Making Money Now: Market Neutral Funds

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A year ago, if someone told you that their objective was just to retain their capital without any return, you would have thought they were crazy. Today, that approach sounds pretty good. That is because the market is drastically down, so those who maintained their capital without loss of value are ahead of the most everyone else, even though their portfolios might not have gained a cent.

These lucky people are investors who thought the market would go down and acted on it. One approach they used, little appreciated until this downturn, was investing in a market-neutral fund. This is a fund that attempts to remove market risk by purchasing both long and short positions simultaneously. Stocks that are expected to be performers in the future are purchased long, while those that are anticipated to do the reverse are sold short (see paragraph below for explanation). Therefore, this portfolio would be expected to have less volatility.

Buying long means that an investor purchases a stock in the anticipation that it will rise in value. If it does, the buyer makes money. Short selling is the opposite; it is the process of selling a stock that is not owned, betting it will go down in price. Then, the stock can be purchased and the difference between the short-sale cost and the lower purchase price is the return. For example, a portfolio manager might sell short 1,000 shares of a stock that she expects to go down at $100 per share. If it falls to $90 per share, the difference ($10 X 1000) is captured by the fund manager (minus the interest she has to pay on the loan of the stock).

This is the process used by Vanguard Market Neutral Investor shares (VMNFX). For the year, it is down 4%, while the stock market in general is down 40%, a 10-fold difference. It is a Morningstar large-blend style. In the figure below from Yahoo Finance, VMNFX in blue is the Vanguard Market Neutral Investor share fund. The Dow Jones Industrial Average (DJI) is in black. GSPC in red is the S&P, and IXIC in green is the NASDAQ. The chart speaks for itself.

Since the fund has to be actively managed, its expense ratio is high at 2.79%. This cost works against investors, since it has to be taken out of return. Additionally, it is only during dramatic moves in the market, mostly downward, that the fund's return would be expected to be enticing. VMNFX also requires a minimum initial investment of $250,000.

Nevertheless, other funds necessitate a lesser minimum and have done well in this climate as well. They are not a large blend (Morningstar designation) like VMNFX, but rather vary from medium to small in size and value to growth in investment valuation (see below).

	Minimum $ Investment	Yr. Return (%) (As of 12/12/08)	Expenses (%)	Style (Morningstar)
1st Source Monogram Long/Short (FMLSX)	1,000	-18.11	1.75 + 0.25 12b-1	Medium Value
Hussman Strategic Growth (HSGFX)	1,000	-1.16	1.11	Large Growth
TFS Market Neutral (TFSMX)	5,000	-8.56	2.80	Small Growth

A market-neutral fund can pump up your portfolio when the market is down. The market may stay down for a long time. The problems in our economy right now are systemic and won't go away any time soon. Therefore, reevaluating previous market approaches is reasonable. If the portfolio isn't working in its present form, other possibilities have to be entertained. One such alternative is replacing some long positions with a market neutral fund. It is another way to potentially make money now.