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Should you add hedge funds to your portfolio?

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STERLING INVESTMENT ADVISORS, LTD.

We are frequently asked, "When is the stock market going to drop?" Seeing as how no one can predict the future, we instead explain our investment philosophy and suggest that implementing that philosophy might mitigate our questioner's stock market losses.

We also explain several important things to know about the stock market:

First, a market "correction" is defined as a 10 percent pullback from recent highs, while a 20 percent decline is referred to as a "bear market."

Even when the stock market goes through prolonged periods of low volatility, we have to remember that the market typically experiences a drop of at least 12 percent at some point during the year.

Another important consideration is that of "timing" the market. Many investors, in fact, attempt to predict when the next correction or bear market will occur. But few have successfully done so with any consistency.

However, while it may be impossible to time the market, you can still build a portfolio designed to reduce volatility. This starts with a solid asset-allocation strategy, which typically involves blending the many categories of stocks and bonds, and cash.

In recent years, another option, hedge funds—alternative investments using pooled funds—have become an increasingly popular asset class to complement traditional investments. Hedge funds are designed to not correlate to or behave like other investments. If the stock market retreats significantly, hedge funds are expected to experience lesser losses and may even generate a positive return.

Not all hedge funds are created equal, though, so, we have certain rules when investing in them. First, they must not be an "opaque" structure—meaning we must be able to see their underlying investments. Second, we must have the ability to trade them on a daily basis. Many hedge funds limit when you can withdraw money—some go as far as requiring a three- or six-month advance notice of an investor's intent to withdraw.

Third, a hedge fund must have what we consider reasonable, competitive expenses. Finally, the fund must prove that it can perform in the manner it claims.

We are constantly analyzing several hedged strategies and their historical returns. All too often, we have discovered that many do not produce the desired results. And, in the absence of an extensive history, some new hedge funds even utilize the concept of "back-tested results."

These are hypothetical returns that assume the underlying investments had been in place for the past five or 10 years. We have found that there is often a large divergence between "back-tested" and real returns, which is why we insist on seeing the results of actual investments.

There are countless hedged strategies available to the investing public. After sifting through dozens of them ourselves over the years, those we've chosen as our favored strategies include market-neutral, convertible arbitrage and multi-strategy funds.

The market-neutral strategy, sometimes referred to as "long/short," involves simultaneously buying a basket of stocks long, with the expectation that they will increase in value, while also selling stocks short, expecting them to decrease.

Convertible arbitrage, meanwhile, refers to the practice of selling the common stock of a company short, while buying the convertible bond of the same company. The higher yield from the convertible bond can create a significant income stream with reduced risk. A multi-strategy approach, moreover, employs several different lowly correlated, intricate strategies, including the two previously mentioned.

Overall, it is essential to periodically review your portfolio, particularly after substantial stock market movements. Adding hedged strategies may improve your diversification and reduce your investment volatility during times of turmoil. ●

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