

Taming Volatility while Enhancing Portfolio Returns



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Declines in the stock market and increased price volatility have led many investors to doubt traditional buy-and-hold strategies. Many are becoming increasingly interested in tactical strategies that can capture a significant amount of the market's upside, while having reduced exposure on the downside. One strategy that has achieved this objective is long-short investing. Unlike traditional equity funds that normally profit only when stock prices are increasing, long-short funds can potentially gain regardless of the overall market direction.

In their most basic form, long-short funds purchase (or go "long") stocks that appear attractive and also sell "short" stocks that appear unattractive. Typically, the long positions increase in value when stock prices are rising and the short positions benefit when stock prices are declining. This potential to gain on both sides of the market provides some very appealing risk and reward characteristics.

Risk, Volatility & Drawdown

While most long-only funds have near 100%



exposure to the broad market, long-short funds typically have a much lower net exposure. The Morningstar Long-Short fund category had an average net exposure of 47% at the end of the third quarter. Looked at another way, the Hennessee HF Long/Short Equity Index (HLSI) had a beta of 0.35 measured over the last 10 years versus a beta of 1 for the stock market. This lower market exposure generally leads to portfolios that are less impacted by large swings in the market.

Besides analyzing a fund's beta coefficient, one can also gauge volatility by measuring a fund's standard deviation (SD). Funds with higher SDs are usually classified as more risky investments as there is greater variability (or ups and downs) in their past returns. Over the past 10 years, the S&P 500 had an average annual SD of around 16% compared to around 8% for the HLSI. By comparison, the SD for the Barclay's Long Government/Credit Bond Index was at 9.38%. Investors in long-short funds are still able to participate in the equity markets, but potentially with risk similar to that of a bond portfolio.

At the end of the third quarter, the Morningstar Long-Short fund category had an average cash allocation of 36.5% compared to 2.4% for the Morningstar Large Cap Blend category.

Second, not all short positions are chosen as a hedging vehicle; some are selected because they provide an opportunity. Whereas most long-only funds either avoid purchasing stocks they do not like or underweight them, long-short funds can generate additional returns off the "dogs" managers find in their research - even when markets are rising. The HLSI was able to capture around 58% of the market's upside on average over the past

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Performance through 9/30/09

	1 - Yr.	3 - Yr. Annlzd	5 - Yr. Annlzd	10 - Yr. Annlzd
Hennessee HF Long/Short Equity Index TR	8.04	4.11	6.21	7.24
S&P 500	-6.91	-5.43	1.02	-0.15

Besides reducing volatility, long-short strategies can help preserve value in down markets. Since the short positions generally move in the opposite direction of the long stocks held in a portfolio, they help provide downside protection if markets are falling. Historically, long-short funds have only captured about 30% of the market's downside. Looking back at the past 10 years, the S&P 500 faced a maximum drawdown of almost 51%, while the HLSI had a maximum drawdown of just under 21%.

Enhanced Returns

While the lower net exposure of long-short funds can be a benefit in down markets, it can be a lag on performance if markets are rising. Long-short strategies, however, have some advantages compared to long-only funds that helps make up some of this difference over a full market cycle.

First, long-short funds are able to invest the cash received from short sales into short-term money-market type investments, providing an additional source of return. This differs from long-only funds which generally have minimal cash balances as they are usually fully invested in long positions.

10 years, while having a reduced exposure to the market.

Third, by limiting drawdown in a portfolio, long-short funds are often able to compound their returns from a higher base. This is especially important due to the effects of compounding over a full market cycle when index levels are constantly shifting higher and lower. The following chart compares the performance of long-short funds to the S&P 500, and shows the effects of compounding over multiple years.

Risk Adjusted Return Metrics

By producing consistent returns along with attractive risk and volatility measures, long-short funds are able to generate superior risk adjusted returns. Two metrics that assess performance and risk together are the Alpha figure and Sharpe ratio.

The Alpha figure indicates if a portfolio is outperforming relative to its expected return. It measures performance after adjusting for a fund's beta. Long-short funds have historically generated positive alpha. The HLSI had an annual average alpha of 4.94% measured over the last ten years.