Rowing vs. The Roller Coaster

By Ed Easterling
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Why are so many of the most knowledgeable institutions and individuals shifting away from investment portfolios that have been concentrated in stocks and bonds toward a more diversified and risk-managed profile? The tools and resources are now available to permit investors of all sizes to use this enhanced approach and be successful.

The term “rowing” is Crestmont Research’s analogy for more actively managing and diversifying investment portfolios. It refers to the absolute return approach to investing—seeking generally consistent returns regardless of what’s happening in the financial markets.

As readers of *Unexpected Returns* know, chapter ten is titled “Row, Not Sail.” Earlier chapters explore the concept of secular stock market cycles and the overall drivers of stock market performance. The book then discusses the concept of absolute return investing. *Unexpected Returns*, however, leaves it open for each investor or financial advisor to approach “rowing” in their own preferred way. There are many ways to structure absolute return portfolios using a wide variety of strategies and securities. *Unexpected Returns* is not intended to be a “how to” book that provides specific tactics; rather its objective is to “help me understand.”

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To further explore how and why absolute return investing works and to include additional research since *Unexpected Returns* was published, this article has been developed to explore some of the underlying concepts and to provide illustrations of the effects of “rowing” versus general stock market returns over time.

There are many ways to structure absolute return portfolios. As a result, there is not a single asset class data series that comprehensively represents its returns. For the purpose of illustration, there are series that we can access that reflect a variety of absolute return strategies. Following strong growth in the hedge fund industry over the past decade, there is now a multitude of different absolute return strategies and investment approaches.

Most hedge funds are more than an investment structure; they represent an approach toward investing. These funds generally employ strategies that seek to provide returns regardless of the overall direction of the market. Beyond returns, hedge funds also seek to control risk. Some hedge funds, however, are highly speculative, pursue non-hedged strategies, or otherwise would not qualify as absolute return strategies.

Therefore, hedge funds should be evaluated along several aspects: returns, risk, and the impact on the overall investment portfolio. By the way, it does not matter whether you choose or qualify to invest in typical hedge funds, there are numerous registered funds that employ hedge fund-related strategies and are easily available to investors of all sizes.

There are investment funds, know as funds of hedge funds, that invest across a variety of these hedge funds. Further, there are indexes that reflect the aggregate performance of large sets of hedge funds as well as sets of funds of hedge funds. The result is that we can use some of those indexes to develop examples and illustrate concepts as we explore the impact of risk-managed investing.

Although hedge fund performance will be used to illustrate key concepts of risk and return, an investor does not need to use them to get the benefits of a risk-managed portfolio. There are numerous other alternatives to use or include in a portfolio to enhance its profile. Over the past few years, the range of alternatives has expanded significantly and the growth is expected to continue at a rapid pace. As readers know, *Unexpected Returns* does not advocate hedge funds as an investment alternative. Hedge funds are discussed in the last chapter of the book as an example in the wave of investment evolution; a trend toward more risk-managed investing and absolute return oriented portfolios.

ABOUT RISK & RISK MANAGEMENT

Risk management can be more than simply an instrument to help provide a smoother ride for the portfolio; it's a way to help compound gains into cumulative returns.

Risk can be measured many ways; two of the most common are standard deviation (volatility) and drawdown (losses that occur from the most recent high value to the next high value for the investment). The impact of risk—particularly losses—is often underestimated by most investors.

For a perspective on the impact of losses: If an investor achieves breakeven during months when the stock market experiences a decline, what portion of the increase from months that have market gains does an investor need to realize in order to match the market return? For example, if an investor can avoid the losses during each declining month, what percentage of the upside is needed to ultimately get the market return (i.e. if the market is up 3% during the month, what percentage of the 3% does the investor need in order to cumulatively receive the market return over time)?

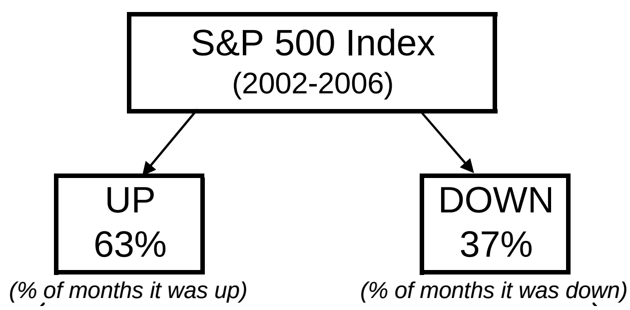
Based upon an analysis of the past fifty years, past ten years, and various other periods, an investor needs to capture only thirty percent of the upside to match the market return (see “Up & Down Capture” near the bottom of the Stock Market section at www.CrestmontResearch.com for details). Yes, only thirty percent! The impact of losses has a dramatic impact on compounded returns.

As a result, we can see that hedge funds not only seek to provide gains from profitable investments, they also seek to use risk management as a way to help compound those gains into cumulative returns. Risk management can be more than simply an instrument to help provide a smoother ride for the portfolio.

What are the practical implications? There are four combinations of performance for an investment relative to the market. For any month, (1) the market and investment both can be up, (2) the market can be down, yet the investment up, (3) the market can be up, yet the investment down, or (4) the market and investment both can be down. For a typical mutual fund or stock market portfolio, the results are highly concentrated in the first and last combinations.

Let’s explore the performance of the stock market over the past five years and the performance of the typical stock portfolio. Figure 1 reflects the stock market, as represented by the S&P 500 Index, over the past five years. Of the sixty months since the start of 2002, 63% of the months have been up and 37% of the months experienced declines.

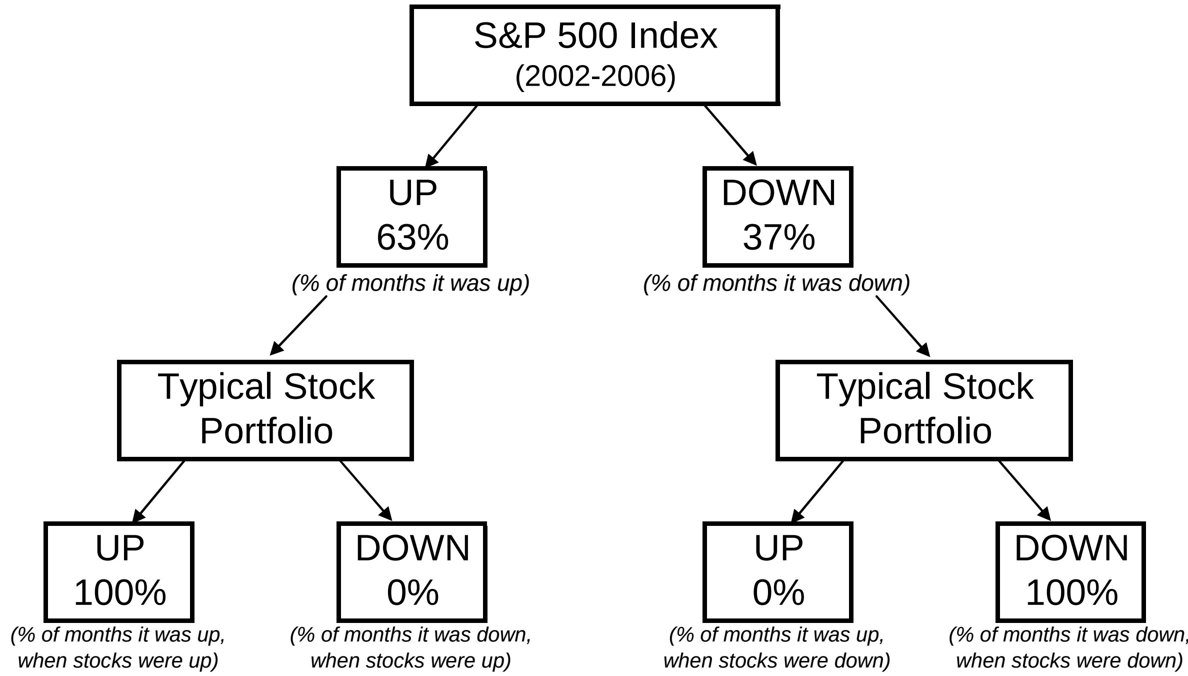
Figure 1. Stock Market Return Profile: Last 5 Years



For the typical portfolio over the past five years, ones that use modern portfolio theory and the traditional approach, the results have generally been similar. Those portfolios are intentionally structured to match the performance of the stock market. Figure 2 reflects what happened to the traditional “benchmarked” portfolios during the same period since 2002.

Previously we saw that the stock market has gone up during 63% of the months over the past five years. Since traditional portfolios of stocks closely track the market, we therefore see that benchmarked stock market portfolios were up about 100% of the time when the market was up. Likewise, we therefore find that the traditional portfolios were down consistent with the market 100% of the down months.

Figure 2. Performance of Traditional "Benchmarked" Portfolios



As for cumulative performance over the past five years since the start of 2002, the S&P 500 (one accepted proxy for the stock market) has a compounded annualized return of 4.3% before dividends, transaction costs, and management fees. With dividends included, the total return on an annualized basis has been 6.2%. Therefore, an investor could have expected annualized net portfolio gains to be somewhere between the 4.3% and 6.2% depending upon transaction costs and their portfolio's relative performance.

THE FIRST RULE

Many have heard that the first rule of investing is "Don't lose money." That rule is important because losses have a disproportionate impact on compounded returns. Simple returns are the returns that occur each day or month. Compounded returns reflect the cumulative impact of gains and losses on prior returns and represent the kind of returns that we can ultimately spend.

For example, if an investment is up +10% one year and down -10% the next, is the investor at breakeven over the two-year period? The result is 0% if we simply average the two years, yet the investor actually will be down by -1% in his account (on a cumulative basis). This occurs regardless of the order of the gain and loss periods. It actually takes an +11% gain to make up for a -10% loss.

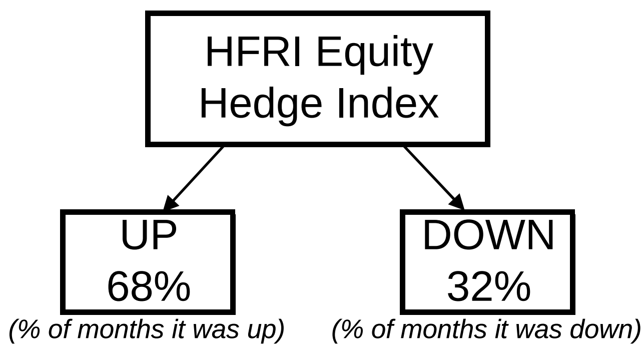
Further, as the loss increases, it requires a greater percentage gain to restore the account to breakeven. For example, it takes a +25% gain to recover from a -20% loss and a +50% gain to recover from a -33% loss. As tech bubble investors have experienced, it will take a +400% recovery to offset the -80% decline that occurred in the NASDAQ. Therefore, as discussed earlier, one key benefit to avoiding losses is that it only requires 30% of the upside in the market to achieve market returns.

STOCK MARKET STRATEGIES

So if hedge funds (and similar absolute return strategies) work hard to control risk as well as achieve gains, how have they done over the past five years since the start of 2002—especially the ones that are primarily investing in stocks with some element of hedging? HFRI, a respected hedge fund industry index service, has a fairly large number of hedge fund indexes based upon a wide variety of strategies, including several indexes related to stock market investment strategies. Since this discussion relates to stock market investing, we will focus on the hedge fund index that includes "stock-pickers" with some hedging (there are other indexes that relate to market-neutral equity strategies that are generally fully-hedged or equity strategies that sometimes don't hedge).

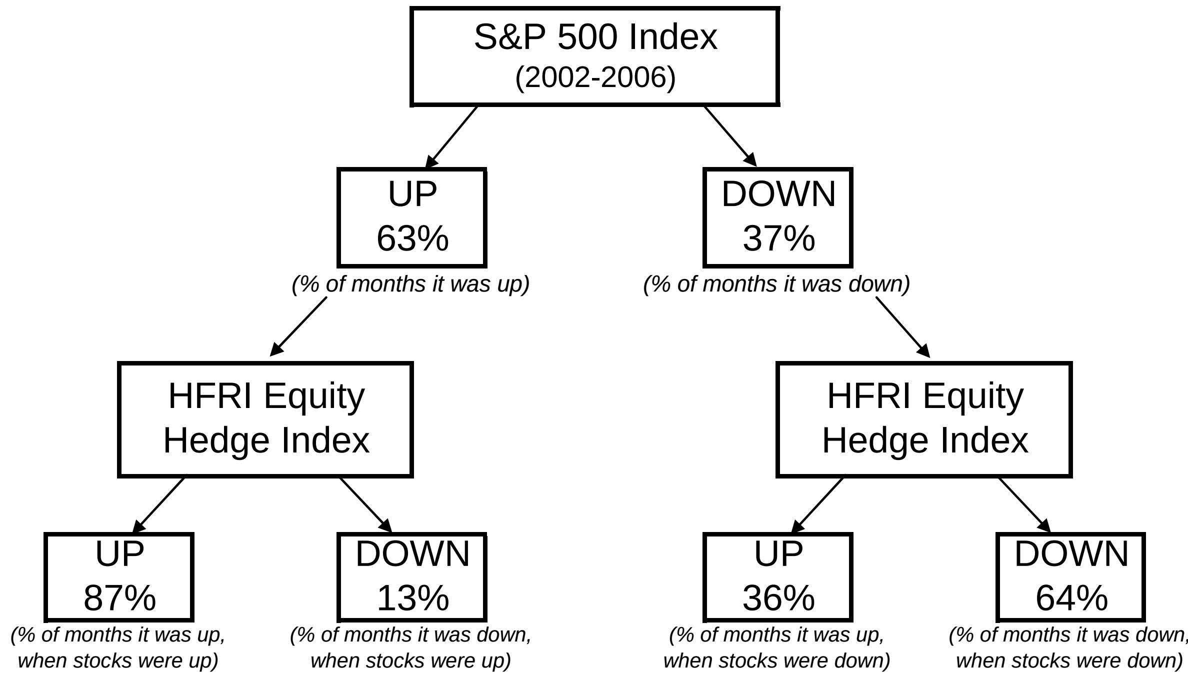
How did the hedged-equity set of hedge fund managers do over the past five years? Figure 3 reflects their up and down performance. The hedge funds were up 68% of the months, slightly better than the stock market (63%). Conversely, the hedge fund set was down 32% of the time, slightly less than the stock market (37%)

Figure 3. HFRI Equity Hedge Index



Also, they displayed somewhat less correlation than the traditional portfolio. There were months when the market was down, yet the group provided profits. Likewise, there were months when the market received marks in the win column, yet the funds fell short. Figure 4 reflects the performance of the hedge funds in relation to the stock market's performance.

Figure 4. HFRI Equity Hedge vs. S&P 500



As for investors' accounts, they experienced an annualized net compounded gain over the past five years since the start of 2002 of 8.9% after all fees and expenses. Their performance well exceeded the returns of the stock market. Beyond good investment skills, how did they do it? How did the hedge fund group exceed net stock market returns by 3% or more on an annualized basis?

The answer lies in their performance in up and down markets—a concept called "capture." The portion of gains realized in up months is known as "up capture." For down months, the portion of losses is called "down capture." For example, in the earlier illustration about the impact of losses on cumulative returns, we found that an investment with down capture of 0% only needs an up capture of 30% to match the market return. The same analysis also showed that a down capture of 50% only requires 64% up capture to match the market return. By contrast, the traditional portfolio has an equal capture profile (100% up and down), which yields the market return. The power of controlling downside risk and losses is that it greatly reduces the upside percentage needed to achieve the same return.

As for the hedge fund group, their performance included a down capture of 31% and an up capture of 55%. The cumulative effect of controlling losses on the downside and getting a reasonable share of the upside provided solid cumulative returns to investors after all fees and expenses.

This controlled-risk "capture" approach is different than the aggressive-risk approach employed by some investments. Whereas capture seeks to limit the variability of upside and downside—to take advantage of the benefits of limiting the downside—the aggressive-risk approach seeks highly outsized gains to offset outsized losses.

For example, banks take a controlled-risk approach by making loans to a variety of people and companies. They want to collect a little profit from each borrower and limit the incidence of losses. On the other hand, venture capitalists invest in a number of risky start-up and growth companies. They expect to have a number of failures, yet also expect to have a number of very profitable "home-runs" not only to offset the losses but also to provide solid cumulative returns. As reflected by the profiles of performance reviewed earlier, the hedge fund group positions their portfolios to take the controlled-risk "capture" approach to seek solid returns with reduced risk, not the aggressive-risk approach that some people perceive.

Please keep in mind that the controlled-risk "capture" approach is also completely different than the traditional concept of beating the market. How often have you heard a broker exclaim that success occurs during periods when an investor is down -14% while the market was down -15%? The "beat-the-market" mindset drives investors to judge performance relative to the market…seeking that little bit of extra return by not losing as much or making just a little more. That approach has not been successful for most investors, as reflected in the fact that numerous studies and reports reflect that the average mutual fund and average investor has underperformed the market after including dividends, fees, and expenses.

The answer lies in their performance in up and down markets—a concept called "capture."

Even though the equity-biased hedge fund group handsomely exceeded the market after all fees and expenses, they only "beat-the-market" during up months less than one-third of time. The goal for many traditional equity managers and mutual funds is to exceed the market by 1% or maybe 2% over time—the rare excess enjoyed occasionally by some and repeatedly by far fewer. For the hedge fund group to average 3% or more annually over the market, it took the skills of investment selection as well as the benefits of downside risk control.

MARKET NEUTRAL STRATEGIES

So what about the funds that are less sensitive to the gyrations of the stock market, investment strategies that take a relatively market neutral approach? To encompass the broad range of absolute return strategies, we can again use a hedge fund index as a proxy for assessing performance. In contrast to the stock market-biased index that was used earlier, we can use the HFRI Composite Hedge Fund Index ("HFRI Composite"). The HFRI Composite is a well-diversified index representing over 1,800 funds across more than twenty-five absolute return strategies. The diversification includes strategies that use stocks, yet others that use financial securities other than stocks. Further, some strategies have a higher level of correlation to the stock market, while others are non-correlated or even oppositely correlated. Therefore, the HFRI Composite represents our proxy for market neutral absolute return strategies.

Figure 5 presents the performance of the multiple strategy hedge fund index. The hedge funds were up 75% of the months, better than the stock market (63%) or the

Equity Hedge index (68%). Conversely, this general hedge fund set was down 25% of the time, less than the stock market (37%) and the Equity Hedge index (32%).

Figure 5. HFRI Composite Hedge Fund Index

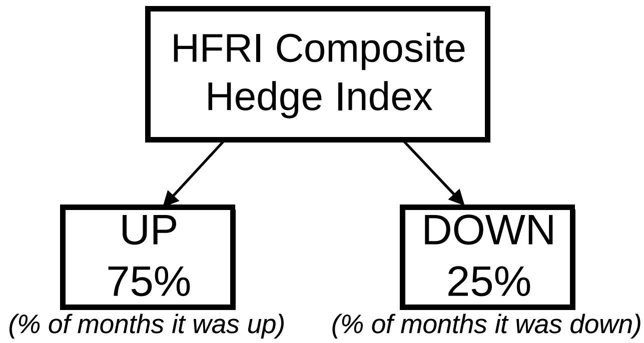
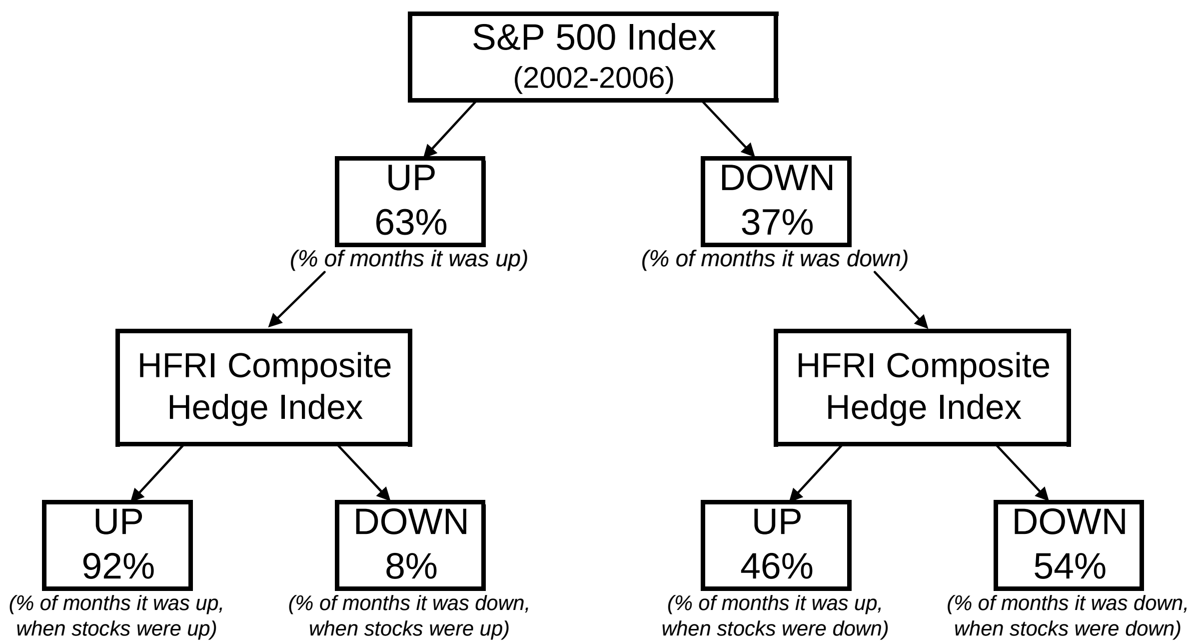


Figure 6 presents the performance of the multiple strategy hedge fund index across up and down markets. When the stock market (S&P 500) was positive, the HFRI Composite was generally positive (92% of the up months) and rarely down when the market was up (8%). When the stock market was down, the hedge fund set nearly split its performance up and down during those periods. Whereas the stock market may have had some impact on the hedge fund set's performance, their ability to control risk in down markets helped investors to preserve capital.

Figure 6. HFRI Composite Hedge Fund Index vs. Stock Market



As for the capture performance, the HFRI Composite experienced 15% of the down capture during down months in the market, while accumulating 49% of the up capture. As we discussed previously, a 0% down capture requires 30% up capture to match market returns and a 50% down capture needs 64% up capture to cumulatively achieve market returns.

Clearly, the HFRI Composite has achieved solid capital preservation during down months in the stock market and has captured a reasonable portion of the upside during up months. Over the past five years since the start of 2002, the result is that the HFRI Composite reflects a net annualized return (after all fees and expenses) to investors of 9.7% while the S&P 500 produced an annualized 6.2% gross total return (before fees and expenses). Again, this emphasizes the importance of controlling downside risk and seeking a modest share of the upside. Not only does it result in a smoother ride, the result is more satisfying.

THE PRESS

For some, these concepts and the related performance may not seem to follow conventional wisdom. Our perceptions are often shaped by what we read in the press or hear from traditional sources. In 2002, for example, as the stock market declined and total returns were -22%, the story headlines about hedge funds often read: "Hedge funds fail to deliver returns." Story after story explained that hedge funds were near breakeven.

The following year, as markets soared and total returns were +28%, the same sources reported: "Hedge funds can't keep up." The stories told how hedge fund returns were just over half of the market's gains. Little attention—except by hedge fund investors, however—was paid to the fact that traditional portfolios remained with net losses across the two years, while the accounts of many hedge fund investors had grown by almost 20% over the same two years.

CONCLUSIONS

The impact of losses is significant to investments and portfolios. That impact is greater than a similar percentage gain…and that impact grows as the magnitude of losses increases. A key value of the hedge fund style of investing—so called "absolute return" investing—is its focus on controlling downside losses and capturing a reasonable share of the upside. As the analysis and studies have shown, as downside risk is controlled, not only does it provide investors with a reduced risk profile and more comfortable ride, but also it requires much less of the market's upside to deliver the same level of return.

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