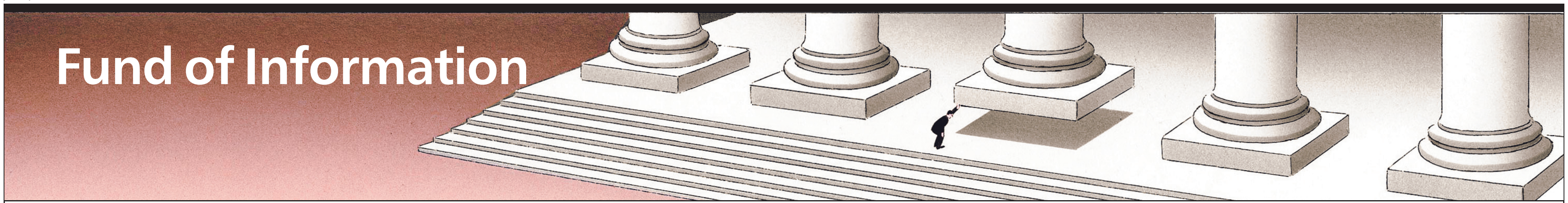

Foreign Stocks, Activists Power Hedge Gains

by Eric Uhlfelder

THE LAST TIME HEDGE FUNDS STARTED A YEAR WITH SIX straight monthly gains? Well, that would be 2007.

While observers are certainly wary of a market correction, few are expecting another Great Recession. And recent gains suggest more measured exuberance. Right before the last recession, hedge funds shot out of the gate, rising 7.35%. The first half of this year saw more modest returns of 4.33%.

In that time, emerging markets, up 8.13%, have been the leading performers for hedge funds, edging out activist funds, which added 8.10%, followed by European funds, which surged 6.15%, according to data from BarclayHedge.

Despite these strong numbers, hedge fund gains still trail Standard & Poor's 500 index total returns, big time. The benchmark is up more than 9% for the first half of the year. That's more than double the average hedge fund's return.

And some strategies continue to struggle. In the first half, commodity-trading advisors lost 1.68%; global macro was barely in the black, up 0.06%; and distressed funds rose just 0.55%.

This mixed record hasn't prevented investors from putting money into hedge funds. HFR, another data provider, reports industry assets hit a record high, closing June with $3.1 trillion. This extends the group's expansion into its ninth year, which began after assets tanked in 2008, falling to $1.41 trillion.

Emerging markets have done very well, in part because rising U.S. interest rates haven't unsettled them as much as feared. Ken Heinz, president of HFR, believes the markets are also benefiting from the sustained rally in U.S. shares and the revival of European and Asian markets, suggesting more global confidence, which tends to support developing markets. A revival in Chinese economic growth has also allayed worries about a more substantial slowdown.

What's Working... And What's Not

Emerging markets funds have enjoyed the first half, but commodities players not so much.

First-Half 2017 Performance

Top Hedge Strategies	Return
Emerging Markets	8.13%
Activist	8.10
European Equities Index	6.15
Bottom Hedge Strategies	**Return**
Commodity Trading Advisors	–1.68%
Global Macro	0.06
Distressed Securities	0.55
Barclay Hedge Fund Index	4.33%
S&P 500 Total Return	9.34%

Source: BarclayHedge

Activists, along with other deal-related strategies, are being carried along by increasing corporate activity fueled by rising stock prices, says Jeffrey Willardson, partner and head of portfolio solutions at Paamco Prisma, which has $30 billion invested in hedge funds.

EQMC Europe Development Capital, the activist fund that claimed the top spot in the *Barron's Penta* 2017 hedge fund survey, continues to hum along, up 19% for the first six months. Small-cap focused managers Jacobo Llanza and Francisco de Juan have benefited from their early entry into the space back in 2010, which is now attracting attention of heavy hitters targeting much bigger fish. They include Third Point's stake in Swiss food-giant Nestlé and Elliott Management's positioning into Dutch paint maker Akzo Nobel.

At smaller firms, EQMC sees plenty of opportunity. "Valuations are getting a bit richer, which may temper longer term returns," says de Juan, "but declining economic and political risk provides greater forward-earnings visibility."

Europe's improving economic health has also powered pure equity strategies. One believer is Alexandre Pini, former manager at private bank Edmond de Rothschild Group, now a partner at Geneva- and Luxembourg-based Iteram Capital. The firm runs €1 billion ($1.16 billion) with €300 million in funds of hedge funds. Iteram, with 30% of its hedge fund exposure in Europe, sees the continent having finally turned the corner after staggering through nearly a decade of financial, banking, and sovereign debt crises. And he expects the recent European rally to have legs, supported by growing business and investor confidence and accommodative central bank policies.

Hedge funds' mixed record this year hasn't stopped assets under management from rising to $3.1 trillion.

CTAs and global macro strategies, which ride broad trends, have also struggled. Eric Siegel, head of multi-asset class solutions at Citi Private Bank, says that "stubbornly low levels of volatility and sudden sharp reversals in exchange and interest rates have caught managers off guard." The same can be said for big-picture indicators like oil and gold. While many managers have defensively allocated to these strategies, they've so far amounted to little more than costly hedges.

They may regain their footing, says Siegel, "when we finally see a return to more normalized levels of volatility." He won't hazard a guess about when that will be. And the Federal Reserve's latest pronouncement about low inflation and its hold on interest rates isn't helping matters

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Distressed securities have been lagging, too. Siegel, says "low spreads and defaults are leading to low levels of opportunities." And he isn't particularly upbeat about the strategy for the rest of the year.

Will stocks finally stumble? Equity market neutral strategies could be the canary in the coal mine. Because the strategy relies in part on betting against stocks, its returns—just 0.7% in 2017—have been held back by rising share prices.

Jeff Willardson sees this as a clue to overvaluation. "We're seeing stocks priced to perfection, with even troubled securities rallying," he notes. Add in Washington's problems, and risk rises. "Combine unproven leadership with any unexpected economic or geopolitical shock and that's a recipe for a much tougher market,"says Willardson. Perhaps volatility-driven strategies will eventually revive. ■