

Investments

Long Short FUNDS

EXAMINING MORNINGSTAR'S NEWEST CATEGORY

With the stock market collapse earlier this decade still lingering in the minds of many advisors, long-short equity funds are becoming increasingly popular investment vehicles. In fact, given the recent explosion of fund offerings, Morningstar created a new Long-Short fund category to assist in tracking them. While some advisors continue to question the merits of long-short funds, others are rapidly incorporating these strategies into their clients' portfolios. For those who dare to venture into the world of long-short investing, many challenges and opportunities await.

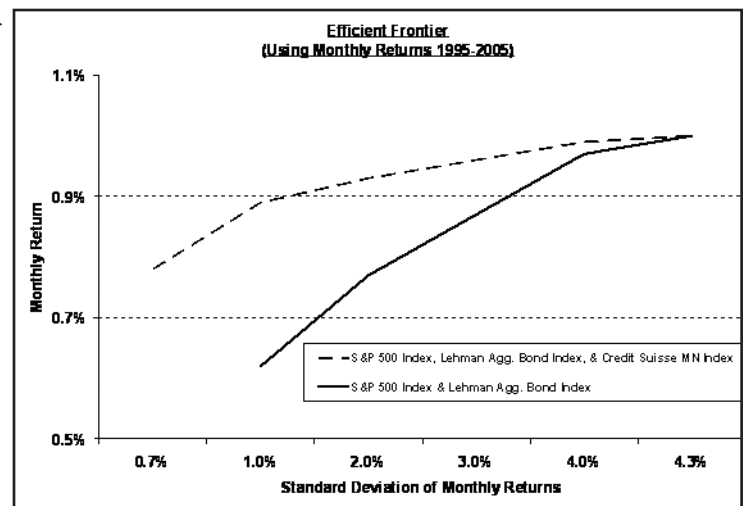
By the broadest definition, long-short equity funds are mutual funds that utilize an investment strategy known as selling securities "short" (i.e., borrowing shares, selling them, and then purchasing them at a later date to close the position). The goal of a short trade is to sell a stock that subsequently drops in value so that it can be repurchased at a lower price, resulting in a profit. Morningstar uses a more stringent definition for inclusion in the long-short category by applying a proprietary materiality threshold based on the actual volume of shorting activity. Morningstar has correctly observed that many so-called long-short funds are failing to employ shorting strategies in a material way.

While common to the private (hedge) fund industry, long-short equity strategies represent a small fraction of the 1940 Investment Advisor Act mutual fund universe. There are fewer than 50 funds identified by Morningstar as long-short, and a large number of these have opened in the past 3 years. Moreover, these funds have below-average asset levels, so the diminutive size of this segment is even more apparent when looking at the dollar commitment by shareholders. Though currently small, these funds are growing rapidly as more advisors turn to these products in hopes of corralling an increasingly volatile equity market.

So what is the value proposition of long-short funds? The creators of long-short funds suggest that they should be viewed as a new investment class that complements traditional portfolio investments such as equities and bonds. Most advisors can agree on the Modern Portfolio Theory (MPT) concepts describing the benefits of diversifying across non-correlated investments. If long-short funds are successful in achieving capital appreciation, while having a low correlation to traditional

investments, then the risk-reward ratio for portfolios may be improved.

To explore the potential advantage of using long-short funds, we can use the Credit Suisse/Tremont Market Neutral Index to represent the investment characteristics of the long-short investment class in a portfolio. The other investments to be considered will be the S&P 500 Index (as a proxy for U.S. equities) and the Lehman Brothers Aggregate Bond



Index (as a proxy for the bond market). By entering the historical returns of these investment choices into portfolio optimization software, we can create the efficient frontier with and without the long-short component. As observed in the graph above, including the Credit Suisse/Tremont Index generates a dramatic and favorable shift in the curve.

In reviewing this example, skeptics will correctly argue that the performance of the Credit Suisse/Tremont Index is an overly optimistic expectation for the universe of long-short equity mutual funds going forward. For one, it is a hedge fund index, and mutual funds face additional expenses and investment limitations in executing long-short strategies. It also reflects performance over a period of time when fewer hedge funds existed and, consequently, it is suggested that even average performance during the period was actually very

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good. Still, despite these concerns, the lack of correlation and low volatility are likely to persist, and even a sizeable drop in return would still result in a more favorable curve.

Advisors who choose to investigate the long-short fund category will benefit from realizing that not all funds are created equal. It is taken for granted that groups of long-only funds in the same style category (e.g., U.S. small cap) will roughly mimic a market index (e.g., the Russell 2000), with some variation in annual return but still having a high statistical correlation to the index and other similar funds. This fund behavior permits an adviser using MPT to develop allocation targets for a given investment class and then to search for a few top performers in the group. In the long-short fund universe, this process cannot be replicated. Not only are long-short funds typ-

Chart 1
Correlation Matrix
(Various Long-Short Mutual Funds Using 2005 Daily Returns)

	Fund 1	Fund 2	Fund 3	Fund 4
Fund 1	-	-	-	-
Fund 2	0.55	-	-	-
Fund 3	0.07	0.19	-	-
Fund 4	0.56	0.48	0.16	-
Fund 5	0.34	0.41	0.16	0.21

Fund 1 - Alpha Hedged Strategies Fund (ALPHX)
 Fund 2 - TFS Market Neutral Fund (TFMNX)
 Fund 3 - GMO Alpha OnLy Fund (GGHEX)
 Fund 4 - Laudus Rosenberg Global L/S Equity Fund (RMSIX)
 Fund 5 - The Arbitrage Fund (ARBFX)

ically not correlated to traditional asset classes, but they are often not highly correlated to each other (see Chart 1).

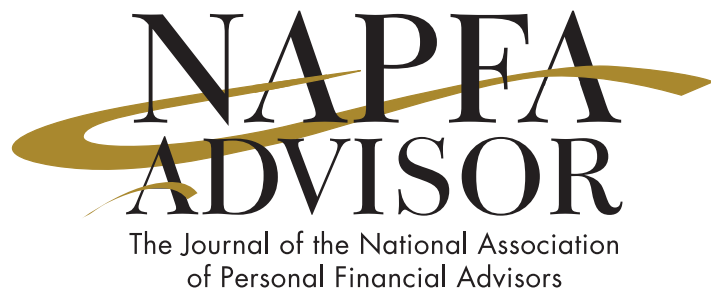
Advisors should recognize this lack of correlation as an opportunity. According to the principles of MPT, there may be as much value in diversifying within the long-short fund category as there is to diversifying across broader asset classes. While some well-known strategies are conducted by multiple long-short funds, such as merger arbitrage and convertible arbitrage, long-short managers are a creative breed. Not surprisingly, the return streams produced are as varied as the strategies used to create them. Given the variety and resulting lack of correlation, a best practice for advisors is to diversify across several non-correlated long-short funds, instead of trying to find a single solution.

Market Neutral Funds vs. Variable-Hedge Funds

Advisors can also more effectively serve their clients by identifying two broad categories of long-short funds, often referred to as "Market Neutral" and "Variable-Hedge," and utilizing them appropriately. The private fund industry has long recognized this division because of the dramatically different results produced by each style.

Market Neutral funds (also known as arbitrage funds) make money by taking offsetting positions in anticipation of a divergence between the long and short portfolios. The net asset values of these funds generally move independently from the market, and returns are achieved by accurately predicting the price movement of individual stocks relative to each other. They are typically characterized by a "static hedge," meaning the ratio of long dollars to short dollars is not intended to change.

Variable-Hedge long-short funds, in contrast, have the discretion to significantly alter their overall market exposure. For example, many of the more aggressive funds are structured such that they could be 100% long (i.e., moving in tandem with the market) or 100% short (i.e., moving inverse to the market) on





any given day. These funds develop unique decision criteria to predict the direction of the overall market and adjust exposure accordingly. While accurate stock picking may be valuable to Variable-Hedge long-short funds, it can often be of secondary importance to correctly timing broad market movements.

Market Neutral strategies generally exhibit very different behavior from Variable-Hedge funds, as seen in Chart 2. Market Neutral funds generally have betas that are near zero. Market Neutral Funds therefore generally provide a much less bumpy ride for investors, often with one-quarter to one-half of the volatility of the S&P 500. Of course, these funds also have lower return targets, generally falling in the 5%-10% per year range. Variable-Hedge long-short funds are characterized by a stronger equity market correlation and higher betas. The higher correlation to traditional equity portfolios makes many funds in this group much less desirable in achieving MPT benefits. Chart 2 compares the 2005 daily returns of several long-short funds to illustrate these differences.

Given the different degrees of market exposure assumed by long-short funds, advisors need an accurate way of ranking managers on a risk-adjusted basis. Theoretical finance gives us the metric known as alpha: the abnormal return generated above that which would be predicted by a fund's risk. Alpha facilitates comparisons of long-short funds with different market exposures (betas). This process will reduce the likelihood of an advisor being mistakenly attracted to high returns that are merely the result of a fund manager taking market exposure, as opposed to adding value.

The long-short fund category appears to have permanently established itself on the mutual fund landscape. With institutional sponsorship on the rise and data providers now recognizing the style, the category will likely experience accelerated growth. While the debate will persist as to whether the category will succeed or fail, the diversification benefits of long-short funds, along with the reduced volatility, present an

intriguing investment option. If positive returns can be consistently produced, then long-short funds would complement most portfolios and expand the MPT efficient frontier. New tools and techniques will be required to rank and sort funds, but those advisors who rise to the chal-

lenge will create opportunities for themselves and their clients. **NA**

Chart 2

Name	Ticker	Correlation with S&P 500 Index	Annualized Standard Deviation of Daily Returns	Beta vs. S&P 500 Index
S&P 500 Index	S&P 500	1.0	10.6%	1.0
GMO Alpha Only Fund	GGHEX	0.35	2.3%	0.12
Laudus Rosenberg Global L-S Equity	RMSIX	0.27	2.4%	0.10
The Merger Fund	MERFX	0.53	2.1%	0.16
Diamond Hill Focus L-S	DHFCX	0.58	9.4%	0.55
Schwab Hedged Equity	SWHEX	0.80	5.7%	0.59
Icon Funds L-S Equity	IOLCX	0.85	21.1%	1.10

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