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## Those Who Play the Ups and Downs

By **NORM ALSTER**

WITH a mandate to bet on both upward and downward stock movements, long-short funds have proclaimed their ability to perform well when the market turns wild or wobbly. So the last three months, as stocks were in gyration mode, swooning in July and storming back in September, would seem to have offered ideal conditions for these funds' managers.

But that is not how it has played out. Despite some strong performances by a few funds, the average long-short fund actually underperformed the broader market, gaining 0.2 percent for the quarter, according to [Morningstar](#), while the Standard & Poor's 500-stock index managed a 2 percent gain.

Yet a few long-short funds, either through inspired timing or spot-on stock-picking, tacked on solid gains in the last quarter that left them with double-digit returns for the year, well ahead of the broad market averages.

With an ever-shifting portfolio mix of longs and shorts, managers describe their positions as being net long or net short by a given percentage. A fund that is, for example, 60 percent long and 40 percent short would be 20 percent net long. The trick last quarter was to have as many short bets as possible when the market, as measured by the Dow Jones industrial average, peaked at 14,000 on July 19. But by mid-September, with the market anticipating and then savoring the benefits of a federal funds rate cut, shorts were little more than lead boots, and managers like Ralph Parks, who had just gone 100 percent long, were racing ahead of the pack.

Mr. Parks manages the Ralph Parks Cyclical Equity fund, which gained 3.25 percent on Sept. 18, the day the Fed cut its benchmark short-term interest rate, the federal funds rate, and the S. & P. 500 rallied by 2.9 percent. Unlike most managers of long-short funds, who describe themselves as fundamentals-oriented stock pickers who thrive by sorting the good apples from the bad, Mr. Parks studies stock charts, describing himself as a momentum investor. That means he buys stocks that have shown strength, avoids or shorts those that have not and does not try to outsmart the market on direction.

With stocks showing strength for more than a week before the Fed's rate cut, Mr. Parks closed all the put option positions in the fund's portfolio on Sept. 17, the day before the Fed's decision. "We wanted to be 100 percent long. It's either a love or hate situation. On Sept. 17 we decided we hated everything short."

The fund returned nearly 17 percent through the first three quarters of this year, ahead of the gain of 9.1 percent for the S. & P. 500.

Earlier in the third quarter, long was the wrong direction for short-term gains. Two funds leaning in the right direction were the Janus Adviser Long/Short fund and Nakoma Absolute Return. "We were probably at our least net long position when the market peaked," said David Decker, lead portfolio manager of Janus Adviser Long/Short, which returned 3.4 percent for the third quarter. By mid-July, Mr. Decker said, "We felt pretty strongly

the market was not discounting the risks.”

At Nakoma Absolute Return, fund holdings have ranged “anywhere from 25 percent net short to 60 percent net long,” said Greg Schroeder, a senior analyst at Nakoma Capital Management, adding that “we were pretty bearish earlier in the year.” By early last quarter, the fund was roughly 10 percent net short.

The fund tilted in the right direction on sector performance as well, going long on large-capitalization companies and shorting smaller companies, which have recently underperformed. Nakoma also shorted several consumer discretionary stocks, including [Winnebago Industries](#). Winnebago sells large mobile homes that are “over 90 percent financed,” Mr. Schroeder said. Hence, sales were sensitive to interest rates, as well as to oil prices — and they both were moving in the wrong direction. “We believe consumer spending will slow,” he said. “We believe Winnebago has exposure to a spending slowdown.” The stock was down more than 18 percent for the quarter.

As the summer wore on, Nakoma began moving again to a net long position, which by mid-September sat at about 20 percent. One growing long position has been in health care. “Relative earnings stability should be valued in a slower-growing or more volatile economy,” Mr. Schroeder said.

The Nakoma fund returned 4.7 percent in the quarter and 11.9 percent for the first nine months this year.

Many successful long-short managers forswear market timing or even broad sector bets, relying instead on their ability to identify specific stocks that are most likely to rise or fall. Thomas Luddy, lead portfolio manager of the [JPMorgan](#) U.S. Large Cap Core Plus fund, relies on a JPMorgan process for ranking companies from least expensive to most expensive. The formula is based on internally derived estimates of cash flow and earnings growth for the next eight years. As a result, Mr. Luddy thinks he can outperform in both rising and declining markets by 2 to 3 percent a year.

The fund has performed smartly since its inception in November 2005. For the first nine months this year, it returned 16.3 percent; it returned 4.8 percent in the third quarter alone.

AN important clue in forecasting long-term performance is a company’s history in investing free cash flow, Mr. Luddy said. Companies that have made successful use of cash are likely to outperform in the future, he said; conversely, companies that have a poor record of making disciplined investment choices may be short candidates. “Our research gives us cheap stocks and expensive stocks,” Mr. Luddy said.

Among the long-short funds that were strong earlier in the year but slipped in the last quarter were American Century Long-Short Equity, Rydex Hedged Equity and ICON Long/Short.

The ICON fund, for example, returned 9.9 percent through September, but even after a late rebound, it left investors with a loss of just over 1 percent for the third quarter. Todd Burchett, the fund’s manager, said his portfolio was hurt by one unexpected consequence of the credit crunch.

“There was a significant deleveraging of hedge funds,” he said. They sold off the more liquid stocks to raise cash, he added. Often, these were the presumably rock-solid long positions in the ICON portfolio. One example was [Boeing](#), which beat earnings forecasts but still dipped after peaking in late July.

Some managers note that in strong markets, holding short positions will chip away at returns. “Investors should

expect some underperformance in a dramatically strong market,” said Christopher Baggini, lead portfolio manager of the Nationwide US Growth Leader Long-Short fund. “If the market goes up 25 percent, we’re not going to look as good going up 12 to 15 percent.”

BUT last quarter’s market, with its turbulence and downward drafts, offered favorable conditions, Mr. Baggini said. The fund returned 2.7 percent, bringing its gains to 10.4 percent for the first nine months of the year. Although the fund can go as high as 50 percent net long, on the market peak of July 18 it was only 26 percent net long. And the fund had made some good sector bets.

“We have avoided banks and anything credit-related,” he said. The fund profited from short bets on [Countrywide Financial](#), which it closed out when the stock dropped below \$20.

Market turmoil also created buying opportunities for the fund in mid-August, Mr. Baggini said. He picked up shares of Crocs, the maker of trendy, brightly colored footwear, after the stock fell to \$45 from \$60 on “general market malaise.” Crocs shares have since rebounded, and ended the quarter at just over \$67 a share. “Volatility is good for us,” Mr. Baggini said.

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