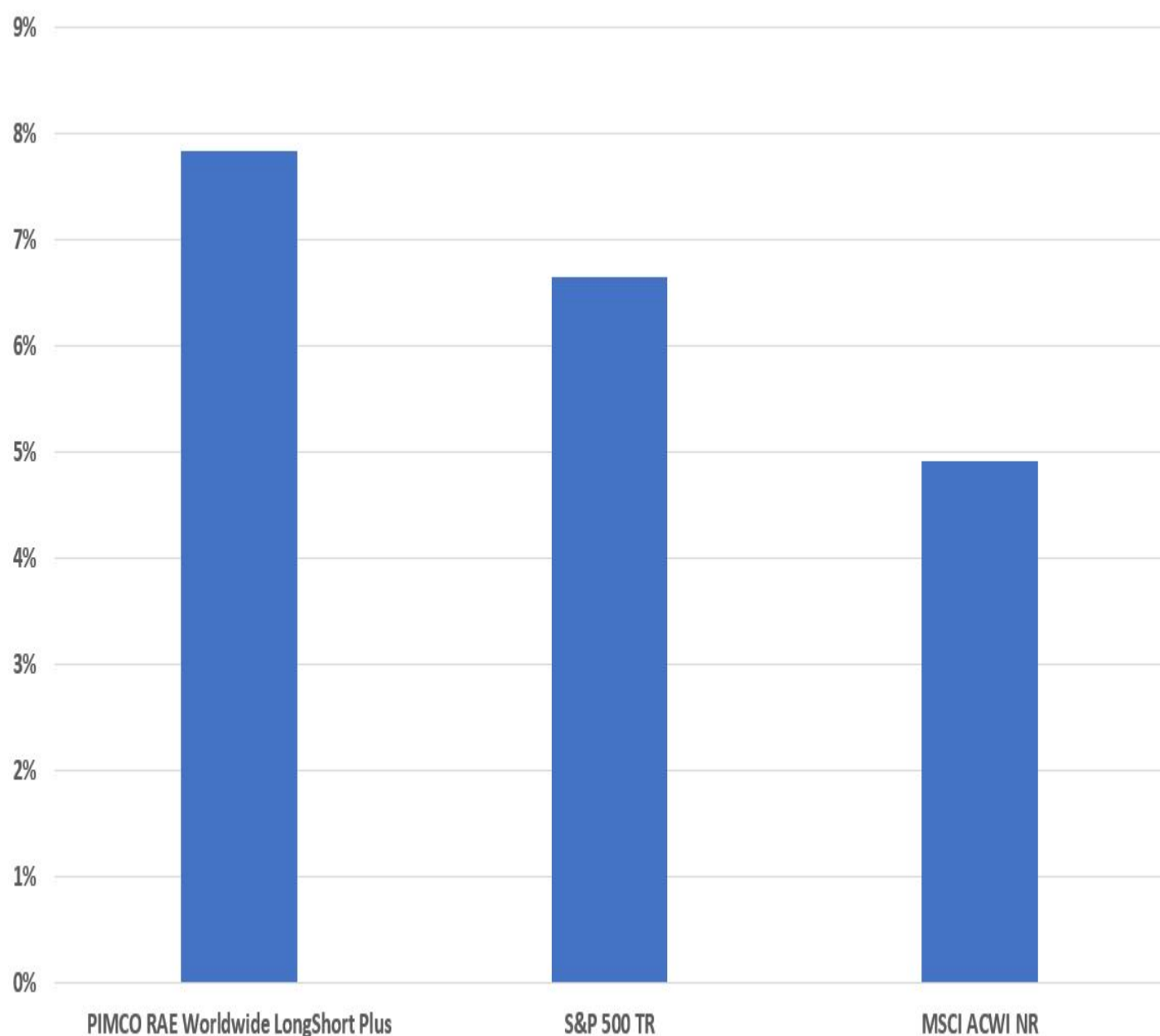


In The Market Carnage, One Long-Short Fund Looks Impressive

Some mutual funds short stocks (bet on them to go down) at least with part of their portfolios, and Morningstar has a long-short category with 248 of them. I ran a screen on Morningstar.com's premium mutual fund screening tool to see which of them had lost 3% or less for the year-to-date period through December 24th and also had a five-star rating, meaning a fund's volatility adjusted return put it at the top of the category over at least the last 3 years. For the year through December 24th, the S&P 500 Index dropped 10.36% including dividends. My return criteria were admittedly arbitrary, but hopefully not unreasonable. If a long-short fund is down 5% when the market is down 10% in one period, has the fund failed? It's not easy to say. But I wanted to be more stringent and see if any funds that had done well against each other for an extended period of time had also weathered the storm the market has delivered recently with a better than -5% return for the year. First of all, 38 of 248 long-short funds (or only 15%) dropped 3% or less for the year. Also, the category average return was -9.14%, only slightly better than the index's loss including dividends. That was a little disappointing; it's unclear that the category is earning its keep. The fund that made the grade, dropping 3% or less and posting a five-star rating was the PIMCO RAE Worldwide LongShort Plus (PWLIX) fund. The fund has been around since late 2014, and is subadvised by Robert Arnott's firm Research Affiliates. Arnott and others are listed as portfolio managers. This is not a typical long-short fund whereby a research team proceeds stock-by-stock, deciding what to buy and what to short on valuation or other factors. First, this fund gets its equity exposure (both long and short) through index-tracking equity derivatives which are collateralized with a bond portfolio. The fund tries to deliver positive returns with its equity exposures, of course, but also through its bond portfolio delivering a higher return than the cost of the derivatives. Second, this fund is normally long a worldwide index of low volatility, high yielding, and low leverage stocks and short a worldwide capitalization weighted index where stocks are ranked according to the value the market accords them. Market capitalization indexes arguably create distortions, whereby the prices of the largest stocks are unduly elevated and those of the smallest stocks are unduly depressed. That means the combination of being long an index not based on market capitalization and shorting a capitalization weighted index can benefit an investor by owning relatively cheap stocks and shorting relatively expensive stocks. Besides low volatility stocks outperforming capitalization weighted indices in long term backtests, the fund can benefit from what it calls "dynamically managed global equity market beta." In other words, the fund typically has more equity exposure when markets are less volatile and less when they're more volatile. The fund's literature argues that these three sources of return – the low volatility equity income strategy, the actively managed absolute return bond strategy, and the dynamically managed global equity market beta strategy – are uncorrelated. It's likely that the correlation argument is true. After all, the low volatility equity income strategy is similar to a value approach to stock investing. The low volatility strategy was devised by a finance professor named Robert Haugen who studied the works of Benjamin Graham and took issue with the assertion of modern academic finance that one had to incur high volatility to achieve a superior return. Haugen showed that high volatility stocks were mostly what Graham called the "glamour" stocks that ran hard for a while, but wound up flaming out. Lower volatility, boring companies that didn't capture investors' imaginations (and then disappoint them by not fulfilling extreme expectations) plugged along and eventually produced superior returns. The dynamically managed global market beta strategy, however, is a kind of momentum strategy. If it's adding exposure when market are calm, it's likely adding exposure when they're

going up ? or at least not declining and *vice versa*. So the two equity strategies fight against each other to some extent ? or complement each other, depending on how you look at it. One potential problem is if low volatility equity income strategies are much in favor now and, therefore, become so expensive that they don't have much return potential over market capitalization strategies. Then the investor is dependent on the momentum-like dynamically managed beta strategy and the bonds outstripping the cost of the derivatives for return. But maybe relying on two strategies isn't so bad. And the fund has acquitted itself well, producing a 7.84% annualized return for the 3-year period through December 24th, 2018. That's better than the S&P 500 Index's 6.65% return and amounts to a performance good enough to land the fund in the top percentile of the Morningstar long-short fund category over that stretch. The fund has achieved that superior return with lower volatility -- a 6.82% standard deviation of returns compared to a 9.4% standard deviation of returns for the index. The comparison to the S&P 500 Index -- the typical way Morningstar displays returns for long-short funds on its website -- may work too much in the fund's favor lately since shorting international stocks has undoubtedly helped it. But the fund has also been long international low volatility stocks, and, overall, it's been easier to beat a global index lately than a domestic one. three years is also not a very long period of time, but we don't have much more history on this fund. Investors will have to make due with that for now in their analyses.

3-years annualized through Dec. 24, 2018



Finally, while the institutional share class's 1.28% expense ratio isn't cheap by plain equity fund

standards, it is compared to long-short funds, where shorting stocks, which can entail paying dividends, can get expensive in a hurry. Altogether investors have a long-short option worthy of consideration in this fund, which has the potential to beat the index simply and provide an uncorrelated source of returns in a portfolio.