A growing number of money managers are juggling multiple roles, handling plain-vanilla mutual funds for mom-and-pop investors as well as hedge funds for wealthy individuals and institutional investors.

Regulators and lawmakers have raised concerns about the trend, saying it could lead managers to favor deep-pocketed hedge-fund investors over the smaller fry investing in mutual funds. Some major fund companies, including Vanguard Group, staunchly defend these so-called side-by-side management arrangements. Others, such as Fidelity Investments, avoid the practice. Even new academic studies are divided on the issue of whether small investors are well-served by side-by-side management.

For fund companies, hedge funds -- private investment pools for wealthy and institutional investors -- can be much more lucrative than mutual funds. Hedge funds often charge a 1% or 2% management fee, as well as a 20% performance-based fee, while the average domestic stock mutual fund charges a management fee of roughly 1.5%. Hedge funds’ hefty performance-based fees could give managers an incentive to favor those vehicles over mutual funds -- say, by allocating their best investment opportunities to hedge funds.

Mutual funds now sharing managers with hedge funds include offerings from
Vanguard, Pioneer Investment Management, Nationwide Mutual Insurance Co.’s Gartmore Global Investments and Ameriprise Financial Inc.’s RiverSource Investments. Such arrangements account for a small but growing slice of the fund universe, industry experts say. There are 124 individual portfolio managers simultaneously running mutual funds and hedge funds tracked by investment-research firm Morningstar Inc., compared with 112 last year and fewer than 60 in 2002. About $448 billion was invested in actively managed stock mutual funds run by companies that also managed hedge funds in 2004, according to Scott Gibson, an associate finance professor at the College of William & Mary’s Mason School of Business.

Many managers in recent years have left mutual-fund firms for the bigger paychecks and lighter regulation of the hedge fund world, and defenders of side-by-side management say that it helps mutual-fund companies retain talented employees and access a broad pool of top money managers. But critics say the practice gives managers an incentive to favor hedge funds with their best investment opportunities and distracts them from running their mutual funds. Some moonlighting managers acknowledge the possible pitfalls. “This is an area rife with potential problems,” says Michael Jones, chief executive officer of Clover Capital Management, who runs MassMutual Select Small Company Value and other mutual funds, as well as Clover hedge funds.

A number of major fund companies steer clear of the practice. American Century Investments offers a traditional mutual fund that uses hedging strategies, and such funds “are a better deal for shareholders,” says Phillip Davidson, a senior vice president at the firm. Fund giant Fidelity has no in-house hedge funds and prohibits managers from running outside ones.

Other major players, however, defend side-by-side management. “It allows us to look at a very broad universe of managers and hire the best that we can find to run money for our shareholders,” says Joe Brennan, principal at Vanguard. While Vanguard runs its index-tracking funds in-house, it uses outside firms to manage most of its other offerings. About half of those 26 outside firms also manage hedge funds, Mr. Brennan says. Among the moonlighting managers are Wellington Management Co. employees Edward Owens, manager of the Vanguard Health Care fund, and Karl Bandtel and James Bevilacqua, two managers of the Vanguard Energy fund, according to recent filings.

In 2003, the House of Representatives approved a measure, later shelved, that would
have barred an individual from running a hedge fund and mutual fund simultaneously. In congressional testimony earlier this year, Susan Wyderko, then director of the Securities and Exchange Commission’s Office of Investor Education and Assistance, said that the practice “presents significant conflicts of interest that could lead the adviser to favor the hedge fund over other clients.”

There are several ways that moonlighting managers can favor hedge funds over mutual funds. A manager might sell shares of a stock in his hedge fund before his mutual fund because he knows the sale could drive the price down. Instead of assigning a trade to a particular fund at the time it’s executed, a manager can “cherry pick” trades. He may make a trade in the morning and assign it to the hedge fund or mutual fund later in the day depending on its performance. And a manager who has access to a limited number of shares of a hot initial public offering might favor his hedge fund with them.

Shorting stocks, a strategy often used by hedge funds that typically involves selling borrowed shares with the hope of buying them back later at a lower price, can also lead to potential conflicts. A manager may have a short position on a stock in a hedge fund while holding a long position -- a bet that the price will rise -- on the same stock in a mutual fund.

The SEC doesn’t dictate how managers should address these potential conflicts, and practices can vary widely among managers who run both hedge funds and mutual funds. Ric Dillon, CEO of Diamond Hill Investment Group Inc., manages several Diamond Hill mutual funds as well as a Diamond Hill hedge fund. He says he doesn’t short any stocks that are held in long positions in other funds, calling the policy a key way to avoid conflicts of interest. Diamond Hill Long-Short and Diamond Hill Small Cap, two funds managed by Mr. Dillon that have five-year records, both rank near the top of their categories over that period, according to Morningstar.

Other moonlighting managers take a different approach. Peter Jankovskis, director of research at OakBrook Investments LLC in Lisle, Ill., runs the Pioneer Focused Equity mutual fund and an OakBrook hedge fund. He says “it happens frequently” that the hedge fund will short stocks held in long positions in the mutual fund, but says the situation doesn’t present a conflict because the two funds have different time horizons. Pioneer Focused Equity has delivered five-year annualized returns of 8.5%, outperforming about 80% of its large-blend peers, says Morningstar.

Filings for the Vanguard Explorer and Vanguard Mid-Cap Growth funds note that co-manager Edward Antoian of Chartwell Investment Partners runs a hedge fund that
generally has ”a limited amount of overlap of investments” with the mutual funds. Vanguard spokesman John Woerth said in an email that the firm ”works closely with all of our advisers to ensure that they are employing talented and experienced investment personnel as well as devoting the necessary research resources in the management of our funds.”

The two Vanguard funds’ trustees divide the assets among several different firms, which independently manage a portfolio of stocks for the fund. While Mr. Antoian joined the Mid-Cap Growth management team just this year, the Vanguard Explorer Fund, which he has managed since 1997, has delivered five-year annualized returns of 11.3%, outperforming about 70% of its small growth rivals, according to Morningstar.

Managers who use the same strategies for mutual funds and hedge funds have the advantage of devoting their attention to a single investment approach. But the manager could face the task of divvying up trades between the funds. Jerry Paul, CEO of Quixote Capital Management LLC, uses similar strategies to run a Quixote hedge fund and the QCM Absolute Return mutual fund. He says trades can be allocated fairly based on objective criteria like assets in each fund or availability of cash. The mutual fund, launched late last year, has gained 5.5% so far this year, falling near the bottom of its midcap-blend category, according to Morningstar. Mr. Paul says that Morningstar has miscategorized the fund and that ”our strategy is not one that’s designed to keep up with a bull market environment in equities.”

Recent academic studies are divided over whether side-by-side management harms small investors. Researchers at the College of William & Mary’s Mason School of Business and the Wharton School examined more than 450 mutual funds run by companies who also manage hedge funds and found that between 1994 and 2004 those
funds underperformed similar funds by about 1.2 percentage points a year. Researchers at Loyola University Chicago, the University of Illinois and the University of California at Irvine compared more than 200 mutual funds run by moonlighting managers with non-side-by-side funds with a similar investment style. The funds with moonlighting managers outperformed the other funds by about 1.5 percentage points annually from 1990 through 2005.

Starting last year, the SEC began requiring funds to disclose other types of accounts run by the manager and total assets in those accounts in a "statement of additional information." This document is often posted on the fund company's Web site, but can also be requested from the company or found on the SEC's Edgar Web site (sec.gov/edgar.shtml). The statement must provide information on other types of funds run by the individual manager -- not the fund company. To find out what types of funds are managed by a fund company, investors can search adviserinfo.sec.gov.

Write to Eleanor Laise at eleanor.laise@wsj.com