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Analysis: Hedge funds bank on a second-half jolt

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NEW YORK/BOSTON (Reuters) - The first half of the year was a tumultuous one on Wall Street, but just going by the numbers it was a ho-hum period for most hedge funds with many managers posting flat to slightly lower returns.

To date, the average hedge fund is down 1.45 percent, according to data released by Hennessee Group LLC on Thursday. But compared to the 7.6 percent decline in the Standard & Poor's 500, the lackluster performance of the \$1.6 trillion hedge fund industry doesn't seem so shabby.

Still, for wealthy investors, pension funds and university endowments, all of which have come to expect hedge fund managers to make money in both good and bad markets, simply posting smaller losses than a benchmark index may not cut it.

And that means in the second-half of the year the pressure will be on managers, many of whom are still trying to regain their investors' confidence after a brutal 2008 that led to many fund liquidations, to end 2010 firmly in the black.

Even star managers like John Paulson whose investors celebrated his double digit returns in 2008 and 2007, may be feeling the heat. This year, Paulson's flagship Paulson Advantage fund is down nearly 9 percent.

"A lot of funds rebounded last year from 2008, but if an investor is looking at them over a three-year-period and they are flat this year, they're not making money," said Jayesh Punater, founder of Gravitas Technology, which provides financial services to hedge funds.

The fear for many managers is that if they can't turn things around in the second-half, investor redemption requests could surge in December and reverse the trend of new money coming into the industry.

Already, investors have sent roughly \$24 billion into hedge funds in the first five months of 2010, about the same amount they added in the last four months of 2009, according to data from TrimTabs.

To be sure, hedge fund managers had to navigate their way around a lot of obstacles and unforeseen events in the first six-months of the year.

Concerns about Europe's sovereign debt, the impact of financial regulatory reform on bank earnings, the potential for a double-dip recession and the still unexplained reasons for the May 6 flash crash all have played havoc with various investing strategies. The first-half has been a particularly rough one for funds focused on pro-growth, global macro and currency strategies.

"The noise quotient in the market has been very high this year and it is hard to make money when there is that amount of underlying volatility," said Jason Bonanca, head of strategy and research for hedge fund MKP Capital Management in New York.

FLAT IS THE NEW UP (AGAIN)

But ultimately managers, who are often paid a 2 percent management fee and take 20 percent of annual profits, will have to justify those high fees with returns to their investors, who might have made more in a bank account even in times of low interest rates.

"People who are flat are not going to be happy but given all the headwinds that you've seen this year, what's important is they haven't lost their capital," said Robin Lowe, head of equity hedge for the United States and Europe at Man Group (EMG.L: [Quote](#), [Profile](#), [Research](#)). "This industry's about long term capital growth, and that also means capital preservation... If you are flat to slightly positive on the year and indexes are down around 10 percent, that's a pretty good outcome."

WHAT WORKED

Still, some strategies have found positive territory.

Investors who bet on corporate debt have fared better than most, as fixed income funds were up 5.69 percent in the first half, according to numbers released by the Hennessee Group.

Distressed investing also fared well in the first half of 2010, with distressed global security funds up 6.86 percent on average through June, according to data from HSBC Private Bank.

But some experts feel those strategies have run their course and forecast that investors will put their money into other strategies, favoring managers who select stocks, bet on big events like mergers and get the global bets on currencies and interest rates right.

"The hottest strategies right now are event driven, equity long short and global macro," said Carrie McCabe, who founded Lasair Capital after running Blackstone Alternative Asset Management and FRM Americas.

While global macro funds on average are flat according to Hennessee, several macro-oriented funds have seen out-sized returns.

Autonomy Capital which oversees about \$1 billion, is up 17 percent since January after gaining 3.6 percent in June, people familiar with the fund's returns said. **New York-based hedge fund Conquest Capital Group's macro fund is up more than 20 percent this year,**

"This is really a great time to be in macro -- this amount of imbalance is what generates returns over the long haul," said MKP's Bonanca.

On the event-driven side, James Dinan's York Capital has gained roughly 25 percent over the last 12 months, people familiar with the \$14 billion New York-based fund's performance said. Part of the reason event oriented managers could deliver big gains in the second half of the year is that world wide growth hasn't picked up as quickly as many had expected, leaving companies ready to grow by acquisition.

INVESTORS TAKE A SECOND LOOK

In spite of the flat returns, demand for hedge funds has actually grown again since the financial crisis and is expected to pick up more in the second half of the year and into early 2011, investors and industry analysts said.

"These days investors are asking themselves where do you put your money? Cash yields you nothing and real estate is not doing particularly well either," said Lasair's McCabe. "That leaves stocks and hedge funds," she said.

As investors scout for investments, they will have plenty of new managers to choose from as a bevy of industry veterans are spinning out of their old firms to launch their own.

"Quite a lot of managers are leaving their firms and going out on their own and at the banks a lot of people are concerned about the Volcker role and hence are looking to open their own shops," Gravitas' Punater said, noting most recent launches have been in the \$100 million to \$500 million range, while a handful of new managers have raised over \$1 billion.

But the question remains how much money these relative newcomers will be able to raise. Some industry analysts said that in uncertain times they would prefer to go with blue-chip managers who boast a longer track record and have weathered storms before.

"I like having money with people who have been through changing times before," McCabe said.

(Reporting by Emily Chasan and Svea Herbst-Bayliss)

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