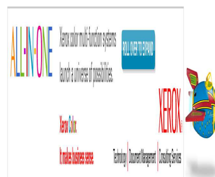

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FIVE FOR THE MONEY

By Marc Hogan

Hedging Without a Hedge Fund

Can't muster the megabucks needed to gain entry? These mutual funds use hedge-like strategies, and they could help lower overall portfolio risk

It's been an up-and-down summer for stocks, and Labor Day weekend might not mark the end of Wall Street's worries (see BusinessWeek.com, 8/18/06, **"Can the Rally Keep Up?"**). As uncertainty continues over economic growth and inflation, many investors may be looking for ways to reduce risk in their portfolios. In small doses, mutual funds that use hedging strategies can help do just that.

Hedge funds—private investment pools that cater to wealthy investors—have gotten plenty of buzz in recent years for their sophisticated strategies and exclusive allure. Nevertheless, typical investors probably can't meet the lofty investment minimums and high fees that hedge funds demand. Enter hedge-like mutual funds (see BusinessWeek.com, 12/12/05, **"Funds Made to Deliver"**).

Like hedge funds, these mutual funds strive for top-notch returns in any kind of market. Some hedge-like mutual funds can give a portfolio extra diversification—and reduce overall risk—because, as with commodities or real estate, their returns usually don't correlate with the broader stock market. "If you've got a longer time horizon and you want to provide some diversity to your portfolio, a hedging instrument would be a good addition," says Philip Edwards, managing director of Standard & Poor's Investor Services.

SMALL ALLOCATION ADVISED. The funds vary in approach, though selling stock short is generally a component. Investors need to understand the fund they're buying and whether it fits their investment strategy. "Depending on where you want to go, you'll get a different set of returns and your choice will vary considerably," says Lipper research analyst Jeff Tjornehoj.

Hedge-like funds make the most sense when they're only a small piece of a portfolio, not a core holding, analysts say. "You don't want to put more than 10% or 20% of your stock allocation in them," says Robert Pagliarini, president of Los Angeles financial planning firm Pacifica Wealth Advisors and author of *The Six-Day Financial Makeover*.

Still, hedge-like funds can be a good addition to a risk-conscious investor's portfolio (see BusinessWeek.com, 4/6/06, **"Winning the Game of Risk"**). This week's *Five for the Money* looks at five savvy mutual funds that venture into hedge fund turf.

1. Hussman Strategic Growth

Like a hedge fund, Hussman Strategic Growth (**HSGFX**) hedges its bets. The fund uses put and call options on the S&P 100 and Russell 2000 indexes whenever manager John Hussman has a bearish view of the market climates. This is one of those times. "Generally speaking, I continue to view negative economic surprises and upside inflation surprises to be the probable norm," Hussman says in his Aug. 28 weekly commentary.

On a five-year basis, the fund posted average annualized returns of 10.6% through Aug. 29, tops in Morningstar's (**MORN**) long-short category and ahead of the 4.38% turned in by the S&P 500-stock index. More recently, though, Hussman's hedging has held down the portfolio's performance. Its three-year average annualized return of 6.29% places just 42nd in the category.

Still, a number of financial planners say they use Hussman Strategic Growth to help diversify their clients' portfolios. "I typically allocate 5% to 10% of a client's portfolio to this type of investment depending on their risk tolerance," says David Fernandez of Scottsdale (Ariz.) financial-planning firm Wealth Engineering. "The more risk-averse they are, the more I would allocate to this type of fund."

Top holdings include McDonald's (**MCD**), Johnson & Johnson (**JNJ**), and Computer Sciences (**CSC**). Meanwhile, this no-load fund has consistently lowered its expense ratio, most recently to 1.1%, among the lowest in this high-cost category.

2. Arbitrage

While Hussman Strategic Growth varies its short position depending on the market outlook, hedge-like funds called "market neutral" funds aim for equal exposure to long and short positions. This strategy can minimize volatility, but may also reduce gains. One example is Arbitrage (**ARBFX**), which generally buys a merger target and sells short the acquiring company.

In keeping with this approach, Arbitrage's recent returns have been solid if not stunning. Through Aug. 29, its five-year average annualized return of 6.05% tops the S&P 500, though it lags on a three-year basis. The fund focuses on companies with market-caps below $600 million, and top recent holdings include Remington Oil & Gas, ADE (**ADEX**), and Euronext.

Again, Arbitrage and similar fund Merger (**MERFX**) make the most sense as a way to add diversification to a portfolio, financial planners say. "You can't look at an asset on its own," says financial planner Barry Kaplan of Atlanta-based Cambridge Southern Financial Advisors. "Would I put Tabasco right on your tongue? No way. But if it's part of the chili, I've got to have it, or it's not chili."

Arbitrage's special sauce doesn't come especially cheap, though it compares well against its peers. This no-load fund carries expenses of 1.7%.

3. Calamos Market Neutral Income
A convertible-arbitrage strategy has helped steer Calamos Market Neutral Income (**CVSIX**) through more than 15 years of solid returns. The fund invests in convertibles—bonds that can be converted into a company's stock—while shorting the underlying stock.

Through Aug. 29, the fund has posted five-year average annualized returns of 5.04%, beating the S&P 500, albeit only modestly, 4.38%. However, the fund lags 6.51 percentage points behind the broad benchmark on a three-year basis. "It hasn't historically done well when the convertible bond market has been soft, but generally speaking it's been a very consistent, steady performer," says Morningstar senior analyst Dan McNeela.

Calamos Market Neutral Income reopened to new investors at the end of 2005 after shutting its doors to newcomers in early 2003. It carries a 4.75% front-end load and an expense ratio of 1.57%.

4. Diamond Hill Long Short Fund
A more aggressive option is Diamond Hill Long Short (**DIAMX**). The fund holds long positions just like a typical mutual fund, but it also has a slightly smaller portfolio of short positions on stocks it deems overvalued. "The managers have proven pretty adaptive to picking good stocks to invest in, and we also like them as value managers in general," says Morningstar's McNeela.

The long and short of it: The fund has put up benchmark-beating numbers. Through Aug. 29, the fund has posted three-year average annualized returns of 19.79%, tops in its category, vs. 10.95% for the S&P 500. Managers Ric Dillon Jr. and Charles Bath keep portfolio turnover low, which can boost after-tax performance.

From an expense standpoint, Diamond Hill Long Short is near the cheaper end of this costly group. It has a 5% front-end load and a 1.55% expense ratio.

5. Quaker Strategic Growth Fund
Another more adventuresome choice is Quaker Strategic Growth (**QUAGX**). The fund is probably best known for its eight-calendar-year streak of beating the S&P 500, which puts it second behind Bill Miller's 15-year run at Legg Mason Value Trust (**LMVTX**). Manager Manu Daftary has racked up that track record by buying stocks of all sizes, from micro-cap to large-cap, and also selling stocks short.

In the five years ended Aug. 29, the fund recorded an average annualized return of 7.54%, sixth in its category. Among top holdings are Phelps Dodge (**PD**), General Dynamics (**GD**), and ConocoPhillips (**COP**). However, its shareholders fork over a 5.5% front-end load, plus a hefty 2.04% expense ratio.

Of course, some of these funds can be risky on their own, so investors should gauge their risk tolerances carefully. Still, used properly, many hedge-like funds can be important tools to reduce risk overall in a broadly diversified portfolio, analysts say. After all, why should big-money investors get all the advantages?

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