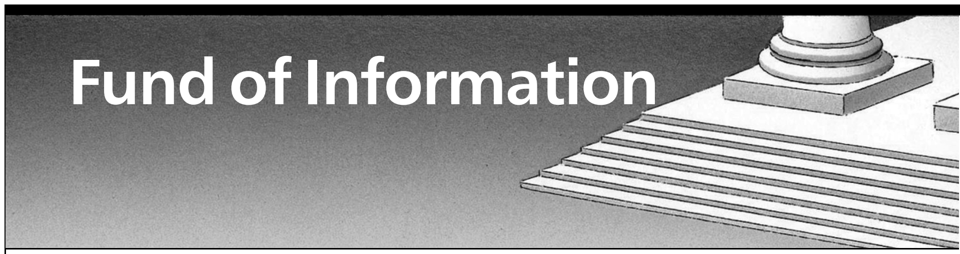

Big Money Hits Hedge Returns

by Eric Uhlfelder

HEDGE FUNDS ESTABLISHED THEIR REPUTATION for delivering positive returns—or at least beating the market—when the tech bubble burst in 2000-'02. Many managers sold ahead of the crash, which helped the industry outdistance the Standard &Poor's 500 by an average of more than 21 percentage points annually during those years.

Hedge funds' client base was much different then: High-net-worth individuals and family offices controlled 80% of the assets, and their focus on aggressive growth and performance uncorrelated to other assets drove industry expansion. They understood that volatility was part of the price of admission. And when managers failed, they were dumped.

After hedge funds' strong performance amid the tech bust, pension and sovereign wealth funds, endowments, and foundations took note. They wanted protection against losses, too. By 2007, institutions controlled about half of the assets, with high-net-worth individual and family offices holding the remainder.

Amid 2008's financial crisis, in which hedge funds again did relatively well, the floodgates opened. Citi Investor Services' reports that institutional investors became the biggest industry backers as the crisis worsened. By December 2013, two-thirds of hedge fund assets, or $1.72 trillion, were owned by institutions. Sandy Kaul, U.S. head of business advisory at Citi Prime Finance, expects that will likely jump to nearly three-quarters of the industry's anticipated $4.8 trillion in assets by 2018.

Although institutional money has lifted hedge fund coffers, particularly big ones, to new heights, it's having another effect, too. Since the start of 2009, hedge funds have underperformed the market annually by an average of 8.53 percentage points, according to fund database BarclayHedge. And through the first five months of 2014, the S&P 500 more than doubled the average hedge fund return, up 4.97% versus 2.36%.

Institutionalization makes outperformance less likely, says Jeffrey Willardson, managing director of Pacific Alternative Asset Management, which runs nearly $10 billion in hedge funds of funds. "Protection from downside volatility also typically means lagging performance when markets turn positive," he says.

Institutions hold three-quarters of the assets in funds that have more than $3 billion. Ali Tocco, global head of Capital Introduction at JPMorgan Chase, says they are attracted to larger funds because of their ability to meet their operational demands, such as putting risk managers on investment committees. The bigger funds also tend to be less volatile than smaller funds and have the capacity and liquidity to manage larger allocations without greatly affecting valuation.

Rob Printz, principal of III Associates, with $3.4 billion of largely institutional assets under management, acknowledges that in recent years "we've become more conservative both in terms of portfolio construction and use of leverage."

Research now shows the best-performing funds tend to run less than $1 billion, notes Bailey McCann, senior editor at the industry tracker Opalesque. "Their investment universe is greater than bigger funds because they can target smaller as well as larger opportunities," she explains. "Their scale enables them to move in and out of a greater range of positions more deftly, and they may be less risk constrained than larger institutionally backed funds."

Willardson echoes this point. In their demand for less volatile, absolute returns, institutional investors tend to require managers to draw more precise boundaries around how and where they can invest. And as strategies and manager behavior become more bounded, so does performance.

The spirit and talent that made many hedge funds daring investments are being compromised by the dominance of institutional investors and fund managers' hunger for their big and sticky assets. ■