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Fund Managers Bracing for a Sell-Off

Bear tactics: How a handful of gloomy fund managers are preparing for a sell-off

By [Ben Levisohn](#)

Investors have a right to feel sunny. The recession has most likely ended, analysts are raising predictions for third-quarter earnings, and the Standard & Poor's 500-stock index is up 56.8% since its March low. So why are some prominent fund managers feeling gloomy?

All of the managers featured in this story bumped up equity exposure in their portfolios earlier in the year—they are not permabears. But some look at the economy and still see troubling signs of stress. Others have analyzed the stock market's rally and determined that it may have come too far, too fast, and are preparing their portfolios for a market sell-off.

The Hedger

JOHN HUSSMAN

President, Hussman Investment Trust

During the first quarter of 2009, when the S&P 500 fell 12.7%, John Hussman watched the \$5.2 billion Hussman Strategic Growth Fund ([HSGFX](#)) gain 7%. That wasn't the result of brilliant stock picks, although his selections did outperform the market. Rather, it had to do with a strategy Hussman uses to hedge his portfolio with option contracts. He has employed it since opening his Ellicott City (Md.) fund shop nine years ago.

Hussman sells calls (options betting that the stock market will climb) and buys puts (options betting the market will fall) on the S&P 500, Russell 2000, and Nasdaq 100. When he hedges the entire dollar value of his portfolio, as he did at the start of 2009, he's betting that his stocks will gain more (or lose less) than the general market. As a result, he should make (or lose) the difference between the return on his stocks and the overall gain or loss from his hedges. So while his stocks rose just 1.45% from January to March, his fund was up 7% because the market dropped 11% and his hedges paid off.

As the market turned in March, Hussman stuck with his portfolio of companies with stable sales and operating margins, including AstraZeneca ([AZN](#)), which is 3.5% of the fund, and Johnson & Johnson ([JNJ](#)), at 3.19%, rather than follow the crowd into beaten down financials and cyclical stocks. He also bought call options, a bet that the stock market would rise. That gave him exposure to the overall market without having to buy companies he didn't want to own for the long run.

As the market climbed, so did the value of the options, reducing some of the fund's losses from hedging. (It was down 0.8% in the second quarter, compared with 23.8% for the S&P 500.) But in late September, he sold the call options, judging the market "strenuously overbought." Translation: Stocks are not cheap. He calculated that at current prices, stocks would return just 6.6% annually, well below their historical levels of about 10%. Market volume, too, has been underwhelming, an indication that many investors prefer to sit on the sidelines. Add in tough economic conditions, and the rally could be coming to an end. "I'm extremely concerned we've put a Band-Aid over an infection," Hussman says.

The Technician

BARRY JAMES

President, James Investment Research

Back in February, Barry James, president of Xenia (Ohio)-based James Investment Research ([GLRBX](#)), started adding stocks to the \$545 million James Balanced Fund. His timing was off—it usually is, he says, since the technical indicators he follows tell him what's going to happen but not when. Nevertheless, he continued buying equities through the market's low and into April and May, bringing the fund's equity position from under 35% to 55% at its peak. (In a "normal" market, James usually has a 50/50 split between stocks and bonds). But like Hussman, James thinks the market has overreached. During past rallies from extreme sell-offs, markets peaked when 70% of stocks had traded above their 50-day moving average, or the average stock price over a 50-day period. That number is now near 90%, says James.

Investor sentiment has reversed from March lows as well. Then, the investor sentiment surveys James follows showed most shareholders to be bearish. Now less than 30% of investors say the market is due for a near-term fall. "That's never a good sign," says James. He expects a drop of at least 20% in the next few months and has cut his fund's stock position to 40%. He is putting money into sovereign debt from countries such as New Zealand and Australia that offer higher rates than do U.S. Treasuries. He also likes gold and silver producers, including Barrick Gold ([ABX](#)) and Silver Wheaton ([SLW](#)), which should benefit if the dollar continues to fall. The James Balanced Fund is up 5.91% this year, after being down 5.5% in 2008.

The Fundamentalist

JOHN LEKAS

Manager, Leader Short-Term Bond Fund

On Mar. 31, John Lekas, the Portland (Ore.) manager of the \$205 million Leader Short-Term Bond Fund ([LCCMX](#)), predicted that the Dow Jones industrial average would hit 9,600. For clients whose money he manages outside of his fund, that meant a move into stocks. But when the Dow hit his target on Aug. 25, Lekas didn't like what he had seen. The market's rally was driven by sentiment, and the fundamentals hadn't improved enough to justify those gains, he says. There was still too much debt on corporate balance sheets, with around \$2 trillion, or 65%, coming due in the next four years.

While refinancing most likely won't be a problem, he says, the new debt will be more expensive, so simply making interest payments will eat up more cash. Meanwhile, companies will find it difficult to boost revenue to make up the difference. To maintain profits, they'll need to lay off more workers. Lekas believes unemployment could hit 16% by the end of 2010. That poses a problem for the markets. "If you don't have real organic growth, you're not going anywhere," he says. By yearend, Lekas expects a Dow of 6,300, a 35% loss from today. He's dumped most of his equity positions in favor of cash, Treasuries, and short-term bonds. (He made a similar decision in January 2008, protecting his clients from much of that year's losses.) Only 10% of his clients' portfolios are in stocks.

The Stockpicker

SHAHREZA YUSOF

Head, U.S. Equities Aberdeen Asset Management

Aberdeen U.S. Equity fund ([GXXAX](#)) had a tough 2008—the large-cap growth fund lost 41%—and this year began with more of the same. "The world looked like it was going to end," says Shahreza Yusof, head of U.S. equities at the U.S. affiliate of global money manager Aberdeen Asset Management. "And there's no point investing in an end-of-world scenario." Instead, the fund held on to its financial stocks even as the crisis

deepened. Top holdings (as of Aug. 31) such as Oracle ([ORCL](#)) and Philip Morris ([PM](#)) International helped it gain 29.9% this year.

Lately, Yusof has been lightening up on stocks that have had the largest gains since their 2009 lows. From June to Aug. 31, the fund cut back on shares of graphics-processor maker Nvidia ([NVDA](#)) by 37% and info tech provider Cognizant Technology Solutions ([CTSH](#)) by 27%. Yusof moved the money into stocks that have lagged the market, boosting positions in Kellogg ([K](#)) and medical-supply company Baxter International ([BAX](#)) by 50%.

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Bull Run Blues

The rally in stocks is "one of the least joyous bull runs in memory," said a Sept. 17 *Los Angeles Times* article, as investors worry about its "unexpected length and magnitude." Market pros are surprised there hasn't been a 10% to 15% correction during the rise. That would be normal in a longer-term bull run and give economic fundamentals time to catch up with "exuberant expectations."

To read the full article, go to <http://bx.businessweek.com/us-stock-market/reference/>

[Levisohn](#) is a staff editor at BusinessWeek covering finance and personal finance.

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