s are mailed by Jan. 31). That means they don't get audited gains or losses until another investment year is almost over, forcing them to file for income-tax extensions. Further, most limited partnerships don't consolidate their reporting with clients' other assets and their portfolios can't be tracked by Advent or other portfolio reporting systems, Zuckerberg says.

> As one advisor says, hedge funds are a "compensation scheme masquerading as an asset class."

You Can Do It, and **Win**

Another trend encouraging advisors to create their own low-volatility, low-correlated portfolios: Hedge funds are no longer necessarily sold on the promise of outsized gains, "but more and more on the back of the diversification argument," according to Harry Kat, a professor of risk management at Cass Business School in London. Kat and other academics, in fact, have published papers saying they can replicate hedge fund performance because hedge-fund managers don't add as much alpha as they may advertise. (For more, see: *Can Hedge-Fund Returns Be Replicated?* by Jasmina Hasanhodzic and Andrew Lo, August 2006.) The academicians conclude that one way to replicate hedge fund performance is to dynamically trade futures around equity and fixed-income indexes. This is why Kat's 2005 paper, with Helder Palaro, is entitled: *Hedge Fund Returns: You Can Make Them Yourself!*

Advisors say they are growing adept at using hybrid funds without necessarily having to bother with trading futures (let the asset manager do that). But how? That is the vexing question. And advisors say it takes study. Of course, there are simple ways, i.e., choosing one-off funds. Trubey, the Morningstar analyst, says there are market neutral funds and "equity variable" funds (see table). Trubey cites Hussman Strategic Growth as "the closest you can get to a traditional hedge fund."

Isbitts, however, chooses among many different no-load funds from 12 different asset classes. From these—distressed debt funds, to merger arbitrage, to REITs to long/short funds—he creates personalized, multi-manager strategies based on a client's need: conservative, moderate or aggressive. The result is an absolute-return portfolio, but only cheaper, liquid, more tax efficient with greater transparency and flexibility, Isbitts says. (Isbitts intends to package this as a multi-manager mutual fund, and declined to offer return data until the audit is complete.)

Zuckerberg also takes a decidedly more sophisticated approach than just buying one fund. In his firm's basic "hedged asset" portfolio, Zuckerberg uses four basic strategies to build a hedge fund-like portfolio. (Zuckerberg would not divulge details, so as not to give away his intellectual property; other advisors interviewed were also unwilling to offer complete details.) First he'll use a basic long/short fund, such as American Century Long/Short Fund. Then he'll add a sector rotation fund, an "alternative assets" fund (such as international real estate or alternative energy) and, lastly, a venture-capital fund, such as PowerShares Redrocks Listed Private Equity. (Apollo and KKR, among others, have also floated public private-equity funds.) Zuckerberg's hedged portfolio, only a year old, returned about 18 percent, net of manager fees, in 2006. The portfolio has a back-tested R-squared (correlation co-efficient) of about 0.48 compared to the S&P 500 and a standard deviation about 40 percent less than the market, he says. In short, those are hedge fund-like statistics but with no incentive fee piled on top.

"I believe that for most people, investment success is about getting what they want out of their money, not about beating a market index," Isbitts says. "People don't come to you because they want to own stocks and bonds. They work with you because they want certain things out of life, and their portfolio is the currency that allows them to get those things. Your job is to make sure they take the best path to get there."

BUILD YOUR OWN HEDGE FUND

These mutual funds enable investors to short the market or take outsized bullish positions.

Fund	Ticker	What It Does	12-Month Return
ProFunds Rising Rate 10	RTPIX	Tracks inverse of daily performance of 10-year Treasury.	5.3%
ProFunds Short OTC	SOPIX	Tracks inverse of NASDAQ 100.	-1.28
Rydex Inverse S&P 500	RYARX	Tracks inverse of S&P 500.	-7.1
Rydex Nova	RYANX	Delivers 1.5 times daily performance of S&P 500.	19.4

Returns through 12/31/06. *Source: Morningstar*

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