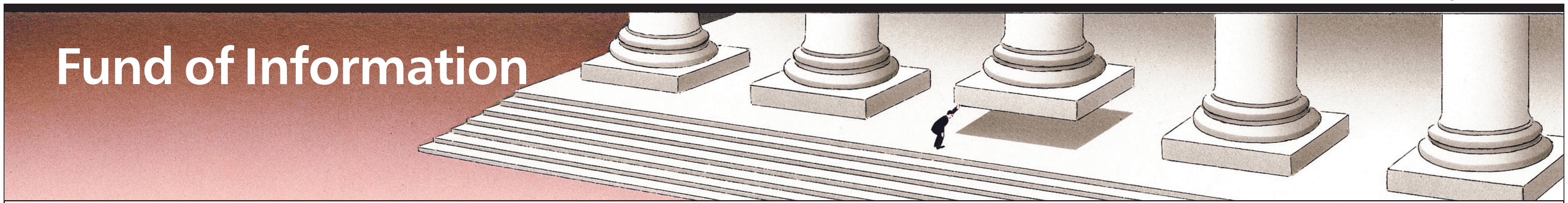

Fund of Information

Hedge Funds' Day of Reckoning Is Here

by Eric Uhlfelder

THERE'S A PARALLEL THESE DAYS BETWEEN POLITICS AND hedge funds. After more than a year of listening to Donald Trump's fiery rhetoric, voters from his party suddenly seem to realize he means what he says. Similarly, hedge fund managers are finally comprehending a message they've been receiving for two years or more: Big institutions and high-net worth investors aren't likely to toss any more money their way until performance improves.

Preqin, an alternative investments research house, reported last month that 48% of the 270 hedge fund managers it polled now believe that industry assets are likely to decline in the year ahead, after seven successive years of increases. Only last December, 72% of the managers Preqin surveyed thought assets would increase again in 2016.

Last week's news about big outflows at Brevan Howard and staff cuts at Tudor reinforce the message.

The decline is under way. According to hedge fund tracker HFR, net flows have been negative since the last quarter of 2015 and on through the first half of this year (see chart at right). It's not a flood—$25 billion in an industry that manages more than $2.9 trillion—but a steady trickle.

The message was reinforced by last week's news that once-hot European manager Brevan Howard suffered $3 billion in net withdrawals from its underperforming master fund in the first half, and that Tudor Investment was cutting 15% of staff. Neither has made the *Barron's Penta* performance-based ranking of the Best 100 Hedge Funds in recent years.

The problems partially result from a change in market outlook. With stocks at all-time highs and bonds at record low yields, investors in hedge funds naturally are looking for alternatives. Preqin's survey showed that hedge fund managers themselves acknowledge that there are fewer opportunities in credit (bond related) and equity strategies.

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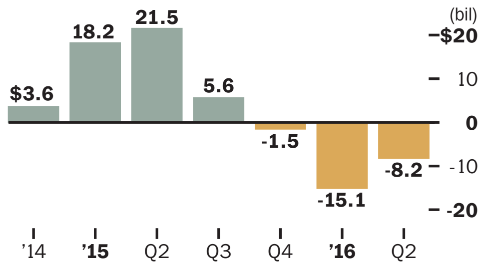
"I think what we are seeing is a shift in how investors seek alternative sources of return, and hedge funds are now bearing the brunt of this initial reallocation," observes Jonathan Miles, managing director and head of the hedge fund advisory at Wilshire Consulting.

Offsetting the uneasiness about stocks and bonds are more enthusiasm for Commodity Trading Advisors (CTAs) and global macro strategies that can cushion upcoming bumps in traditional assets. "We see economic and political uncertainty continuing and market volatility rising," says Eric Siegel, head of hedge fund research and management at Citi Private Bank. When that happens, "fundamentals and valuation tend to take a back seat to other factors on which these strategies look to capitalize," he notes. In addition to CTA and global macro, Siegel adds market-neutral, volatility arbitrage, and quantitative as fund strategies poised to benefit.

Jeff Willardson, who runs portfolio construction for Paamco's $10 billion fund-of-funds, feels the most important adjustment his firm is making is the addition of hedges across strategies to reduce market sensitivity. "This is an appropriate way to manage portfolios," he says, "given such high valuations and low economic growth and earnings prospects." He has cut back on event-driven funds, concerned that they've developed a herd mentality.

Hedge fund problems run deeper than shifting market sentiment. Investors of all sorts are dissatisfied with active investing, which is hurting mutual funds, too. Active mutual funds have seen $24 billion in outflows this year as investors flock to cheap, index-based exchange-traded funds. For hedge funds, the risks are greater because many cling to the rich 2% management fee and 20% profit cut, versus the average fee of just 0.68% for an actively managed equity fund. Hedge funds on average have returned 3.56% per year in the past five years through July, according to BarclayHedge. That compares with the Standard & Poor's 500 index's 13.38% average annual return over that time.

Hedge Fund Net Asset Flow ($bil)



Source: HFR

The recent disappointments seem to have dinged hedge fund managers' notorious confidence. Preqin's survey found they now expect 2016 returns to come in at just 3%. Through early August, the S&P 500 was already up over 8%.

The New Jersey State Investment Council is a good template for near-term trends. The state's $72 billion pension fund decided to more than halve its commitment to hedge funds, taking it down to 6% from 12.5% over the next year. As part of the shift, New Jersey will cut its equity exposure from 3.75% to zero and its credit exposure from 3.75% to 1%, while maintaining its CTA and global macro positions at 5%.

To lure assets, hedge funds must trim expenses. Paamco has been negotiating lower management fees from the hedge funds it invests in: They now are paying less than 1%, and its performance fees are near 10%. New Jersey's pension fund is looking to secure mandates based on management-only fees ranging between 0.75% and 1.25%—just like a mutual fund.

To counter negative trends, Preqin found that managers are "concentrating on improving transparency of their funds and their businesses, strengthening their middle- and back-office infrastructure, and educating investors about their funds and the industry." But if performance doesn't improve, none of this will matter. ■