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GETTING GOING
 By JONATHAN CLEMENTS



What Price Cachet? As Hedge Funds Struggle, Mutual Funds Look Even Better

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Keep up with the Joneses? Maybe you shouldn't.

Wall Street thrives on envy, and nothing triggers more envy than hedge funds. They are the financial playground of the rich, offering not only cachet, but also the prospect of dazzling returns.

Make no mistake: If you buy a hedge fund, you will get your cachet. The dazzling gains, however, may prove elusive. Many hedge funds have struggled this year, and some -- notably Amaranth Advisors -- have recently been hit by big losses. Indeed, you could be better off with humdrum mutual funds.

Sluggish returns. Consider a study by Roger Ibbotson, founder of Ibbotson Associates -- now a unit of Chicago researchers Morningstar Inc. -- and Peng Chen, the firm's president.

Hedging Your Bets
 Instead of buying a hedge fund, you could better diversify your portfolio with mutual funds like these.

FUND	EXPENSES	MINIMUM
American Century Int'l Bond	0.87%	\$2,500
Fidelity Int'l Small Cap Opportunities	1.27	2,500
Vanguard REIT Index	0.21	3,000

Sources: Morningstar; fund Web sites

The authors note that, based on the TASS database, hedge funds appear to have clocked an eye-popping 16.5% a year between year-end 1994 and April 2006, easily outpacing the 11.6% average for the Standard & Poor's 500-stock index. Yet this 16.5% average is mighty misleading, for two reasons.

First, when hedge funds are added to performance databases, they sometimes include earlier results. This "backfill bias" skews the average upward, because only funds with stellar returns typically report their prior performance. Second, when poorly performing hedge funds go out of business, their dismal results are often ignored, leading to so-called survivorship bias.

What happens if you eliminate survivorship and backfill bias? Messrs. Ibbotson and Chen calculate that hedge funds returned just 9% a year, less than the S&P 500's 11.6%.

"The returns are diminished substantially," says Mr. Ibbotson, a finance professor at Yale University. "But there's still a diversification benefit and there's still evidence of management skill" once you adjust results for the low risk taken by many hedge funds.

Risky business. Diversification benefit? Low risk? You might be scratching your head.

Aren't hedge funds run by swashbuckling money managers who scour the globe for investment opportunities and then aim to magnify their gains with massive amounts of leverage? Sure, those guys exist -- and they're often the folks who end up posting horrendous losses.

But many hedge-fund managers don't fit the popular image. They aren't seeking blockbuster returns. Instead, they try to clock moderate gains every year, no matter what's happening in the stock and bond markets.

"Clients hear 'hedge fund' and they think 20%-annual-return gunslingers," says Chris Cordaro, a financial planner in Chatham, N.J. "And we're saying, 'We'd be happy with 6% to 8% a year.' With hedge funds, we're looking to get better-than-bond returns with the same or less risk."

As Mr. Cordaro sees it, hedge funds offer a way to further diversify a conventional stock-and-bond portfolio. Thinking what I'm thinking? If the goal is lower risk, hedge funds aren't the only game in town.

In fact, they have a fistful of drawbacks. A "fund of funds" hedge fund, which makes its money by investing in other hedge funds, might have total costs of 5% a year, and possibly more.

Information can also be hard to come by, you might have to pony up \$25,000 for even a low-minimum hedge fund, you could be limited to monthly or quarterly purchases and sales, you might get performance information just once a month and you need to be an "accredited" investor who meets certain wealth or income requirements.

"I believe hedge-fund strategies should be part of people's portfolios," says Pittsburgh investment adviser Louis Stanasolovich. "But why pay the high costs? A mutual-fund alternative is better for a lot of people." He notes that mutual funds "have daily liquidity. You have full disclosure. You can get in for as little as \$1,000. And you don't have to be an accredited investor."

Mr. Stanasolovich favors mutual funds such as Alpha Hedged Strategies, **Arbitrage Fund**, **Merger Fund** and Rydex Absolute Return Strategies, which he expects to deliver moderate returns with low volatility. He also likes Leuthold Asset Allocation, **Pimco All Asset** and Pimco All Asset All Authority, which have a lot of investment flexibility, not unlike a "global macro" hedge fund.

Going cheap. These are all intriguing funds. But I'm not buying. Remember, we're aiming to reduce risk -- and it strikes me that, for ordinary investors, there are simpler and often cheaper ways of doing that.

"The reason to buy any alternative asset class is for its diversification and low correlation," says Nelson Lam, an investment adviser in Lake Oswego, Ore. "Hedge funds are just a very expensive way of doing that. If you want to reduce risk in a traditional balanced strategy, you can add low-correlation assets like real-estate investment trusts, international small-caps and international bonds."

To tap into these sectors, Mr. Lam suggests funds such as American Century International Bond, Fidelity International Small Cap Opportunities and Vanguard REIT Index. True, these investments don't have hedge-fund cachet. But as you can see from the chart, the price tag is a whole lot more palatable.