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Why Your Portfolio Needs More Risk

By ROB SILVERBLATT
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Slide Show: 7 Mutual Funds for Gamblers

By any standard, money manager Malcolm Gissen has had a complicated relationship with risk over the past couple of years. After losing 62 percent in 2008, the Encompass Fund, which Gissen co-manages, gained a staggering 137 percent last year, cementing its reputation as one of the more volatile funds in the industry. "Most mutual fund managers tend to invest for mediocre results. Their goal is to perform in line with their benchmark," says Gissen, whose returns—for better or worse—have been anything but mediocre.

[See 7 Mutual Funds for Gamblers.]

Encompass is one of a small group of funds that have a "go-anywhere" mandate (meaning they can invest in essentially any type of security), and Gissen wields that power freely. Late last year, for instance, his fund had about 20 percent of its assets in gold-related investments. Despite all that, Gissen's attitude toward risk is surprisingly straightforward: "We don't like risk," he volunteers.

[See *U.S. News*'s list of the 100 Best Mutual Funds for the Long Term, and use our Mutual Fund Score to find the best investments for you.]

This, of course, begs the question: What exactly constitutes a risky portfolio? "When people think about risk ... they think, 'What's going to be the next AIG or the next Enron?'" says Chris Konstantinos, a portfolio risk manager at Riverfront Investment Group, a Virginia-based advisory firm. "That's a really important risk, but it's not the entire side of the risk equation. It's just one piece."

Lately, the market has shone a light on an entirely different type of risk, one that's far more paradoxical and difficult to grasp. "Sometimes the biggest risk you can have in your portfolio is not having enough risk," says Konstantinos. "And certainly since March of '09, that's clearly been the case."

Advocates of this philosophy point to two main scenarios. In one, a traditionally safe asset class falls off, pulling the rug out from underneath investors who were overexposed to it. That's what many analysts expect will happen to bond investors once interest rates start creeping up. In the other, a risky type of investment takes off, leaving those who don't own it behind in a cloud of dust. That's what occurred when consumer discretionary stocks surged during last year's rebound.

In both scenarios, the advantage goes to investors with portfolios that are traditionally seen as risky. The challenge, of course, is achieving the right balance. Many investors can't stomach the swings associated with funds like Gissen's, but there's middle ground to be found. "The right way to look at risk is to look at it from a portfolio construction perspective, which means that in a highly diversified portfolio, there's room for what's perceived as risky kinds of investments," says Konstantinos.

Notably, if employed correctly, seemingly "risky" bets can actually reduce the overall riskiness of an investor's portfolio. That's because they can serve as a hedge, protecting a portfolio against unforeseen events. Until fairly recently, these hedging strategies were, for the most part, only available to sophisticated institutional investors. But now, any retail investor can take part in them. Here's how:

Shorting. Investors who short a security essentially make a bet that it will decline in value. In its most aggressive form, shorting can open investors to limitless losses, but in its tamer iterations, it can be a valuable hedge. Lately, there has been a surge in the number of mutual funds that look to balance out risk through shorting. There are currently 97 long-short funds in Morningstar's database, up from 61 at the end of 2006. While some of these funds can be rather speculative, others take a cautious approach by carving out small positions in which they bet against the same types of securities that they bet in favor of in other parts of their portfolios. This makes the losses less painful should those securities take a dive.

The tradeoff is that two opposing bets can cancel each other out to a certain extent, meaning that investors in long-short funds shouldn't expect to see eye-popping returns. Over the past year, the 97 funds that Morningstar classifies as long-short have average returns of 6.6 percent. By comparison, an investor in Schwab's plain-vanilla S&P 500 Index Fund would have gotten a 25.2 percent return during that same period.

Microcaps. Microcap funds own shares of some of the smallest companies on the market. Often, several of the names in their portfolios have market capitalizations of less than $300 million. Sam Dedio, the manager of Artio U.S. Microcap, isn't shy about the risks associated with such stocks. "You're dealing with much smaller companies," he says. "With smaller companies, there are all kinds of risks. Management experience comes up. Typically, they have only one or two products. Often they don't have a lot of research coverage, [and] oftentimes it's hard for smaller companies to get access to capital, so they can go through some growing pains."

Still, especially for investors with long time horizons, these tiny stocks offer plenty of room for growth. In particular, microcaps usually rally coming out of a recession. In 2009, for instance, Dedio's fund gained 64 percent. Microcaps certainly aren't for all investors, but those who lack exposure to them run the risk of having to play catch-up during strong markets.

Currency plays. For years, retail investors in international bond funds have had access to currency plays. Basically, what this entails is managers owning some bonds denominated in currencies other than the U.S. dollar. For investors who have most of their holdings in American companies, this exposure to other currencies can offset losses if the greenback struggles. In other words, investors can take on risk in one currency to protect themselves against falloffs in another. This also cuts the other way. For investors who have large stakes in emerging markets stocks, which generally do well when the dollar is weak, it could be wise to make a few bets in favor of the dollar to limit risks, says Konstantinos.

Investors looking to make currency plays have seen their options increase considerably in recent years, largely thanks to the proliferation of exchange-traded funds. For instance, PowerShares offers an ETF for investors who want to be bullish on the U.S. dollar (UUP), and a separate one for those who want to be bearish (UDN).

Leverage. This is perhaps the riskiest strategy of them all. After all, excessive amounts of leverage largely caused the crisis that gave rise to the recession. For fund investors, there's a niche set of leveraged options, such as those offered by Direxion. These funds promise returns that are a certain multiple of a given index. For instance, Direxion Monthly S&P 500 Bull 2x looks to get monthly returns that are twice as high (or low) as those of the S&P 500. When the index goes up, so does the fund, and vice versa. On the other hand, Direxion Monthly S&P Bear 2x uses leverage to achieve monthly results that are equal to two times the inverse of the S&P 500. When the index loses, the fund wins. Small exposure to such funds can be used as a hedging technique, but this strategy is generally for speculative investors who have sophisticated approaches.

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