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What Are Inverse Funds?

July Market Review From Your Portfolio Management Team—August 3, 2012

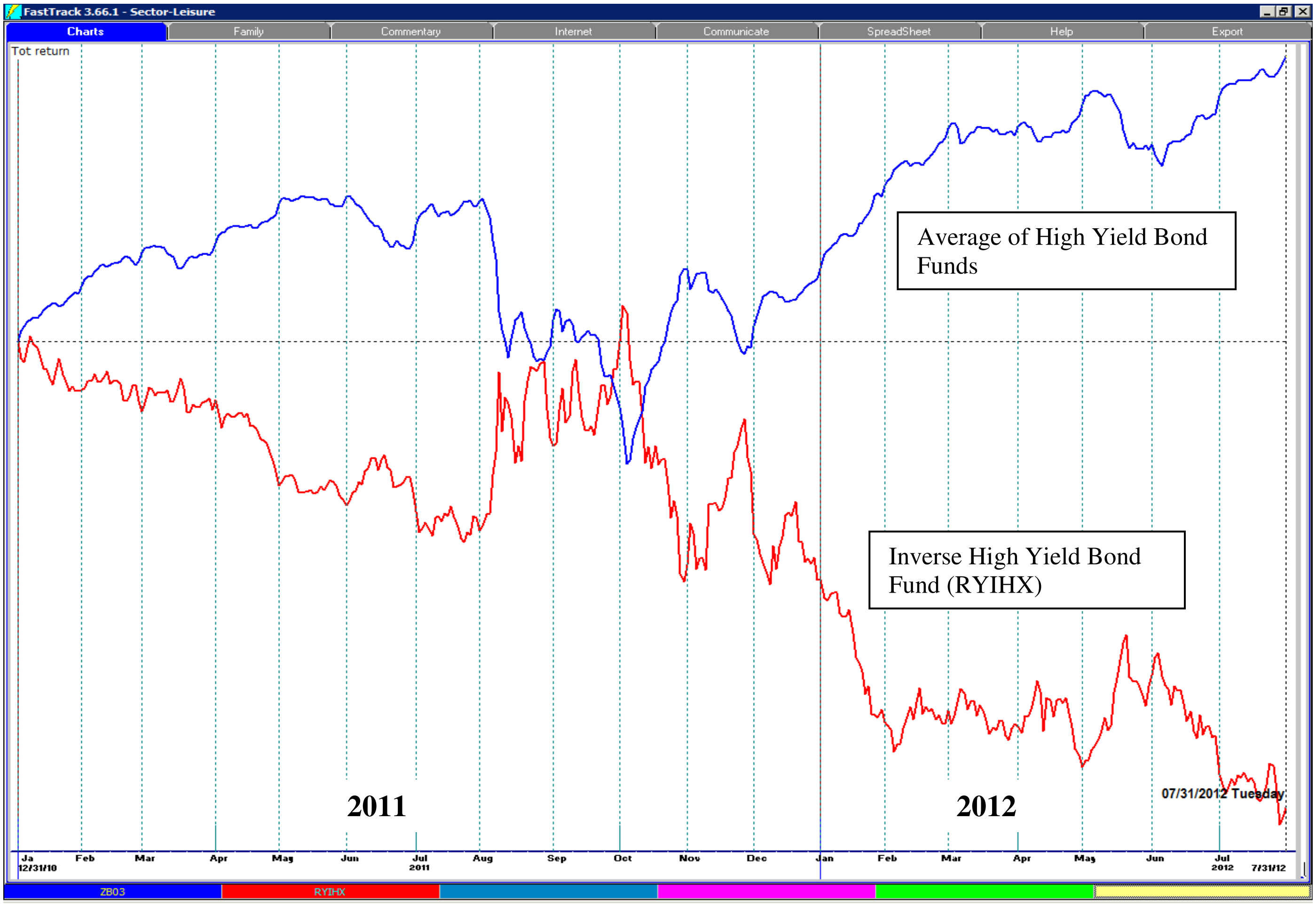
As we celebrate our 30 years in business, it has been interesting to reflect back on those years, and all the changes that have occurred in the business of managing people's money. Back in the early to mid 80s, there were just a few hundred mutual funds to invest in, and the ability to move from various types of stock funds to money market funds was a relatively new phenomenon. Charts were updated by hand, and trades were done over the telephone or by fax machine. (We wondered how we ever did business before the fax machine.) Today, we can trade thousands of accounts with relative ease, and everything can be done over the internet.

Back in the eighties, the main tool to protect the portfolio in times of market stress was to sell any stock or bond mutual funds that were falling in price and put that money in a money market fund. This approach allowed us to avoid much of the financial pain of being invested during the Market Crash of 1987, or the Technology bear market of 2000 – 2002. While effective, it unfortunately meant that we often sold a fund with an excellent manager at the helm that was actually doing a pretty good job in a tough environment. In addition, for clients with taxable accounts it sometimes meant creating a taxable gain.

Because of innovations over the past 10 years, we now have access to additional tools which can help us provide downside protection. A primary innovation is the development of so-called *inverse* funds, which are designed to move in the opposite direction of the primary market. Today there are over 300 mutual funds and exchange-traded funds (ETFs) that are inverse funds which include stock, bond and commodity funds.

Conceptually, if you had a portfolio that held 50% in the Vanguard Index 500 fund, and the other 50% in an inverse S&P fund, the portfolio would behave as though it was 100% in money markets because the gain in one fund would be offset by a loss in the other fund. Why not just sell the Vanguard fund 100% to money market? Well, for a taxable account, it might make more sense to hold some of the Vanguard fund to keep taxes down. In some cases the fund we own may be doing relatively well, and we would like to hold it except that market conditions are forcing us to take action. The inverse funds allow us to protect the portfolio while possibly holding on to some quality funds that are performing well in a difficult market.

We have used these inverse funds sparingly over the past several years. Usually, we have used them during transition periods in the market. A transition period is a period of weeks or months when a prior trend in the market has stalled. There has not been enough of a reversal to claim there is a new downtrend, but the current uptrend has clearly stalled out. The spring of 2010 and the summer of 2011 are two recent examples. We would also consider the past 4 months a transition period, with stocks hitting a peak back around the end of March, but no subsequent breaks to new highs or breaks to new lows. In those situations, we may add inverse funds to provide some cushion to the portfolio while the overall market remains in a sideways, choppy environment. If stocks ultimately resume their uptrend, we sell the inverse funds (possibly at a loss), but hold on to the various traditional funds in the portfolio that are now rebounding. If stocks ultimately turn down, we will sell the traditional funds in the portfolio as they hit their safety nets, while maintaining the inverse funds, which at this point will have moved into their own up-trends.



The chart above shows the return of the average high yield bond fund versus one of the *inverse* high yield bond funds. As you can see, while the inverse fund does not move exactly opposite to the traditional high yield average, it generally moves in an inverse direction. Adding funds like this to a portfolio that contains a mix of stock and high yield funds would definitely provide some ballast in a choppy or down market. We generally would not own these funds over the long run, but would tend to use them during down markets or transition periods.

While technology and investment options have changed the landscape for money managers over the past 30 years, the overriding investment philosophy of FSA has not changed. It is to protect client assets from severe market drops, while participating in the long-term growth in the markets. Inverse funds give us another tool to navigate the treacherous and uncertain market environment that characterizes our investment reality today, and represent another variation of having an exit strategy.