Hedge Funds Trail U.S. Stocks By Widest Gap Since At Least 2005

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The $2.5 trillion hedge-fund industry, whose money managers are among the finance world's highest paid, is headed for its worst annual performance relative to U.S. stocks since at least 2005.

The funds returned 7.1 percent in 2013 through November, according to data compiled by Bloomberg. That's 22 percentage points less than the 29.1 percent return of the Standard & Poor's 500 Index, with reinvested dividends, as markets rallied to records.

"It has been difficult for hedge funds on the short side," said Nick Markola, head of research at Fieldpoint Private, a $3.5 billion Greenwich, Connecticut-based private bank and wealth-advisory firm. "Funds were defensively positioned. Central bank action did bode well for equities and made for a more challenging environment for hedge funds."

Hedge funds, which stand to earn about $50 billion in management fees this year based on industrywide assets, are underperforming the benchmark U.S. index for the fifth year in a row as the Federal Reserve's economic stimulus program pushes equity markets higher. Billionaire Stan Druckenmiller, who produced annual returns averaging 30 percent for more than two decades, last month called the industry's results a "tragedy" and questioned why investors pay hedge-fund fees for annual gains closer to 8 percent.

"We were expected to make 20 percent a year in any market," Druckenmiller, 60, said in a Bloomberg Television interview on Nov. 22, referring to veteran managers such as Michael Steinhardt, Julian Robertson, Paul Tudor Jones and George Soros. "If the market went down more than 20 percent, we were expected to make more."

Government Intervention

The industry traditionally charges clients fees of 2 percent of assets and 20 percent of profits, sometimes with discounts for big investors. Actively managed U.S. stock mutual funds average 1.3 percent expense ratios, according to Morningstar Inc. Such managers averaged gains of 31 percent this year through last month, Morningstar said.

Hedge funds posted a 0.2 percent gain in November, according to the Bloomberg Global Aggregate Hedge Fund Index. They've underperformed the S&P 500 by 97 percentage points since the end of 2008. Some managers cite government intervention in markets, record low interest rates, declining trading volumes and assets moving in unison as reasons for limiting their ability to outperform.

Worst Showing

Bloomberg's index started tracking funds in February 2005. According to Hedge Fund Research Inc., the industry had its worst showing relative to the S&P in 1998, when Long Term Capital Management LP was bailed out by its lenders as Russia defaulted on its debt, roiling markets. The HFRI Fund Weighted Composite Index trailed the equities benchmark by 26 percentage points that year, according to Chicago-based HFR, which has tracked data going back to 1990.

Hedge funds last beat U.S. stocks in 2008, when they lost a record 19 percent, according to data compiled by Bloomberg, and the S&P 500 declined 37 percent. They outperformed the index by the most when they returned 31 percent in 1993, HFR's data show, compared with a 10 percent increase for the S&P.

Comparisons with stocks are off-base because hedge funds have different goals, said Eric Siegel, who oversees $3.5 billion in hedge-fund investments at New York-based Citigroup Inc.'s private bank.

"It's a huge misunderstanding," Siegel said. "Not all hedge-fund clients are looking for super-high-octane returns. They're looking for high-quality returns that have lower levels of risk" over a three-to-five-year investment cycle.

Yen, Corn

Moreover, the managers can trade in all markets, placing wagers on everything from corporate bonds to the yen to the price of corn. They also use derivatives and other complex tools, as well as short selling, or betting against securities, to seek profits and protect against market declines. In a short sale, a trader sells borrowed assets to bet on a decline, hoping to buy them back later and pocket the price difference.

Bonds fell 1.5 percent this year through November, as measured by the Barclays U.S. Aggregate Index, and the S&P GSCI gauge of commodities declined 3.1 percent. While hedge funds have beaten bonds and commodities, they have fallen short of the $21.2 billion Vanguard Balanced Index Fund, which returned 16 percent through November with 60 percent of assets in equities and 40 percent in fixed income. The fund's institutional share class carries an expense ratio of 0.08 percent, according to Morningstar.

Some funds again struggled to keep up with the S&P in November, when the index returned 3 percent.

Renaissance, Tudor

Renaissance Technologies LLC, the $25 billion investment firm founded by Jim Simons and based in New York, rose 1.1 percent in November in its $9 billion Renaissance Institutional Equities Fund, making returns this year 18 percent, according to a person briefed on the gains, asking not to be identified because the fund is private.

Tudor Investment Corp., the $13.4 billion macro hedge-fund firm run by Jones, climbed 3.7 percent in November in its Tudor BVI Global, bringing gains to 12 percent in 2013, a person familiar with the matter said.

Moore Capital Management LLC, the $12.1 billion firm overseen by Louis Moore Bacon, rose 0.7 percent last month in its Moore Global Investments fund, bringing its gain this year to 15 percent, according to the person. Moore Macro Managers increased 1.4 percent in November, bringing its 2013 advance to 11 percent.

Pershing Square Capital Management LP, the $12.1 billion activist hedge-fund firm run by Bill Ackman, posted a 1.2 percent net gain in its main strategy in November, according to a performance update obtained by Bloomberg News. Pershing Square International's monthly return brings its year-to-date advance to 9.4 percent. The fund has $5.1 billion in assets.

Bridgewater, Maverick

Bridgewater Associates LP, the $150 billion firm run by Ray Dalio and based in Westport, Connecticut, posted a 0.1 percent gain in its $16 billion Pure Alpha I fund, bringing this year's return to 4.1 percent, according to a person briefed on the results. Pure Alpha II, with $64 billion, increased 0.1 percent in November and 6.1 percent in 2013.

Lee Ainslie's $9 billion New York-based Maverick Capital Management LP posted a 1.9 percent gain in November in Class A shares of Maverick Fund Ltd., which rose 13 percent this year, according to an investor update.

Boaz Weinstein, who runs Saba Capital Management LLC, lost 0.3 percent in November and 1 percent year-to-date in his main credit fund after losing 3.9 percent in 2012, according to investors. His New York-based firm oversees about $4 billion.

Spokesmen for the fund companies declined to comment on the returns.

Shutting Down

As some managers struggled to make money, others chose to leave the business.

Talal Shakerchi, whose London-based Meditor Capital Management Ltd. has $3 billion in assets, said yesterday that he is shutting the firm's European equity fund, citing an internal review and new rules restricting short-selling.

Arvind Raghunathan's New York-based Roc Capital Management LP, the largest startup hedge-fund firm of 2009, liquidated its main fund in July after losses. Jeff Vinik, the former Fidelity Investments stock picker turned hedge-fund manager, told clients in May that he was returning their capital after performance at his Vinik Asset Management LP slumped since July 2012.

Hedge funds thrived during the 1990s, posting gains every year. They developed a reputation for gaining ground whether markets rose or fell, targeting absolute return rather than performance relative to a benchmark.

'Gradual Erosion'

As funds grew, their performance hewed closer to that of stocks, blunting one selling point: returns that aren't correlated with equity markets. Correlation of the HFRI index to the S&P 500 rose to 0.84 in the five years through October from 0.81 before the financial crisis, according to HFR. The measure shows how often the two indexes rise and fall together; a value of 1 means they move in lockstep.

At the turn of the century, managers proved their worth again when they made money for clients as global equities slumped in 2000 and 2001 amid the collapse of technology stocks and the al-Qaeda terrorist attacks on the U.S.

Since then, as industry assets quadrupled and the number of hedge funds almost doubled, managers have mostly trailed the S&P 500.

"As competition in the industry heated up along with a changing investor base, which doesn't want volatile returns, we've seen a gradual erosion of out-performance," said Francis Frecentese, New York-based global head of hedge fund research at Lyxor Asset Management Inc. "As such, conversations with some managers have implicitly and explicitly switched to their ability to generate relative returns."

Higher Deposits

The mixed performance hasn't dissuaded investors. Clients added $53.2 billion to the industry in the first nine months of the year, compared with $34.4 billion for all of 2012, according to HFR, as consultants emphasize individual managers' risk- adjusted returns, which incorporate the amount of risk taken to generate profits.

"You are not going to make money talking about risk- adjusted return and diversification," Druckenmiller, who closed his hedge-fund firm three years ago and now manages his own capital, said in the TV interview. "You've got to identify the big opportunities and go for them."