

Hedged Mutual Funds Make the Grade

By Lori Pizzani

The relatively new class of hedged mutual funds have generally outperformed traditional mutual funds, an academic study shows. Moreover, those funds run by current or former managers of traditional hedge funds—versus mutual fund portfolio managers with no hedge fund experience—have a tendency to outperform on a persistent basis.

That's good news for the universe of long-short, market-neutral and other mutual funds that employ a growing array of hedge fund-like strategies, but unlike traditional hedge funds, appeal to Main Street's retail investors, offer daily liquidity, lower costs, lower minimum investments and operate in a heightened regulatory environment.

The academic paper, which claims to be the first to make complex comparisons between hedged mutual funds, regular mutual funds and traditional hedge funds, tested three specific hypothesis from 1994 through 2004: regulation, incentives and the strategy and skill of the manager.

The study was co-authored by three academic professors, two from the U.S. and one at the **London Business School**. Fifty-two hedged mutual funds were pitted against 2,179 traditional hedge funds in the study's sampling.

It's not all good news for hedged mutual funds. When these funds' risk-adjusted performance was compared to traditional hedge funds, the study found that hedge funds handily beat their mutual fund wannabes by about 3.3% per year on a net-of-fees basis. That underperformance was attributed to a tighter regulatory framework that prevents mutual funds from employing as much leverage, using as many strategies or investing in as great a percentage of illiquid securities as their hedge fund counterparts.

Moreover, the study found that because hedge fund managers are more richly compensated for performance than mutual fund managers, there was a greater incentive among traditional hedge funds to deliver superior performance.

The study also indicated that even though hedged mutual funds sport higher fees as well as higher turnover, they trounced the universe of 3,679 traditional mutual funds in the sample group that do not employ hedged strategies as a major investment strategy by a margin of 2.6% to 4.8% per year, on an after-fee basis.

"I was pleasantly surprised by the results," said **Nicole Boyson**, assistant professor of finance at the **College of Business Administration** at **Northeastern University** in Boston, the study's co-author. "Hedged mutual funds outpaced traditional mutual funds, but I was surprised by how much."

Moreover, it was clear that those managers who have hedge fund experience did better than those without. Those 27 hedged mutual funds with managers having real hedge fund experience beat the 25 managers having no hedge fund experience by as much as 4.1% per year after fees. In fact, of the 14 hedged mutual funds that vanished over the study period, the managers at all 14 lacked hedged fund management experience.

However, even those managers more skilled in the ways of traditional hedge funds who now, or also, run hedged mutual funds still underperformed the study's universe of traditional hedge funds by up to 2.5% per year after fees, the study found.

This research sheds a bit of light on what has been, up until now, anecdotal evidence of performance differences, said **Jeff Tjornehoj**, senior research

analyst at **Lipper** of New York. Of course, without dissecting the entire universe of traditional mutual funds used in this study, it's hard to know if this is a fair comparison or if sector funds, gold funds and the like were included, he added.

"This is a useful work that touches on a subject that has often been neglected in serious academic studies," said **Dr. Frank E. James**, chairman of **James Investment Research**, the Dayton, Ohio, advisor to the **James Advantage Funds**. One of the complex's funds is the James Advantage Market Neutral Fund, which was in the study's sample. One significant challenge lies in simply classifying hedged mutual funds, he noted. "At different times our fund had been identified as 'special equity,' 'equity,' or a 'long/short' fund," James said.

"I'd have to give them a high mark for this research. They've done some real homework on some of the things that can be confounding," said **Lee Schultheis**, chief investment officer and co-founder of the Alpha Hedged Strategies Fund, a multiple sub-advisor/multiple strategy fund, and also among those funds in the sample group. The fund is managed by **Alternative Investment Partners** of White Plains, N.Y.

Research aside, the sheer size of a pool of money, whether it's a hedge fund or a mutual fund, can be a factor in performance. "It's easier to manage a smaller pool," which can improve performance, Schultheis added.

The report also predicted that hedged mutual funds are not a passing fancy. "We believe that hedged mutual funds will play an increasingly important role as they provide access to hedge fund-like strategies with the fee structure, liquidity and regulatory requirements of mutual funds," the researchers concluded.

MME