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STRATEGIES FOR SUCCESSFUL INVESTING

FUND STRATEGIES

Looking for a mix of mutual fund and hedge strategies?

BUILD YOUR OWN HYBRID

Richard Kang

DEVELOPMENTS IN ANY industry or region can often be perceived as so revolutionary that they evoke terms such as "new paradigm" or "paradigm shift." The institutional investment world has seen such a shift with its understanding of the terms "beta" and "alpha." ("Beta" is the measure of the volatility of a given asset relative to the market; "alpha" is a measure of return not dependent on market volatility.)

It has, in fact, become popular for institutions to construct their overall portfolio based on the concept of beta and alpha separation. The argument is that this method of organization leads to more efficiently run portfolios.

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Thus, it is becoming more common for the larger financial institutions to replace traditional portfolio managers (so-called "long-only" managers, because their mandate allows for holding only long positions in the market), especially those that cover the developed markets, with automated programs that allow for low-cost, or sometimes no-cost, indexing. It is technically possible for a mega-pension to not be charged a management fee by its external index manager. If the external manager is allowed to lend any of the stock in the indexing program, the pension fund can earn a portion of fees earned and thus have a negative management fee. For the rest of us, we'll have to make do with low-cost ETFs and derivatives.

What then becomes of manager selection? Are we simply left to pick amongst various exchange-traded funds in this new paradigm?

According to the proponents of "portable alpha" (the application of separating beta and alpha and recombining them in an efficient manner), if indexing programs provide the beta, then purely active strategies, such as hedge funds, provide the alpha. This is too broad a characterization of how institutions are evolving, but in a way it is true: Broad capital market exposure is attained as much as possible through low-cost indexing programs.

Alpha is generated through some sort of active management applied as an overlay to the indexing program, or separately through certain active managers. In the latter case, active management is applied to areas not commonly explored by many individual investors. In addition to hedge funds, this can include private equity, infrastructure investments, and real estate. (Because of the size of some institutions, "infrastructure" actually means buying a highway or a major shipping port, not just units of a fund.)

So how can you, as an individual investor, make your portfolio similarly efficient? Perhaps the easiest plan is simply to determine your appropriate asset allocation, including the mix of geographic regions and industry sectors. Thereafter, all that is required is to decide what portion within each group to allocate to low-cost ETFs and what amount to allocate to active managers (whether long-only or absolute-return mandates).

Should this philosophy continue to gain traction, we could see a real change in the mutual fund industry. These changes have actually started. Globally, there

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are now somewhere close to 700 ETFs, with combined assets approaching US$600 billion. At the other end of the spectrum, about US$1.25 trillion is held among some 9,000 hedge funds.

There is some debate with regard to the hedge fund numbers, but it's the scale of both the asset size and number of funds that's important here. The bottom line is that the beta and alpha engines in the fund management world are in full swing. The question for the mutual fund industry is whether this means that the average investor is being turned off by mutual funds and is trying to reconstruct portfolios using the beta and alpha building blocks. Good question. I would say that the trend has started, but that it also has a long way to go.

That's nothing but bad news for mutual funds. If we are only near the beginning of the trend for mass acceptance of beta and alpha funds versus plain-vanilla mutual funds, the mutual fund as we know it will have to adapt or certainly lose significant market share.

The first part of the problem with mutual funds is that they have both beta and alpha — unfortunately in the vast majority of cases, a lot of beta and very little alpha. The second part of the problem is that the cost of the mutual fund does not address the first problem. If a mutual fund's return is 90% dependent on the market's inherent volatility (beta) and only 10% dependent on the manager's skill (alpha), then shouldn't the fund charge the full fee on just the 10% of the fund where performance is attributed to the manager's skill? And by extension, should not the other 90% be priced comparably to a low-cost ETF?

Here's an example. A US large-cap equity mutual fund has a 1.5% annual management fee. Assuming the 90/10 breakdown I've just described, the fund's fee structure should be as follows:

☛ 90% x 0.10% = 0.09% (90% of the fund priced at 0.10%, same as, say, the Standard & Poor's Depositary Receipts, or SPDRs)

☛ 10% x 1.50% = 0.15% (10% of the fund remains priced at 1.50%)

☛ **Total fee** = 0.09% + 0.15% = 0.24%

Thus, in this case, a more appropriate management fee would be 0.24%. If we assume that the manager is less market dependent, with a breakdown of 75% market/25% skill, then the fee calculations lead to a 0.45% fee, which is still more than 1 percentage point less than the existing fee.

At this point, Canadian mutual fund companies would never go for such a dramatic fee structure realignment, of course, so I won't continue with this line of thought. Instead, let's look at what might realistically happen to the mutual fund industry in the near future.

First, fund companies can try to acquire ETF providers and/or hedge fund companies. There is only one significant case of a mutual fund company buying an ETF provider — **AMVESCAP Plc** (the giant UK-based owner of AIM Investments in the US and Canada's AIM Trimark Investments) purchased US-based PowerShares in January 2006. Hedge funds have become increasingly mixed within some mutual fund companies since the market collapse of 2000-02, and the trend there will surely continue as the fee potential is too attractive to ignore.

The other alternative for mutual funds is to make adjustments within the mutual fund structure to allow for more creative portfolio management. A recent development is the "hybrid fund." It's actually so early in the development of this product that there is yet no generally accepted term for it.

It is, in fact, a "hedge-like" mutual fund and is often described by its long and short policy exposures. For example, a so-called "130/30 fund" would normally have a leveraged position on the long side to allow for 130% exposure with an offsetting 30% total short position. With this ratio, the overall fund remains as before with a roughly 100% overall long exposure to the market. Let's take this step by step:

☛ First, leverage is applied. For every $100 invested, the portfolio manager will borrow $30 worth of stock and sell the shares short.

☛ Next, the portfolio manager takes the cash proceeds of the short sale, plus the original $100 invested, and purchases $130 of stock long.

☛ Finally, the resulting portfolio is long $130 and short $30. In aggregate, the fund has a 100% net long exposure, similar to a fully invested mutual fund.

A fund of this nature would therefore introduce leverage to a long-only portfolio while adding some short selling. Bridging mutual funds and hedge funds, the term "hybrid fund" is appropriate.

Why this change and is it necessary? Unlike a traditional long-only management structure, the hybrid fund allows the manager to make truly active management decisions. The manager can still pick securities based on favorable situations but can now also target unfavorable securities to short. The traditional mutual fund can, at best, hold greater cash balances when the environment is considered unfavorable.

In addition, this type of structure fits nicely between what exists now in the world of mutual funds and hedge funds. First, this new structure can be offered by prospectus so as to deal with the various hurdles (high investment amount, among others) found in most hedge funds. Also, hybrids may be more appealing than existing hedge funds, which are far less constrained in terms of allowable leverage, degree of shorting, and overall complexity in terms of

strategies and product structure.

What would really interest me is if a hybrid fund manager actually decided to build the fund so that 100% market exposure could be established with indexing instruments (ETFs or otherwise) with a 30/30 long-short equity program overlaid on top of this. Such a fund would still have the 130/30 composition but with the more "portable alpha" institutional approach I described earlier.

A mutual fund company could be truly innovative by building such a product for each asset class. A US equity hybrid fund could have 100% exposure to the S&P 500 Composite Index with a long-short overlay of US stocks. The Canadian version could have S&P/TSX 60 or S&P/TSX Composite exposure with perhaps an overlay of Canadian small-cap stocks, which might provide greater potential for alpha than large-cap stocks.

Such a mutual fund company would truly be an innovator in the industry. I believe this trend is under way right now as mutual fund companies face up to the realities of the competitive investment environment.

However, there's one key requirement for all of the above: The manager must provide true alpha.

How many hybrid funds exist like this in Canada? Not many, yet, and I have not been able to compile such a list. The US market is more advanced in this respect, but it will take time for a robust market to be established here in Canada. Until Canadian products start trickling onto the market, a do-it-yourself investor could replicate this strategy with relative ease.

Here's how to create your own "synthetic" hybrid fund:

☛ ***For the Canadian equity asset class:***

Use **Horizons BetaPro S&P/TSX 60 Bull Plus Fund** (TSX: HXU; recent $27.02) to get your 100% long exposure to the market by using only half of your assets (HXU has 200% long exposure to the S&P/TSX 60 Index). Therefore, for a hypothetical $100,000 cash account, purchase $50,000 worth of HXU. As of that moment, you have a fully invested ($100,000) Canadian equity index portfolio, but you still have $50,000 in cash.

To turn this into a 130/30 program, you can use $30,000 of your cash balance to purchase various stocks that you deem to be favorable.

Through a brokerage firm, you can borrow $30,000 to establish a portfolio of short positions of stocks that you deem unfavorable.

The $20,000 cash balance left over would act as your security blanket after establishing all positions.

The long-short portfolio could be as simple as allocating $5,000 to each of six stocks on the long side and $5,000 each to another six stocks on the short side.

☛ ***For the US equity asset class:***

The procedure would be the same as for the Canadian hybrid, except you would choose one of the Ultra ProShares that I discussed last month. For example, investing 50% in the **ProShares Ultra S&P 500 ETF** (AMEX: SSO; recent US$89.16) would establish a 100% long exposure to the S&P 500 Composite Index. Going long and short the appropriate number of US stocks would be the next step.

In case 1 above, you are building the equivalent of a hybrid or hedged mutual fund for the Canadian equity asset class. The amount of exposure in the various stages can be tweaked to fit your risk tolerance. For example, if you are a more conservative investor, you can use the **iShares CDN LargeCap 60 Index Fund** (TSX: XIU; recent $75.83) instead of HXU to gain the broad yet cheap beta exposure to the S&P/TSX 60 without the use of leverage — in this case, perhaps gain only 70% exposure. With the 30% of your portfolio remaining in cash you can superimpose a smaller long-short program.

The same procedure could be established for US equities but using the SPDRs or a Vanguard ETF and a corresponding US equity long-short program.

At this time, the ability to use levered ETFs for long positions exists only for a few US equity indexes and only for the S&P/TSX 60 through HXU. Hopefully, this niche ETF market will expand to allow for greater flexibility.

One obvious concern with this type of portfolio construction revolves on the issue of risk within a levered portfolio and with shorting. Both are tools that should be given careful consideration because of their magnified effects if things go against you.

Also of great importance is deciding what specific stocks to go long and short. As a reader of *The MoneyLetter*, you have more than enough information to establish a stock selection strategy. More than this, however, is the fact that working with your advisor on such strategies is a prudent step. For the do-it-yourself investor, you simply have to be aware of the added risks in bringing your portfolio into this new paradigm.▼

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