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ALTERNATIVE INVESTMENTS

Hedge-Fund Firms Woo the Little Guy

Some companies that serve institutions and the affluent are adding mutual funds, and ordinary investors may benefit

By JAIME LEVY PESSIN

Hedge funds used to be seen as far cooler and more profitable to run than ordinary mutual funds. So why are some of the cool kids from the hedge-fund world now offering mutual funds for the masses?

Journal Report

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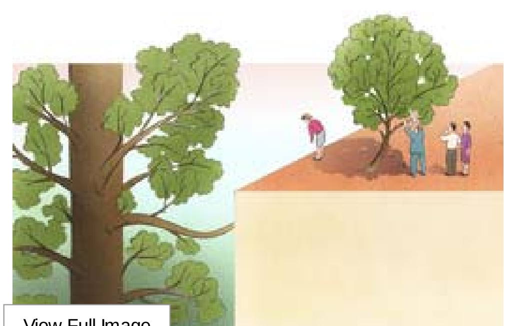
As it turns out, mainstream mutual funds can pull in a lot of cash for the hedge-fund industry, which is still dusting itself off from an embarrassing fall during the financial crisis. So far this year, at least a dozen hedge-fund managers have launched mutual funds that use hedging strategies, according to researcher Morningstar Inc.

These moves might prove to be a boon for ordinary investors: An academic study suggests that hedge-like funds run by hedge-fund pros perform better than similar mutual funds offered by other providers.

Branching Out

Hedge funds were all the rage in the mid-2000s, but the 2008 financial crisis hit these investment pools for institutions and affluent investors hard. Not only did the funds go down in value, but also a lack of liquidity in some markets led many hedge funds to restrict investors' ability to pull their cash out. Hedge-fund holders were stuck continuing to pay steep management fees, leaving a bad taste in their mouths, says Nadia Papagiannis, a Morningstar analyst.



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Min Jae Hong

Hedge funds generally lost less money than broad stock-market indexes in the 2007-09 bear market. Still, once liquidity returned, investors withdrew money en masse, and they haven't been keen to reinvest. In 2009, investors pulled a net total of nearly $56 billion out of the close to 8,000 hedge funds tracked by Morningstar, Ms. Papagiannis says. They withdrew an additional $4 billion through August of this year.

With customers fleeing, hedge-fund managers have realized that going down-market opens up a whole universe of new investors: people of more modest means who suffered massive losses using more-traditional products and strategies and who are looking for new ways to recover from that blow. One way hedge funds and hedge-like mutual funds differ from traditional mutual funds is that the hedged products often do two things at once: They go "long" by buying securities that the managers consider attractive, and they go "short" by betting against securities that appear overvalued. The two-part approach can fare better when markets tumble.

In the first nine months of this year, investors put $13 billion into hedged mutual funds, compared with $10.5 billion in all of 2009 and about $4.7 billion in 2008, according to Morningstar.

Experience Counts

Although some mutual-fund companies have been offering hedged products for years, there is now a critical mass of hedge-fund managers trying to get into the retail world. And according to research by Vikas Agarwal, a professor at Georgia State University, hedged mutual funds run by hedge-fund managers—who have experience with complicated trading strategies—tend to be more successful than hedged funds run by managers without that experience.

Hedging Their Bets

A sampling of mutual funds launched this year by hedge-fund managers

Fund name	Ticker	Morningstar category	Recent Assets ($ mils.)	Firm
Altegris Managed Futures Strategy	MFTAX	Long-Short	$83	Altegris Advisors LLC
AQR Risk Parity	AQRNX	World Allocation	19	AQR Capital Management LLC
Natixis ASG Managed Futures Strategy	AMFAX	Long-Short	49	AlphaSimplex Group LLC
Ramius Dynamic Replication	RDRAX	Long-Short	133	Ramius Alternative Solutions LLC
Thesis Flexible	TFLEX	Long-Short	7	Thesis Fund Management LLC

Source: Morningstar

That's not surprising, says Robert Testa, an analyst at Boston-based research firm Cerulli Associates. "You really have long-only [mutual-fund] managers who are trying to do shorting for the first time, while the hedge-fund manager who has always used the same strategy is just adapting it," he says. To that end, even some mutual-fund complexes are hiring hedge-fund managers as subadvisers for their hedged mutual funds.

While hedged mutual funds incorporate hedge-fund strategies, they must adhere to the same rules as traditional mutual funds to ensure they are appropriate for a mass market. In particular, mutual funds face limitations on short sales, have to provide daily liquidity and must provide detailed prospectuses explaining their risks. That means that hedged mutual funds end up as a sort of "lower octane" hedge fund, says Andrew Lo, chief investment strategist for AlphaSimplex Group LLC, which manages hedged mutual funds offered by Natixis Global Asset Management.

Because they can't use certain high-risk strategies, hedged mutual funds are unlikely to provide the outsize profits that hedge funds sometimes can. Hedge funds outperformed hedged mutual funds by an average of 2.3 percentage points a year between 1994 and 2004, after adjusting for risks, fees and fund characteristics, according to a 2009 study by Mr. Agarwal and two other professors, Nicole Boyson of Northeastern University and Narayan Naik of the London Business School. Still, after adjusting for the same criteria, hedged mutual funds outperformed traditional mutual funds by an average of 2.7 percentage points per year. The study examined 2,179 hedge funds, 3,679 traditional mutual funds and 52 hedged mutual funds.

While they haven't matched the returns of hedge funds, hedged mutual funds might provide more protection than unhedged funds in down markets. A study published in March by professors at Pennsylvania State University and the State University of New York at Albany found that from July 2007 through December 2008, during the bear market, two types of mutual funds that use hedging strategies outperformed a broad stock-market index fund.

Managers say downside protection is a huge draw for potential investors in hedged mutual funds. AQR Funds, the mutual-fund offshoot of hedge-fund manager AQR Capital Management LLC, launched its AQR Risk Parity fund in October. The fund uses futures contracts and related financial instruments to create "much better behaved portfolios with lower downside and better returns over time," says David Kabiller, a founding principal and head of client strategies for AQR.

Stay Cautious

Hedged mutual funds provide another benefit that even institutional investors or super-rich individuals might appreciate: transparency and oversight. After Bernie Madoff's Ponzi scheme came to light, some big investors might be willing to trade lower rewards for increased regulatory oversight. At the very least, hedge-fund managers offering a mutual fund might be sending a "signal to the market that they're not doing fraudulent stuff," says Mr. Agarwal. "They're open to offering a product in a transparent, regulated market."

Still, investors should be cautious when deciding whether to put money into a hedged mutual fund. For some hedge-fund managers launching hedged mutual funds, it is the first time they're offering a highly regulated, mass-market product. That means they may not have much experience working within the Securities and Exchange Commission's rules for mutual funds, nor will they have a disciplinary history that's easy to check out.

Also, even though hedged mutual funds don't take on the same risks as hedge funds, they still may be exposed to different kinds of risks than traditional mutual funds—something that retail investors need to recognize before putting money in one.

AQR recently made a change designed to ensure that individual investors know what they're getting into: It raised the investment minimum for people who want to invest directly in its mutual funds to $1 million. Investors working with financial advisers, however, can still invest much lower amounts.

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