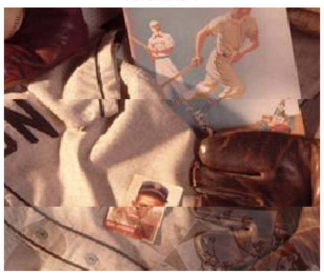
5 strategies to help uncertain investors

These alternatives help clients hedge risk and reduce volatility while staying in the market

Recommend (7)

By Jeff Benjamin
September 26, 2010 6:01 am ET

As soon as the dust started to clear after the 2008 financial crisis, a lot of investors learned the hard way that their portfolios weren't nearly as diversified as they should have been.



That reality, which is still present to a large degree across multiple asset classes, has financial advisers looking in the direction of alternatives for non-correlated performance.

"Advisers and their clients are still suffering from post-financial-crisis syndrome, and they see repeats of the financial crisis around every corner, whether those fears are real or not," said Rick Lake, owner of Lake Partners Inc.

In such an environment, investors aren't looking for alternatives to help them sound impressive at cocktail parties or to squeeze a few more percentage points out of a hot sector. Right now, investors are looking for more ways to manage the risk that has become so relentless over the past few years.

The following are some of the ways that advisers can tap into the alternatives universe to help their clients hedge risk and dampen some volatility while staying in the market.

1. LONG/SHORT EQUITY

In a choppy, sideways market cycle like this one, the biggest risks are longer-term beta bets, and stock picking is the name of the game. But unless a manager is going both long and short, the only alternative to owning a stock is holding cash. Thus, the real alpha advantage comes when the strategy involves going both long and short inside the same portfolio.

Whether the long/short strategy is pursued through a hedge fund manager or through the growing list of registered products such as mutual funds, it still comes down to doing enough research to understand the kind of market exposure that you are getting for your money.

A traditional long/short strategy can build net-long or net-short exposure inside a portfolio, which is different from a market-neutral strategy that seeks to balance and offset long and short positions.

The classic long/short strategy is also more flexible than the recently popular 130/30 funds, which are designed to be up to 130% long and 30% short. The downside of the 130/30 strategy is the rigid structure and the fact that many of them were rolled out by long-only managers and fund companies that didn't possess the right level of expertise on the short side.

It can take some digging to find the right long/short fund strategy because many of the fund-tracking firms are struggling to categorize some of the new iterations on alternative funds, but there are some packaged products that offer easy exposure to long/short investing.

One example is Weitz Partners III Opportunity Fund (WPOPX), managed by Wally Weitz, owner of Wallace Weitz & Co. The fund, which is categorized by Morningstar Inc. as a large-cap blend and has a five-star rating, is highly regarded for not falling into the 130/30 marketing trap.

2. LONG/SHORT BONDS

The long/ short strategy is also a promising path toward non-correlated returns, assuming that you are working with a good

The top muni bond funds

Market Data »

Fund	Ticker	YTD
PIMCO Extended Duration Instl	PEDIX	28.74
PIMCO Extended Duration P	PEDPX	28.65
American Century Target Mat 2025 Inv	BTTRX	25.79
American Century Target Mat 2025 Adv	ACTVX	25.57
Vanguard Extended Dur Treas Idx Instl	VEDTX	24.84

Enter Ticker LOOKUP

PROVIDED BY MORNINGSTAR®

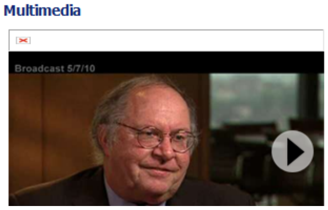
Most Popular

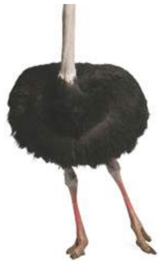
Read | Recommended | Commented

- Real estate money managers stanch the bleeding
- Insurers' closing of VA funds rubs advisers the wrong way
- A time to discuss retirement policy
- Morningstar may drop star ratings for leveraged, inverse ETFs
- 5 strategies to help uncertain investors
- L.A. real estate mogul and investment guru charged with fraud

More Popular »

Multimedia





manager.

In this case, a good example is the MainStay High Yield Opportunities Fund (MYHNX), subadvised by Dan Roberts, senior managing director at MacKay Shields LLC.

Even though the fund technically uses a 130/30 model, the strategy incorporates enough flexibility to keep its market correlation below 80%.

The fund, categorized by Morningstar as high yield, has been able to navigate some difficult market conditions recently, which is a testament to both management and the long/short strategy, which includes leverage.

The fund has held up well amid tough markets because of management's focus on risk rather than returns, said Morningstar analyst Nadia Papagiannis.

"Management substantially dialed down risk in 2008 by investing in shorter-term, higher-quality bonds but resumed risk at the end of the year as bond prices picked up," she said.

There are also global versions of the strategy, including the Eaton Vance Global Macro Absolute Return Fund (EIGMX), which Morningstar lists in the world bond category.

This fund, managed by Mark Venezia at Eaton Vance Corp., was shorting Greece's sovereign debt five years ahead of the country's financial crisis, which isn't the kind of protection you could get from a long-only strategy.

U.S. investors in general tend to be underexposed to foreign debt, which is why a global long/short strategy could greatly enhance portfolio diversification.

3. MANAGED FUTURES

One of the few positive byproducts of the financial crisis has been the light shed on the managed-futures space for its lack of correlation to traditional investments such as stocks and bonds.

In 2008, for example, when the S&P 500 fell by more than 38%, the average managed-futures fund gained more than 18%.

And as might be expected, the financial services industry has responded by figuring out ways to position these traditionally alternative-class investments into portfolios for the investing masses.

It is still possible to do this the old-fashioned way, by investing through a commodities-trading adviser, but the mutual fund industry is making access a lot more user-friendly with lower minimums and better liquidity.

Be advised, however, that these aren't one-size-fits-all products, and as the fund industry jumps on this bandwagon, it will become increasingly important to dissect the products.

The Rydex/SGI Managed Futures Strategy Fund (RYMFX) is an index fund pegged to the S&P Diversified Trends Indicator Index, which is a diversified composite of commodities and financial futures designed to provide exposure to major global market trends.

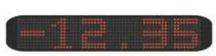
In 2008, the Rydex fund gained more than 8.5% and helped put retail access to managed futures on the map.

But last year, when the S&P 500 gained 38%, the Rydex fund fell by 4.3%, proving that, as a stand-alone product, it is far from a panacea in the alternatives space.

The most recent entrant into the fund space is the Altegris Managed Futures Strategy Fund (MFTAX), which is an actively managed fund that invests in various strategies from the Altegris 40 Index, which tracks 40 individual CTAs.

The near-zero correlation to the broader markets should be reason enough to find room in a diversified portfolio for managed futures, but it is important to pay attention to the multiple shades of gray that will continue to fill this fast-growing space.

4. TACTICAL INVESTING



In the world of investing, the word "tactical" has become a not-so-secret code word for active trading or what some might even refer to as market timing — a concept that goes against the grain of traditional buy-and-hold investing.

Tactical investing can be applied across virtually any asset class or investment category because the ultimate objective is to be nimble enough to take advantage of opportunities and to avoid doing nothing during a severe downward cycle.

Although there are myriad products and platforms available to make tactical investing possible for just about anyone, this isn't the kind of strategy that most advisers will have the time or inclination to explore on their own. But that is OK because there are packaged tactical products already on the market that can provide that particular slice of active-investing exposure.

Direxion Funds, an $8 billion asset management firm with a host of leveraged and inverse products geared toward tactical strategies, has also been rolling out some mutual funds that offer tactical-trading exposure across various markets.

The Direxion Commodity Trends Strategy (DXCTX) and the Direxion Financial Trends Strategy (a href=http://www.investmentnews.com/section/investment-profile?

ticker=DXFTX>DXFTX) are both index-based and will go long or short on components of their respective indexes.

The Direxion Long/Short Global IPO Fund (DXIIX) takes a tactical approach to investing in newly public companies by going long at the initial offering and then shorting the stock after it has been trading for a while and momentum starts to fade.

One thing to keep in mind with a tactical strategy is that portfolio turnover will be high, which can introduce higher tax consequences for investments held outside a qualified retirement account.

The RiverNorth Core Opportunity Fund (RNCOX), which uses a tactical strategy in trading closed-end funds, based on discounts to net asset values, had 300% turnover in 2008 and 200% turnover last year.

5. CORE ALTERNATIVES STRATEGY.

For straightforward exposure to alternatives, the closest thing to a turnkey solution is a fund that seeks to offer a diversified portfolio of non-correlated investments. This can be an ideal strategy in situations when dampening risk and volatility is more important than chasing performance, which pretty much sums up the current environment for a lot of investors and advisers.

Core managers typically will blend a wide variety of underlying strategies, funds or subadvisers to create a non-correlated alternative-investment vehicle that can be used as part of a larger and more traditional portfolio.

The Aston/Lake Partners LASSO Alternatives Fund (ALSOX), managed by Frederick Lake of Lake Partners, combines such strategies as hedged equity, long/short fixed income, arbitrage, futures and specialty hedges for a fund designed to fit into the alternatives slice of a portfolio.

Another example is the Absolute Strategies Fund (ASFIX), which is managed by Jay Compson of Absolute Investment Advisers LLC. This fund allocates assets to 15 subadvisers, with each concentrating on investing in different alternatives strategies.

There also is the Direxion/ Wilshire Dynamic Fund (DXDWX), subadvised by Cleo Chang of Wilshire Associates Inc.

The Direxion fund re-balances monthly across 17 asset classes, including stocks, bonds, cash, commodities and real estate, with a goal of adjusting the correlation to the market, depending on the outlook.

If the market outlook is negative, the fund's correlation might be as low as 70%, but if the outlook is bullish, the fund can apply some leverage and bring the correlation up to 130%.

"In a core strategy, you're mostly looking for the manager skill or alpha that can generate a non- correlated return," said Mark Willoughby, principal at Modera Wealth Management Inc.

E-mail Jeff Benjamin at jbenjamin@investmentnews.com.

Comments

You must be logged in to leave a comment. Login | Register

Submit