ALTERNATIVE INVESTING

Hedge-Fund Performance Goes From Bad To Less Bad

Stock funds were the top performers in the first-half standings

By Eric Uhlfelder

The hedge-fund industry continues to do this year what it has been doing for more than a decade—trailing the stock market big time.

Hedge funds on average generated less than half the returns of the stock market in the first half of 2019, posting a net return of 7.2%, according to industry data tracker BarclayHedge. The S&P 500 returned 18.5%.

Performance varied widely depending on strategy.

"Equity long bias funds" led the way, returning more than 10.6% on average. These are funds run by managers who believe in largely unhedged exposure to the market.

One such fund, which has generated annualized returns of more than 14% since its launch in 2007, is **Valley Forge Capital**. Manager Dev Kantesaria guided the fund to a gain of more than 34% during the first half of the year, continuing his commitment to a concentrated portfolio of less than a dozen stocks that he's in for the long run. The fund focuses on large-cap domestic companies purchased at what Mr. Kantesaria considers material discounts to their intrinsic value.

The second-best-performing strategy was funds investing in emerging markets, with an average return of 8.7% in U.S. dollar terms, a turnaround from their decline of nearly 11% for all of 2018.

According to **Cheyne Capital**'s Carl Tohme, who has generated nearly 10% annualized returns since he started his fund in 2008, emerging-markets investments benefited in the first half from greater stability than last year in currency markets and U.S. interest rates, improved prospects for resolution of the U.S. trade war with China, and increasing economic stimulus by officials in China and Europe.

The category of "event driven" funds was the third-best gainer of the first half, returning 6.9% on average. These funds look for specific triggers that will move a stock or credit. Leading the group was Jason Mudrick's Distressed Opportunity fund, which soared more than 29%. Focused on the trading inefficiencies of the high-yield-bond and high-risk leveraged-loan markets, the fund has averaged 12.3% annualized returns since it started a decade ago.

With markets having broadly anticipated the Federal Reserve bias toward higher interest rates during the first half of 2019, fixed-income strategies (whose fortunes tend to move inversely with rates) generally trailed the pack. Funds focused on asset-backed loans and mortgage-backed securities generated returns of less than 3.2%.

Fund flows

Despite net redemptions of nearly $23 billion during the first half of the year, hedge-fund assets continued to rise as returns easily offset that decline. Data tracker Hedge Fund Research reports total industry assets rose from $3.1 trillion at the beginning of the year to a record $3.25 trillion at the end of June. The industry "concluded its strongest first half of a calendar year" in terms of performance, says HFR President Kenneth Heinz.

Several large fund launches added to the asset count, including the $2 billion equity market-neutral fund **Woodline Partners**, started by two former Citadel traders, Michael Rockefeller and Karl Kroeker. Market-neutral funds keep their long and short exposure roughly in line with each other. Also in the first half, Martin Taylor, who shut down Nevsky Capital several years ago, raised $1.5 billion for his new hedged-equity shop, **Crake Asset Management**.

Several big hedged-equity funds, also known as equity long/short funds, returned investor capital in the first half, including the $12 billion Highfields Capital, $3.8 billion Omega Partners and $2 billion Criterion Capital Management.

From the buy side

Volatility in markets this year has sustained institutional investors' defensive posture, which is increasingly focused on relative-value strategies—investments that bet on the realignment of securities whose prices usually trade in sync but have diverged.

Investing $4.5 billion of the Florida Retirement System Trust Fund's money in hedge funds, Ash Williams is defensively targeting relative value, along with broad-trend exposure in global macro and managed futures, both of which aim to profit from market reaction to economic or political events around the world.

Assets in hedge funds continue to rise, to a record $3.25 trillion.

"When you look at the entire global spectrum of investible assets," says Mr. Williams, chief investment officer of the Florida State Board of Administration, "it's hard to find anything that offers reasonable value. This begs the need for more insurance-like exposure."

Jens Foehrenbach, chief investment officer of the $14 billion funds-of-funds group **Man FRM**, also figures relative value is well suited for the markets' growing volatility since the fourth quarter of last year. "Prolonged sharp price rises and falls have increased spreads between assets that should trade in line with one another," he says, "and relative-value managers can potentially profit by betting these spreads will likely correct, which these days can occur within several weeks or days." He believes this kind of rough ride will likely remain with us into next year.

Ray Nolte, CIO of SkyBridge Capital, which runs $6 billion in funds of funds, also includes relative-value managers in his portfolio. But SkyBridge has more than three-quarters of its exposure in cash-flow-oriented securities—including structured credit and credit long/short funds—targeting managers primarily focused on consumer-related debt and modestly short corporate credit. "Volatility is not going to disappear anytime soon," says Mr. Nolte, "but I don't believe it's reflective of near-term systemic problems."

Still, he thinks the chance of recession increases in the second half of 2020 as economic and political uncertainties grow, especially as the presidential election approaches.

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Better but Inconsistent

First-half 2019 performance of select hedge-fund strategies; returns in percent

	Jan-June 2019 Net Returns	1-Year Net Returns	3-Year Annualized Net Returns	5-Year Annualized Net Returns
Equity Long Bias	10.64%	−0.25%	7.53%	3.49%
Emerging Markets	8.67	1.86	6.56	3.30
Event-Driven	6.87	2.62	6.41	2.92
Global Macro	6.62	1.87	2.44	2.56
Collateralized Debt Obligations	5.92	4.18	13.29	7.10
Fixed-Income Relative Value	5.44	2.77	4.72	3.40
Commodity Trading Advisers	4.20	3.11	−0.46	1.12
Equity Long/Short	4.13	−0.67	4.36	2.80
Credit Long/Short	3.92	3.21	3.83	2.65
Multistrategy	3.59	−1.26	2.50	2.37
Distressed Securities	3.35	−2.55	6.41	1.01
Asset-Backed Loans	3.16	6.24	7.18	7.31
Merger Arbitrage	3.05	3.22	4.02	4.24
Mortgage-Backed Securities	2.12	2.68	5.46	4.33
Equity Market Neutral	−0.77	−2.71	0.81	1.67
BarclayHedge Hedge Fund Index	7.24	1.11	5.74	3.38
S&P 500 Total Return Index	18.54	10.42	14.19	10.71
J.P. Morgan Global Gov't Bond Index	4.98	6.14	1.22	3.17

Note: Ranked based on first-half 2019 net returns
Source: BarclayHedge, HFR (data for Fixed Income Relative Value)