Opinion **On Wall Street**

# Hedge funds confused by turns in markets

Many are struggling to cope with asset prices moving in ways they would not normally expect

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Gains on GameStop trades boosted Senvest but other hedge funds have posted more mundane performances © AP

**Laurence Fletcher** MAY 1 2021

Hedge funds have posted their best start to a calendar year since before the financial crisis. But, behind the strong headline numbers, managers are struggling to cope with some confusing moves in markets.

Funds gained a tidy 6 per cent in the first quarter, according to data group HFR, helped by rising stock markets and a sharp rally in beaten-down so-called "value" areas of the equity and credit markets that some funds favour.

Some returns have been eye-popping. Senvest, helped by a well-timed position in GameStop, has gained 67 per cent. Crispin Odey's Odey European fund, one of the sector's most volatile funds, is up 56 per cent, and Lee Ainslie's Maverick Capital, which latched on to the value rally, is up more than 40 per cent.

But, those figures aside, most investors in hedge funds have not enjoyed such strong gains, and many managers' returns have been far more mundane. For instance, equity hedge funds gained 7.1 per cent in the first quarter, based on performance averaged by the number of funds. But that figure is skewed by strong gains from smaller funds. When performance is weighted by assets instead, then funds were up a more modest 2.8 per cent on average.

And for every chart-topping manager, there is a fund languishing deep in the red. HFR data shows the gap between the best and worst-performing funds is higher than at any point in the two years before the coronavirus crisis.

"Hedge fund performance in the first quarter has been like the [equity] market — the indices are very good, but some underlying strategies, or sectors, have underperformed," said Cedric Vuignier, head of liquid alternative managed funds and research at Syz Capital.

A major problem for many managers is that markets are not really functioning in the way they would normally expect them to. Trillions of dollars of central bank stimulus, as well as the surge in retail investor activity during the pandemic, have broken some of the tried and trusted relationships between news and price movements that managers have based their systems on.

Take London-based Sandbar Asset Management, which has lost 3.9 per cent in its $2.4bn Global Equity Market Neutral fund this year. It highlights the relationship between share prices and changes in earnings expectations. Normally, and intuitively, an improvement in expectations about a company's earnings should mean that its share price rises, while greater pessimism should send the shares lower.

Instead, this correlation has dropped sharply in recent months "to levels not seen in the last decade", Sandbar said in a presentation to investors. And in sectors such as aerospace it has turned negative, meaning that improving earnings expectations have actually pushed share prices lower.

Swedish hedge fund firm IPM has been another victim of a change in market relationships. Once regarded as one of Europe's best computer-driven macro managers trading currencies, bonds and stocks, it has fallen foul of a change in the market correlations it relies on. Its assets have slumped from $8bn to $1bn and the firm, owned by finance group Catella, is now shutting down, noting that the investing environment has been tough "for strategies focusing on economic fundamentals".

What this all adds up to is a loss of what industry insiders call “alpha” — jargon for the industry’s “secret sauce”, or the highly prized extra value that managers supposedly add through the bets they take on stocks and other securities.

Alpha matters because it is the main justification hedge funds use for charging clients their high fees. Beating markets is hard, and therefore alpha is scarce and valuable. If a hedge fund’s returns just come from the market’s gains, rather than from a manager’s skill, then why not just buy a cheap index tracker instead?

Sandbar, which admitted its own alpha has been “poor”, cites data from Morgan Stanley showing large negative alpha among its global equity long-short hedge fund clients this year. In other words, making these highly-researched bets lost them money.

The data also shows that funds’ alpha in the first quarter was far below the average generated over the past decade, and well below difficult years for hedge funds’ bets such as 2016 and 2018.

Hedge funds performed well in 2020s market chaos and are still on average in the black this year. But some managers will nevertheless be worried. If they cannot convincingly show that their well-researched and carefully placed bets add any value, then clients will question why they need to be invested with them at all.

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