



Diversification: The Free Lunch That Is Getting Harder to Find

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Once thought of as the free lunch of the investment world, diversification is getting harder to find.

Advisors staring into the abyss of a bear market are finding that conventional approaches to diversification, such as increasing allocations to fixed income, may not work in today's environment.

Another option to fixed income is offered by absolute return mutual funds. These are not hedge funds, and they do not invest in hedge funds, but they strive to offer the benefit of low volatility and low correlation to conventional asset classes – especially to equities.

We spoke with Brian Hlidek and Jay Compson, with Absolute Investment Advisors, whose mutual fund offers such a strategy.

Ominous Signs for Fixed Income

Hlidek and Compson illustrate the problem with fixed income in the history of 10 year bond yields over the last 43 years:

Ten Year Treasury Yield: 1965 to Present



Source: Bloomberg

January 08 Data



“Most advisors just remember the last 20 years - the gilded age – when rates came down dramatically,” says Hlidek, adding “there were a few hiccups along the way, but they were short lived.” He believes treasury yields are now very likely near secular lows. Yale, Harvard and other endowments have been aggressively trimming down fixed income in recent years. The typical endowment has an average fixed income allocation of 10%. Yale’s is 4%, and almost no institution has an allocation over 20%.

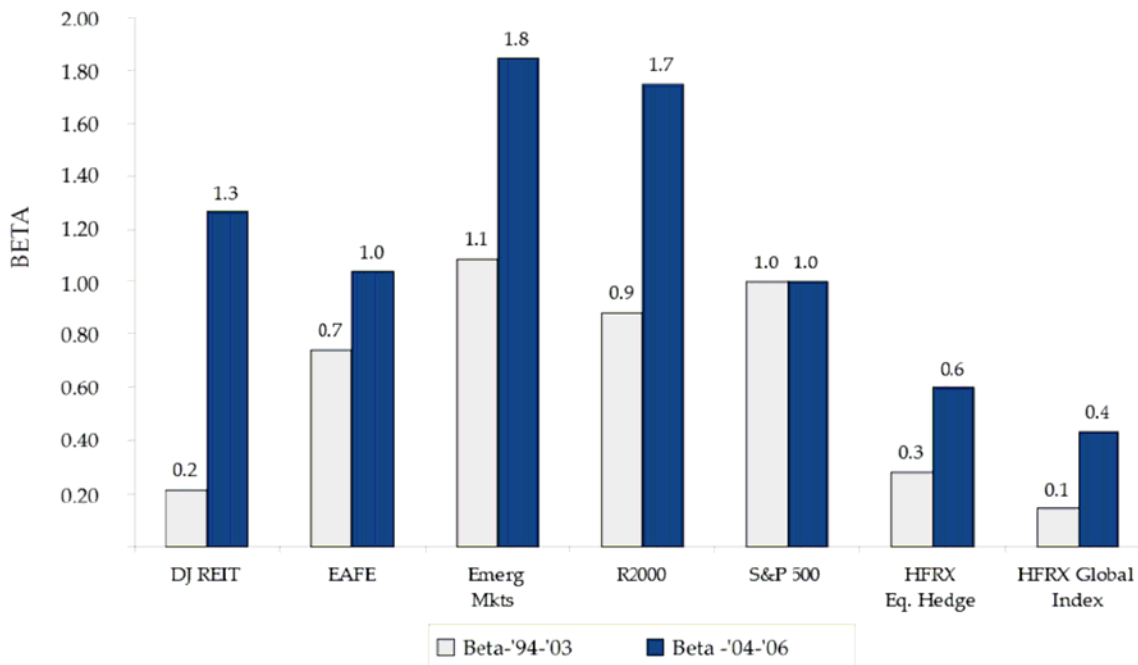
To further illustrate the risks in today’s fixed income markets, ten year Treasuries now yield approximately 3.5%. Looking at a three year holding period, a 75 basis point increase in yields would reduce total return to 2%. A 100 basis point increase translates to a 1% return, and a 225 basis point increase (roughly the amount yields have dropped in the last seven months) sends returns into negative territory.

Adding to the danger of rising yields are corporate spreads, which tightened from 2003 to 2007, and played a big role in strong returns for the Lehman AGG over this time period. Compson says investors now face a “double whammy” - low yields and record low corporate defaults.

Although the bond market has performed acceptably in last six months, Hlidek suggests lightening up on fixed income as part of the rebalancing discipline.

The Diversification Dilemma

The [beta](#) (relative to the S&P 500) of many asset classes has increased over the last several years:



Some asset classes are significantly above one. Compson believes hedge fund betas have spiked as they have taken on more assets, forcing them to take on more market risk. “Correlation of asset classes has created a diversification dilemma, and there is no easy way out of this” says Compson.

A recent study by Richard Bernstein, chief investment strategist at Merrill Lynch, shows a pattern of increasing correlation between various asset classes and the S&P 500 over the last eight years:

Table 2: 5-Year Correlations of Selected Asset Classes to the S&P 500

5-Year Correlations	2/28/2000	1/31/2008	Change
MSCI EAFE	32%	93%	61%
Hedge Funds	35%	90%	55%
Art	-31%	12%	43%
Russell 2000	62%	91%	29%
Gold	-24%	-3%	21%
Real Estate	51%	63%	12%
Goldman Sachs Commodity Index	-14%	-26%	-12%
T-Bills	34%	-1%	-35%
High-Grade Corporate Bonds	47%	-38%	-85%
Long-term Treasuries	37%	-54%	-91%

Source: Merrill Lynch Investment Strategy



The data shows rolling five-year correlations to the S&P 500 of rolling 12-month returns. Bernstein's analysis does not include absolute return strategies. He notes that "our analysis continues to show that 2000's non-correlated asset classes are now often highly correlated to the S&P 500, and their diversification benefits now seem to be greatly reduced, if not completely eliminated." Bonds and cash are identified as the assets with powerful diversifying benefits, and we would add commodities and absolute return strategies to this list.

Compson notes that absolute return investing should not be confused with risky investing. "Broadly speaking, this is a big mistake made by many advisors," he says. Some alternative strategies are specifically designed to reduce risks. Compson notes that "compared to a typical portfolio with huge systematic risk, they are not risky. The struggle for advisors is to accept being different."

Evaluation Techniques

Absolute return strategies work best for advisors who are concerned with capital preservation and risk reduction, and not with those whose goals are "hitting the home run." The beauty of the strategy is its accessibility to all investors. It will resonate particularly well with high- and ultra-high net worth clients who want to emulate some of the tactics used by endowments.

Advisors evaluating absolute return funds need to use a range of metrics in their analysis. Peer group comparisons may not be relevant, and comparing performance to traditional benchmarks (such as the S&P 500) obscures the value these funds offer.

Morningstar assigns absolute return funds to a variety of categories, including Long-Short, World Allocation, and Conservative Allocation, which can make identifying these funds difficult. The Long-Short category, created by Morningstar two years ago, includes funds pursuing specific strategies (such as merger arbitrage) and others taking an extremely defensive position (i.e., market-neutral funds). Given the range of funds and the diversity of strategies within the Long-Short category, advisors should use peer group comparisons with caution.

Dan Traub, an advisor with [Braver Wealth Management](#) in Newton, MA, uses absolute funds for their risk reduction value, and not directly as a proxy for fixed income. "The most important thing we look at is performance in both up and down markets. In a market like today, we expect flat or slightly negative results. But we don't expect these funds to be up as much in a strong bull market. When the market is up 30%, a 10% return is okay."

Advisors should consider the beta relative to both equity and fixed income markets. Some funds, such as the Gateway Fund (GATEX), will have a higher



beta to the S&P 500. Other funds, such as Absolute Strategies (ASFIX), specifically target a low beta relative to the S&P 500. Especially for funds with low beta to the S&P, advisors should utilize the [Sharpe Ratio](#), which measures the fund's return per unit of risk, independent of its covariance to any index.

A low correlation is essential in reducing volatility. [Fund Grades](#) offers a convenient feature to simultaneously view fund correlations to a variety of indices. Correlations are dynamic and, for many investments, have the undesirable quality of converging to one in a down market. It is precisely this phenomenon which creates the opportunity for some funds with low correlation to add diversification value.

Expect to pay higher fees for this class of funds. By design, these funds are delivering low beta and high [alpha](#). Expense ratios for these funds should be viewed relative to their alpha exposure. The cost of beta is almost free, since it can be purchased through a low cost index fund or ETF. For a comprehensive discussion of assessing fees for active management, see the [paper](#) by Ross Miller on this subject.

The most important element of fund evaluation is a careful assessment of the fund's strategy. Traub looks for "consistency in the performance, methodology, and process used by the fund. "

For a fund of funds, it must be run with a consistent overall strategy, and must carefully select funds and sub-advisors that contribute to this strategy. Advisors will want to understand the fund's composition and selection process for sub-advisors and, in particular, look at the following:

- Size of fund – Larger funds will have access to more sub-advisors and to those that are more skillful.
- Liquidity – Do the sub-advisors invest in illiquid securities and, if so, with what criteria, constraints, and risk controls?
- Diversification of sub-advisors – Advisors will want to assess the level of diversification across sub-advisors in the fund, whether sub-advisors are style-box agnostic, and the degree of independence and flexibility they have in pursuing their investment strategy.
- Complexity of strategy – How complex is the strategy of the fund and of the sub-advisors? Simplicity, and fewer moving parts, is preferable when the goal is risk-reduction.

An open end mutual fund may use hedge fund managers and hedging strategies, but will not invest directly in hedge funds. Funds are custodied by the fund manager, and trading is done through separately managed accounts (SMAs),



with the sub-advisors providing trading instructions. The fund is priced by the fund administrator, not by the sub-advisors.

The final decision is the amount of the portfolio to dedicate to alternative strategies. Hlidek suggests allocating 10-20% of your portfolio. He says, “Go ahead and manage the rest actively or passively, with funds or ETFs. The real challenge of the next five to ten years will be finding diversification.”

Compson’s goal is to at least meet the returns of a traditional 60/40 portfolio over the long term, but to get there without the same level of volatility. He believes the combination of volatility and a bear market create a great environment to assess skill. As Warren Buffett famously noted, “when the tide goes out we see who is wearing a bathing suit.”

Sample Funds

Below are some funds that offer absolute return or similar strategies. This is not a complete list of all such funds. We have chosen to show total return data for the period from June 30, 2007 to February 29, 2008, because this period encompasses significant volatility and the current bear market.

Many of these funds have significant holdings among HNW and UHNW investors, whose assets are managed by RIAs, in the Advisor Perspectives universe. We show the ranking of the funds among the [Most Popular Mutual Funds](#) in our universe, as of February 29, 2008. A value of n/a indicates no significant holdings in the universe.

Ticker/ Morningstar Category	Fund (strategy)	Rank in Advisor Perspect ives Universe	Total Return 6/30/07 - 2/29/08	2 yr period: 2/28/06 - 2/29/08		
				Total Return	Monthly Std. Deviation	Beta to S&P 500
ASFIX Long-Short	ABSOLUTE STRATEGIES FUND (fund of funds)	665	-0.2%	8.0%	2.5%	0.19
CVSIX Long-Short	CALAMOS MARKET NEU INC FD (convertible arbitrage and covered call writing)	n/a	-0.2%	8.7%	3.6%	0.26
GATEX Long-Short	GATEWAY FUND (holds S&P 500 and sells call options against it)	20	-1.1%	12.8%	3.8%	0.40
HSGFX Long-Short	HUSSMAN STRATEGIC GROWTH (holds equities and hedges with options)	n/a	3.1%	6.3%	4.7%	(0.13)



	under certain market conditions)					
OGNIX Long-Short	JP MORGAN MKT NEUTRAL (long-short strategy based on large cap core stocks)	n/a	-3.3%	6.2%	5.2%	0.01
SWHIX Long-Short	SCHWAB HEDGED EQUITY FUND (large cap long-short strategy based on Schwab's equity ratings)	n/a	-7.2%	4.7%	6.2%	0.52
ALPHX Long-Short	ALPHA HEDGED STRATEGIES (fund of funds)	29	-3.1%	8.4%	6.6%	0.31
RYMSX Long-Short	RYDEX ABSOLUTE RETURN STR (utilizes multiple investment styles)	n/a	-6.2%	3.3%	6.9%	0.42
DHLSX Long-Short	DIAMOND HILL LONG/SHORT (large cap 130/30 with option writing)	n/a	4.9%	18.7%	7.0%	0.49
TLSAX Long-Short	TEMPLETON GLOBAL LNG/SHT-A (global long-short)	n/a	-7.5%	9.0%	8.4%	0.58
BPTRX Mid-Cap Growth	BARON PARTNERS (mid-cap growth long-short)	373	-9.2%	11.0%	16.2%	1.32
FGLSX Long-Short (see note below)	FUSION GLOBAL LONG-SHORT (trend following)	n/a	n/a	11.0%	6.1%	.47
S&P 500	S&P 500 Index		-10.3%	7.9%	9.8%	1.00
Russell 2000	Russell 2000 Index		-17.0%	-3.7%	12.8%	1.29
HFRXEI	HFRX Equity Hedge Index		-5.7%	7.0%	6.7%	0.52
HFRXEMN	HFRX Equity Mkt Neutral Index		-5.3%	5.5%	4.2%	0.16

Source: Bloomberg and Morningstar

FGLSX is a new fund. It is based on the Smart Switch Index, which the fund tracks. Two-year data is for the index.

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