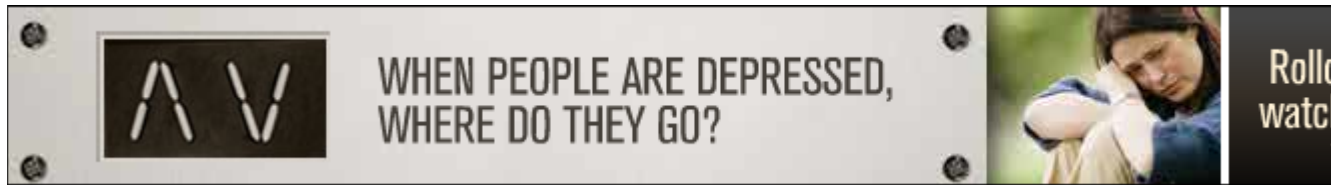


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Mutual Fund Investing

## Hedge Your Bets With This Long-Short Fund

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I often write about alternative asset classes, such as commodities, that can reduce the volatility in a portfolio because they produce returns with a low correlation to stocks. There are also strategies for combining long and short positions in stocks that can play a similar role in a portfolio.

Typically they are only available through hedge funds. But on Friday I had the opportunity to chat with portfolio manager Mark Fedenia and senior analyst Greg Schroeder, two of the decision makers for a very interesting little mutual fund called the Nakoma Absolute Return Fund (NARFX).

The basic idea is that combining long and short positions can produce steady returns, regardless of whether the market is rising or falling. In pursuing this they have a lot of flexibility as to how much they can be short and long.

Although they unambiguously describe themselves as bottom-up (stock pickers) they do incorporate some top-down (big picture) themes as well.

A successful example that illustrates this is their decision to be short **Cabela's** (CAB) . From the bottom-up perspective, they felt the outfitter's expansion plans were too ambitious, competition from Bass Pro Shops would be formidable and that the company was relying too much on its branded credit card for revenue and earnings. From the top down, they felt that higher gas prices and the slowing economy would hurt a lot of consumer-discretionary names.

One point Fedenia and Schroeder stressed is that there will be some short positions, such as the one in Cabela's, that work out well and others, such as the net short position in energy, that don't. What should matter is the result of the overall portfolio, whatever the short position.

There is an intricate blending that goes on in the fund to create the results, which thus far have been exactly as advertised: slow steady returns with much less volatility than the market.

Sticking with the short Cabela's/short energy idea, there is a built-in partial hedge between the two. The managers feel that higher gas prices benefits the CAB short position, but obviously higher gas prices the short position on energy. If the trend in oil prices reverses, that would probably be good for their energy short and bad for their CAB short.

This type of hedge exists throughout the fund.

Philosophically, they realize that noone can be right 100% of the time. The goal, therefore, is to be right more often than they are wrong -- a point I have tried to stress in my writing since long before I ever heard of Nakoma.

The managers also use stop orders on their positions. I have written several times that stop orders are not the ideal tool for risk management. Specifically, putting an 8% stop under every position seems like a bad idea, and the team at Nakoma gets this. They said their policy on stop orders is not mechanical. What that means is that if it makes sense to put a 5% stop under one stock (or above for a short position) and a 20% stop under another stock, they have that flexibility.

The decision to close a position usually comes from a change in the drivers of a stock (this could be after a stock works out well or does not work out well) or if they realize they have made a mistake. The willingness to recognize mistakes, like a short on **Research In Motion** (RIMM) from earlier this year, tells me they are more concerned with the result they deliver than their egos.

This fund's fees, which are capped at 1.99% through 2008, may be contentious for some. This rate may seem high, but it is very much in the ballpark for other long-short funds. This investment category tends to be more expensive because selling short incurs expenses that long does not. Over time, as the fund gets bigger, the managers believe they will be able to lower the fee.

Fedenia and Schroeder believe that track record matters. They note that even though this fund is very new, they have executed this strategy for several years in the hedge-fund world. To be clear, the accompanying chart does *not* show the performance of the mutual fund, but the same crew with the same strategy in a hedge fund.

Integrating a fund like this into a diversified equity portfolio should reduce volatility and increase risk-adjusted return. This is an important concept if the market is going to be more volatile for the time being, especially if we are late in the stock-market cycle.

Another idea we discussed was using an absolute-return fund like Nakoma as a bond substitute. Fedenia and Schroeder believe that, over the next couple of years, interest rates could go higher. This makes sense to me for a couple of reasons; a weaker dollar puts pressure on the Fed to raise rates to make U.S. assets more attractive overseas, and the yield curve is likely to steepen as this economic cycle slows.

And it's generally not a good idea to hold bonds when interest rates are rising. The yield and the price of bonds have an inverse relationship. If rates are going up then prices are going down. Bonds with longer maturities are generally more sensitive to this relationship.

If that scenario makes sense to you, then an investment with the attributes of the Nakoma fund could very well serve as a proxy for part of your bond portfolio, volatility-wise, although it won't replace the yield.

My own take is that the ability to capture most of the market's return over the long term with far less volatility should appeal to a lot of people. Investors who save a lot relative to their needs can take less risk in their portfolio and still reach their financial goals.

#### **Smoothing the Market's Bumps**

Nakoma Absolute Return Fund's managers have a strong track record with the same strategy at a hedge fund.



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**Off to a Strong Start**  
Nakoma Absolute Return Fund's performance since inception.



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*At the time of publication, Nusbaum had no positions in any of the securities mention in this article, although positions may change at any time.*

*Roger Nusbaum is a portfolio manager with Your Source Financial of Phoenix, and the author of Random Roger's Big Picture Blog. Under no circumstances does the information in this column represent a recommendation to buy or sell stocks. Nusbaum appreciates your feedback; [click here](#) to send him an email.*

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