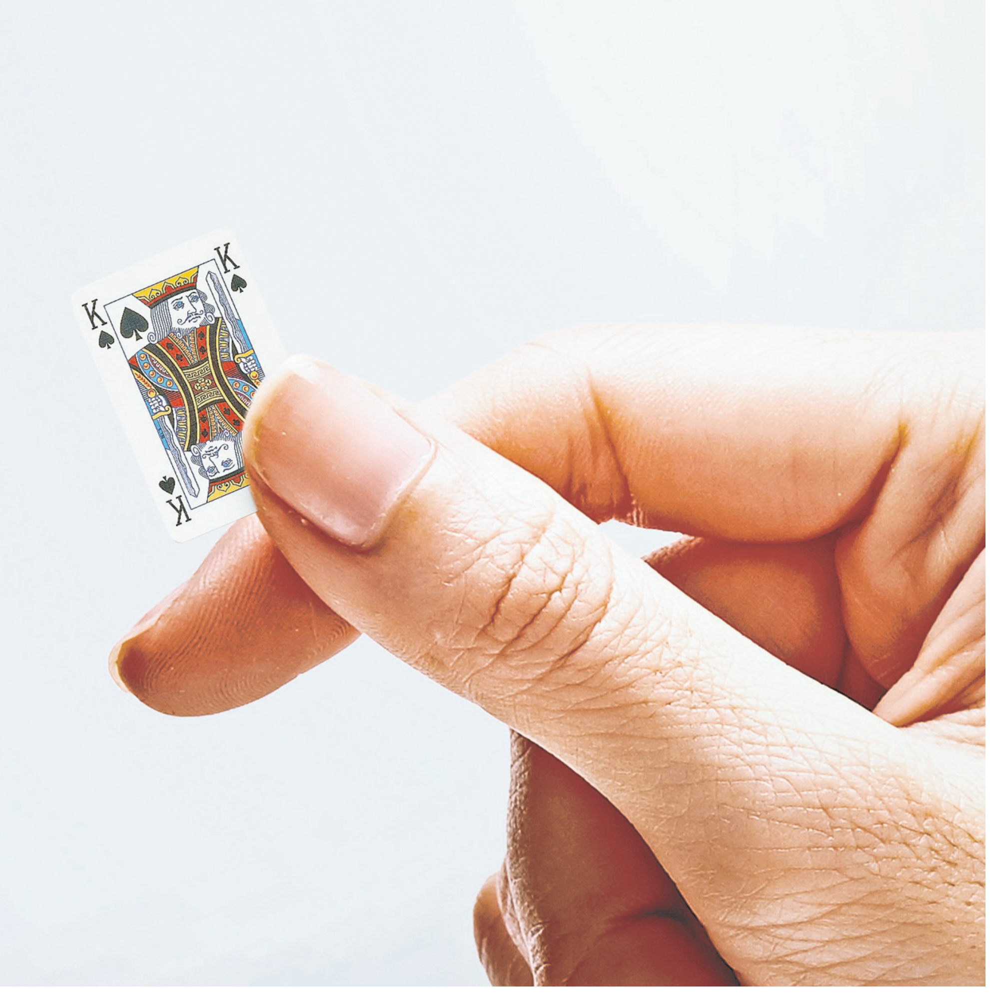
ALTERNATIVE INVESTING

As Hedge Funds Struggle, These Are Standing Out

A review of top performers suggests that smaller funds often do better than giants



By Eric Uhlfelder

The hedge-fund industry continued its losing streak last year.

The industry once again trailed the market in 2018, marking 10 straight years it has underperformed the S&P 500, according to data from BarclayHedge. But the general decline has masked a more complicated truth.

My recent review identified hedge funds—private investment partnerships designed for wealthy individuals and institutional investors—that have managed to outpace the market not only last year but over much longer periods. One of the findings was a link between fund size and long-term performance.

But not the way many may think. *Smaller* funds often do better.

Some large, venerable managers certainly are still doing well, including Renaissance Technologies' $27.1 billion equity fund (up 15.34% based on trailing five-year net annualized returns); the $18 billion global macro fund Element Capital (up 13.28%); and Citadel's $19.3 billion Wellington multistrategy fund (up 11.86%). All topped the market's returns of 8.49% over the same period.

Of the 60 established diversified funds in the review with the best five-year returns, more than half are managing less than $1 billion. (See accompanying table with 25 of the reviewed funds. The full list of 60 is with the online version of this article at WSJ.com/FundsETFs.)

The three top-performing funds over the five years through 2018 had an average asset size of $600 million.

MMCAP out of Toronto, for example, has generated returns of nearly 28% a year since the beginning of 2014. The fund's "event driven" strategy typically seeks out opportunities related to events like mergers and corporate structure, and also engages in private investments.

Some smaller hedge funds are dealing expertly —in several cases beating the big players during the past five years.

Hong Kong-based KS Asia Absolute Return, a multistrategy fund, delivered annualized returns of more than 20%. And New York-domiciled MAK One, which targets distressed credit and equity opportunities, has realized returns of nearly 19.5% over the past five years.

The managers of these three funds declined to be interviewed for this article. But a co-manager of another of the smaller funds, Amin Nathoo at the $354 million hedged-equity Anson Investments Master Fund, says, "We're able to more quickly respond and profit from opportunities across all segments of the market than much larger funds that can't establish sufficient exposure in smaller-cap shares."

▲ PH&N's Hanif Mamdani says the Fed's U-turn has bought the bull market more time, but investors should be cautious.

Anson returned more than 19% last year and has racked up net annualized gains of 11.8% since its launch in 2007, compared with the S&P's 6.8%.

The 60 funds reviewed were filtered from thousands that report to three databases of hedge funds that met four criteria: broad investment strategies only (i.e., no country, sector or industry funds or leveraged versions of core funds), a minimum of $300 million in assets, performance history of at least five years and gains of at least 5% in 2018. Why this hurdle? 2018 was the first year in a decade that the S&P 500 lost money, and hedge funds faced criticism that they aren't truly hedges.

'Structured' stands tall

The review's top-performing strategy is structured credit. Representing one-quarter of the 60 funds, structured credit involves pools of debt obligations that generate cash flows supporting various slices, or tranches, that vary from investment-grade to non-investment-grade and equity. They each come with distinct risks and yields.

Though the strategy dates back well before 2008, the vast majority of extant structured-credit funds came into being after the financial crisis, in large part due to regulations that now prevent banks and insurance companies from holding non-investment-grade and unrated tranches of structured credits. Most managers target mispricing in these tranches.

Hudson Cove Credit Opportunity Chief Investment Officer David Wu argues the strategy's rally since the end of the financial crisis will likely continue. Unlike what happened to mortgage securities a decade ago, Mr. Wu sees much better underwriting, less-leveraged consumers and corporations, and lower default rates. But he believes managers must proceed with caution as the rally moves into a second decade.

There is concern that an increasing number of fund managers piling into and expanding their presence in this area could drive questionable securitizations to meet their demand. But it's possible to see where underwriting standards may be slipping, says Clay Degiacinto, CIO of Axonic Credit Opportunities, by looking at the loans that make up a securitization,

Multistrategy success

Multistrategy funds, which have perennially underperformed in the hedge-fund industry, had eight funds on the list—the third most of any strategy, tied with equity funds.

Segantii Asia-Pacific Equity Multi-Strategy focuses on relative value and opportunistic trades that have helped the fund deliver annualized returns of 17.6% over the past five years. Chief Executive Kurt Ersoy says the fund excelled last year by having low market exposure and with further downside protection provided by shorting indexes toward the end of the year when investors were dumping positions. For the rest of 2019, Mr. Ersoy sees renewed investor interest in China driven by continued capital-market overhauls; the country's "A" shares joining the MSCI Emerging Market Index; and renewed government stimulus.

"All the things that worried the market in the fourth quarter last year are still with us," says Hanif Mamdani, manager of the PH&N Absolute Return fund, which was up 10.4% over the past five years. While he thinks the Fed's U-turn on raising interest rates has bought the bull market a few more quarters, he says investors need to cautiously diversify beyond securities that have been doing well.

The fourth-largest strategy on the list, global macro, is market agnostic. Managers make long and short bets on economic gauges, including interest rates and currencies, stock and bond indexes, and commodities.

What many macro managers see from their high vantage point is giving them pause. Said Haidar, whose fund Haidar Jupiter gained nearly 11% since January 2014, sees "weak data coming in globally, involving auto sales, shipping numbers, machine orders and factory output, and the bond market is recognizing this risk more than equities." Mr. Haidar's three largest fears: escalating trade wars, a hard Brexit and Italy deciding to leave the euro.

Characteristics many of the managers share, says Oliver Newton, head of portfolios at the $85 billion alternative-asset adviser Aksia, include being "experienced, astute observers of markets and investor behavior, willingness to challenge convention and think outside the box, commitment to their convictions, and having operations and investor base that support their style of investment."

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Hedge-Fund Review

Hedge funds employing a broad investment strategy and listed by five-year annualized returns through Dec. 31, 2018. Includes those with at least $300 million and 2018 returns of at least 5%. Shown: 25 funds out of a review of 60.

FIRM | CITY	STRATEGY	FUND ASSETS (IN MILLIONS) Dec. 31, 2018	FIRM ASSETS (IN MILLIONS) Dec. 31, 2018	2018 NET RETURNS	3-YR. ANNUALIZED NET RETURNS	5-YR ANNUALIZED NET RETURNS	WORST DRAWDOWN SINCE JAN. 2014	5-YEAR ANNUALIZED STANDARD DEVIATION SINCE JAN. 2014
MMCAP | Toronto	Event-Driven	$621	$621	9.12%	37.72%	**27.89%**	-9.47%	13.49
KS Asia Absolute Return | Hong Kong	Multistrategy	720	946	20.17	26.72	**20.64**	-3.14	8.61
MAK One | New York	Opportunistic Distressed & Equity	458	665	51.70	24.50	**19.45**	-17.93	18.83
Segantii Asia-Pac. Eqt'y Multi-Strat. | Hong Kong	Multistrategy	2,897	2,897	11.34	8.85	**17.64**	-6.20	10.09
Renaissance Inst Equities BB | New York	Equity Long/Short	27,100[1]	60,600[1]	8.52	14.94	**15.34**	-5.00	9.87
STS Master Ltd I | Steamboat Springs, Colo.	Asset-Backed Securities	2,270	3,020	10.29	12.96	**14.83**	-4.50	5.18
Woodson Capital Partners B | New York	Equity Long/Short	354[2]	354	20.76	17.00	**14.80**	-11.52	11.28
John Street Vantage Strategy | London	Systematic Macro	1,298	1,616	13.28	10.23	**14.43**	-10.80	14.60
Astra Structured Credit Investments | London	Structured Credit Relative Value	370[3]	398	14.59	10.77	**13.82**	-7.70	5.32
Element Capital | New York	Global Macro	18,000	18,000	17.30	13.88	**13.28**	-7.46	10.10
Waha MENA Equity | Abu Dhabi, UAE	Mideast & N. Africa Eqt'y Long Bias	357	684	6.62	10.72	**13.24**	-6.37	7.69
Hildene Opp Master | Stamford	Distressed Credit	1,956	9,345	11.94	14.27	**13.14**	-8.56	6.36
Serone Key Opportunities USD | London	Structured Credit	332[4]	409	9.34	15.10	**12.92**	-4.31	4.06
Vector Capital Credit Opp. Master | San Francisco	Credit Long/Short	361	4,200	11.62	17.58	**12.61**	-3.90	4.07
Citadel Wellington | Chicago	Multistrategy	19,345[5]	27,938	9.03	9.00	**11.86**	NA	5.40
Millstreet Credit | Boston	Credit Long/Short	425[6]	425	15.80	32.20	**11.50**	-23.88	10.60
Blue Diamond Non-Directional | Pfäffikon, Switz.	Relative Value Volatility	659	659	17.27	9.54	**11.41**	-9.52	9.92
Black Diamond Credit Strategies Master | New York	Distressed Credit	755	8,000	12.20	11.51	**11.37**	-5.84	7.28[7]
Citadel Global Equities | Chicago	Equity Long/Short	3,005[5]	27,938	5.87	5.81	**11.37**	NA	5.20
Autonomy Global Macro | New York	Global Macro	4,900	5,200	16.70	15.68	**10.98**	-8.10	8.79
Haidar Jupiter | New York	Global Macro	391	391	8.09	17.56	**10.97**	-31.98	19.75
LibreMax Value Offshore | New York	Structured Credit	666	5,661	5.26	9.00	**10.91**	-2.30	3.98
Alcentra Structured Credit Opp II | London	Structured Credit	422	37,700[8]	5.66	13.57	**10.72**	-3.52	4.67
Chatham Asset High Yield | Chatham, N.J.	High-Yield Credit Long/Short	602	4,241	5.07	14.26	**10.69**	NA	3.81
Hildene Opportunities Master II | Stamford	Opportunistic Credit	814	9,345	9.16	10.87	**10.46**	-5.40	3.61
Review Averages				10.68	11.94	**10.81**	-7.68	6.39
S&P 500 Total Returns				-4.38	9.26	**8.49**	-13.52	10.85
BarclayHedge Average Hedge Fund Returns				-5.23	3.53	**2.69**	-7.43	4.27
J.P. Morgan Global Government Bond Index (USD)				1.02	1.76	**2.97**	-4.51	3.03

1 Renaissance assets are as of Jan. 1, 2019 2 Woodson's commingled fund assets are $253 million and has two Separately Managed Accounts valued at $101 million that invest in the same securities as the fund. 3 Astra's commingled fund assets are $64 million and runs three SMAs valued at $306 million that invest in the same securities as the fund. 4 Serone has $270 million in its commingled fund and $62 million in an SMA that invest in the same securities as the fund. 5 Citadel Wellington includes Citadel Kensington Global Equities Fund; fund and firm assets are as of Jan. 1, 2019. 6 Millstreet has $50 mllion in its commingled fund and $375 million in serveral SMAs that invest in the same securities as the fund. 7 Black Diamond Credit Strategies historic annualized returns and five-year annualized standard deviation are from launch date (August 2009) through February 2019. 8 Alcentra Group had $37.7 billion in assets as of July 2018. NA: not available

Source: Eric Uhlfelder for The Wall Street Journal, with initial data from BarclayHedge, Preqin and Morningstar

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