BARRONS

FUNDS

Lousy End to First Half Doesn't Bode Well

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Table: May Hedge Funds: Best, Worst, Biggest

HEDGE FUNDS COULD BE in for a bad year, because the European sovereign-debt crisis and recent "flash crash" have revived risk aversion. So says Marc Malek, managing partner of Conquest Macro Fund, a commodities trader running $500 million.

"We're not necessarily looking for a repeat of 2008, but the problems both in Europe and America are so large that they cannot be ignored," says Malek, 40. "I'm one of the ones who believe we are headed for a double-d

So far, the data back him up. Hedge funds will likely finish the first half of 2010 this week with virtually zero returns, giving up gains made earlier in the year, says Ken Heinz, president of Hedge Fund Research. HFR's composite Hedge Fund Index gained 0.86% as of May 31, compared with the Standard & Poor's 500's loss of 1.49% over the same span.

Malek's Conquest Macro Fund was up 19% as of May 31, thanks to strong foreign-exchange profits. Macro funds generally were off 0.59%, according to HFR.

Risk appetite has diminished across the globe as more economies have faltered, a fact that hedge funds—with their heavy market exposures—seemed ill-prepared for. Says Malek: "There's increased concern about any default's effect on nascent recovery." And with hedge-fund performance also faltering, Malek says that the current fee structure of 2% of assets and 20% of gains is a "rip-off" of pension funds and wealthy investors: The hedge funds are not living up to their mandate to make money in all markets, even risk-averse ones.

Conquest Macro runs a risk index published by Bloomberg that gave a strong indication of rising risk aversion back in May, when the flash crash occurred. Risk-seeking has been mostly the rule since December 2008, says Malek.

The flash crash also offered an ominous view of modern systems trading. Most of the trading done on the major exchanges follows algorithmic patterns set up by proprietary-trading desks. Each system uses its own circuit breakers, and shuts down at the first sign of trouble. Simultaneous shutdowns, says Malek, will cause more flash crashes.

There were some hedge funds that performed strongly in 2009: those that invested to profit from credit improvement and the increasing flow of deal transactions, a trend that continued into 2010. First-half winners in this topsy-turvy environment included special-situation funds. HFR's private issue/Reg D offerings rose 7.13% through May 31. Distress- and restructuring-focused funds rose 4.73% through May 31. Surprisingly, short-biased funds lost 5.67%.

HFR's Heinz notes that bigger funds showed slightly higher average returns. Bigger funds also benefitted from investors' risk aversion: They're viewed as more established—and safer.

One standout performer was long-short fund Senvest Partners, with assets of $250 million and a 20% gain through May 31. Richard Mashaal, portfolio manager, says Senvest invested in tech stocks like SanDisk (ticker: SNDK) and Radware (RDWR), and mortgage insurers, such as Genworth Financial (GNW). "We've done pretty well taking the other side of the fear trade," says Mashaal. "The trick is not to get too greedy." A particularly astute purchase was **Royal Bank of Scotland** $25 (RBS.M) preferred shares, bought for about $8 each in the dark days, and tendered for $14 in April. Mashaal says he also has started investing in shares of Banco Santander (STD).