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Small Investors Embrace Hedge Fund-Like Strategies

High market volatility prompts a search for downside portfolio protection in tactical asset-allocation ploys as some funds aim to limit risk

By David Bogoslaw

(Corrects affiliation of fund manager Christopher Zuehlsdorff in 19th paragraph.)

With the economic recovery recently turning bumpy, investors have grown wary of downside risk in their investment portfolios and are increasingly willing to give up some returns in exchange for protection from those risks. Volatility spiked in May, as concerns about European sovereign debt and a bigger-than-anticipated slowdown in China's economy shook the market's confidence.

More than nine months into an economic recovery, you would expect investors to be reaching for high returns, but that's not the case, says Jeff Cusack, president of Forward Funds, who's seeing much greater interest in risk control. The traditional approach to modern portfolio theory, which focuses on diversified asset allocation and portfolio manager selection, is being challenged as never before, he says.

"Financial advisors are saying: 'We need to be more tactical and nimble'" because their clients are telling them they can't handle anything akin to the losses they suffered in 2008, Cusack says. He believes the missing piece in most portfolio management is what he calls exposure management. "Sometimes you should be out of the way—not fully invested and watching the value of your assets go away."

While hedge funds lost much of their luster in the fall of 2008, when they proved not to be as insulated from high correlation among asset classes as most people had been led to believe, financial advisors and retail investors are entrusting more money to mutual funds with hedge fund-like characteristics. Tactical allocation portfolios generally comprise a core strategy—broad exposure to traditional asset classes such as developed market stocks and government and corporate bonds—and a satellite strategy. The latter typically holds international small-cap stocks, emerging market stocks, and debt, along with U.S. and non-U.S. real estate via Real Estate Investment Trusts, or REITs. Since some of these portfolios use index-tracking exchange-traded funds, the high fees for active management could irk some cost-conscious investors.

Tactical allocation portfolios aim to make money for investors in both up and down markets. A key way to achieve this is by minimizing volatility in the portfolio. The Goldman Sachs Absolute Return Tracker Fund (GARTX), which tries to replicate the returns generated by a broad assortment of hedge funds, had a two-year volatility of 7 percent as of May 31, 2010, far less than the 24 percent for the Standard & Poor's 500-stock index, and 36 percent for the Goldman Sachs Commodities index, over the same period. In May 2010, the fund was down 2.43 percent, vs. an 8 percent loss for the S&P 500 and a loss of 11.3 percent for international stocks, says Theodore Enders, portfolio strategist for Goldman Sachs Asset Management's Portfolio Strategy Group.

A MINIMUM STAKE OF $1,000

The portfolio currently has positions, through futures contracts, that track the S&P 500 index, TOPIX (the Japanese large-cap index), the United Kingdom's FTSE-100 index, and the Eurostoxx index, along with a position that inversely tracks the Russell 2000 index—a bet against U.S. small-cap stocks. The fund has holdings in the iShares MSCI Emerging Markets index (EEM) and uses futures contracts to bet against the U.S. 10-year Treasury Index. It also has futures contract positions that track the S&P 500 Commodities index and its precious metals sub-index, and allocates some money to cash, largely through money market funds. The portfolio avoids single-security positions such as industry pair trades, merger-arbitrage deals, and individual stocks.

"It's based on the premise that most hedge fund returns can be traced to long and short positions in broad markets," Enders says. "Hedge funds as an asset class have a high correlation to equities during bull markets and a low correlation during bear markets," and the Absolute Return Tracker maintains those correlation relationships over extended periods. Enders emphasizes that the correlation during a 12- or 24-month bear market can be low—around 0.5—not negative. Investors need a minimum of $1,000 to invest in the portfolio.

The Legg Mason Permal Tactical Allocation Fund (LPTAX) is a fund of funds that takes both a strategic and tactical approach in managing its portfolio. It invests in ETFs, exchange-traded notes, open- and closed-end funds, and alternative investments such as commodities, real estate, and foreign currencies. Since hedge funds have been Permal's core business, "we have a unique insight into what hedge funds are doing, " says Christopher Zuehlsdorff, co-manager of the $70 million fund, which launched in April 2009.

On the strategic side, the fund managers decide what portion of assets to put into equities, fixed income, alternative asset classes, and cash. An investment committee meets weekly to discuss the market environment, identifying moves to make on a weekly or monthly basis within specific asset classes.

A TIME FOR ACTIVE MANAGEMENT

"One thing we've done more recently is to favor stability over cyclicality [in U.S. stocks]—health care, utilities, consumer staples—and underweight financials, energy, and telecom," says Zuehlsdorff. "We've trimmed our emerging markets exposure since they rallied so much and [we] are getting that exposure now through multinationals in the U.S., Asia, and Europe" that export to emerging economies. An independent risk committee reviews the portfolio every month and advises the managers on specific risk factors to which the fund is exposed, whether intended or unintended, he says.

Now is a time for active management, says Zuehlsdorff, citing recent changes in economic indicators such as interest rate hikes in Australia and India that could slow down those economies, plus a lack of improvement in U.S. unemployment levels.

Johanna Kyrkland, co-manager of the Schroder Multi-Asset Growth Portfolio (SALAX), seeks to dampen volatility through asset-class diversification. She allocates capital according to where she thinks we are in the economic cycle. Currently, the fund has a 45% weight in equities, which is below the 60% level it would typically hold during a recovery phase. Elevated risk related to consumer and institutional deleveraging in the West is the main reason she cites for the conservative stance on stocks. The fund has nearly a 20% allocation to high-yield and investment-grade corporate debt, but shies away from government bonds because they don't meet the fund's required return of inflation plus 5 percent. The rest of the fund is in foreign currencies—particularly in emerging markets—and commodities.

During short periods, such as the grimmest two weeks in October 2008, correlations among asset classes climb so high that diversification won't help, Kyrkland concedes, saying that it nonetheless works over longer time horizons. She believes in having downside protection in the portfolio, but says you can't expect to get attractive returns without taking some risk. With tactical allocation portfolios, you have to keep in mind that you're paying for insurance and you want to ensure that the price of that insurance is appropriate to the risk you're taking, she says.

"BETA LEVERAGE," THROUGH INDEXES

"Today, it's wrong to hedge yourself to generally feeling worried about the world. You have to be specific," Kyrkland says. For example, while she was confident in equities overall last year, she was concerned that European economies could weaken further on the sovereign debt crisis and wanted to hedge for that. "We found a cheap way was to hedge against the euro. We went short the euro last year. We identified a specific risk and there was a cheap hedge to position for it."

The Forward Tactical Growth Investor (FFTGX), currently with $618 million in assets, requires a minimum investment of $2,500. The fund is invested mostly in ETFs that track the S&P 500 index, the Nasdaq Composite index, the Dow Jones Industrial Average, and the Russell 1000 index. In lieu of leverage, the fund uses what Cusack at Forward Funds calls "beta leverage," meaning it invests in indexes that have higher volatility than the S&P 500 and can offer bigger returns. Just after U.S. stocks began to plunge anew in January 2009, the strategy went to 100 percent cash. A week after the market put in a low on March 9, 2009, Forward's models started to register bullish signals and the fund began to shift back into stocks.

In the first quarter of 2010, the portfolio ranged from a 60 percent weight in stocks to an 80 percent weight in cash. While Cusack sees stock valuations as mostly fair, with a massive amount of liquidity from both sidelined investors' cash and low interest rates, the fund's model is based on momentum driven by trading volume and market breadth—two things that are lacking right now.

Something that intrigues Cusack is that while the tactical approach is labeled "alternative," it's not attracting the typical alternative-asset allocation of 3 percent to 5 percent. "More often, [retail investors] are making this a core allocation. We're getting a 35% core allocation typically because advisors don't think they're getting return expectations or risk [protection] out of traditional strategies."

FOR NOW, UNCERTAINTY AND INSTABILITY

Traditional portfolios rely heavily on large-cap stocks, but because those are the most efficiently priced part of the market, there's not much opportunity for a manager to get any additional return there, Cusack says. Once you add fees for active management and advisory services, you end up with a "really low single-digit" return, and "absolutely no downside protection because you're essentially fully invested in the strategy." Now that investors are focusing more on absolute returns, it makes sense for an absolute-return strategy to be their core strategy, especially given the dearth of value traditional portfolio allocations have provided, he adds.

Zuehlsdorff at Permal, Legg Mason's hedge fund affiliate, doesn't believe there will be a repeat of 2008, but sees uncertainty and instability persisting in the short term. He sees a variance of monetary policies between developed and emerging countries, as well as differences in inflation between geographic regions, which he says has important implications for how asset classes perform.

"We're seeing nice economic growth from emerging market economies, but that doesn't imply emerging market equities are going to do the best this year. The U.S. is on fairly solid footing, but I don't expect to see a strong, sustained rebound," Zuehlsdorff says. "We can see how fragile the recovery is, given what's going on in Europe—and possible tightening measures in China."

There's a disconnect between retail investors' growing interest in absolute return strategies and their unwillingness to accept any downside risk. That's a problem because these portfolios can't guarantee protection against every short-term bump in the market.

"We promise them downside [insurance] on a three-year time horizon, not on a monthly or yearly basis," says Ryan Caldwell, portfolio manager of the Ivy Asset Strategy Fund (WASAX), which launched in 1997. "If we hedge away all the volatility, we'll also hedge away all the return."

Bogoslaw is a reporter for Bloomberg Businessweek's Finance channel.