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Markets

Hedge Funds in Pain Watching Record S&P 500 Rally They've Missed

By Lu Wang
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- Managers caught wrong-footed as their shorts outperform longs
- Lousy returns may force risk-taking as funds seek to catch up

Photographer: Michael Nagle/Bloomberg

In this article

SPX
S&P 500
2,874.69 USD
▲ +17.71 +0.62%

GS
GOLDMAN SACHS GP
235.11 USD
▼ -1.23 -0.52%

FB
FACEBOOK INC-A
174.65 USD
▲ +1.75 +1.01%

MS
MORGAN STANLEY
48.14 USD
▲ +0.01 +0.02%

INDU
DJIA
25,790.35 USD
▲ +133.37 +0.52%

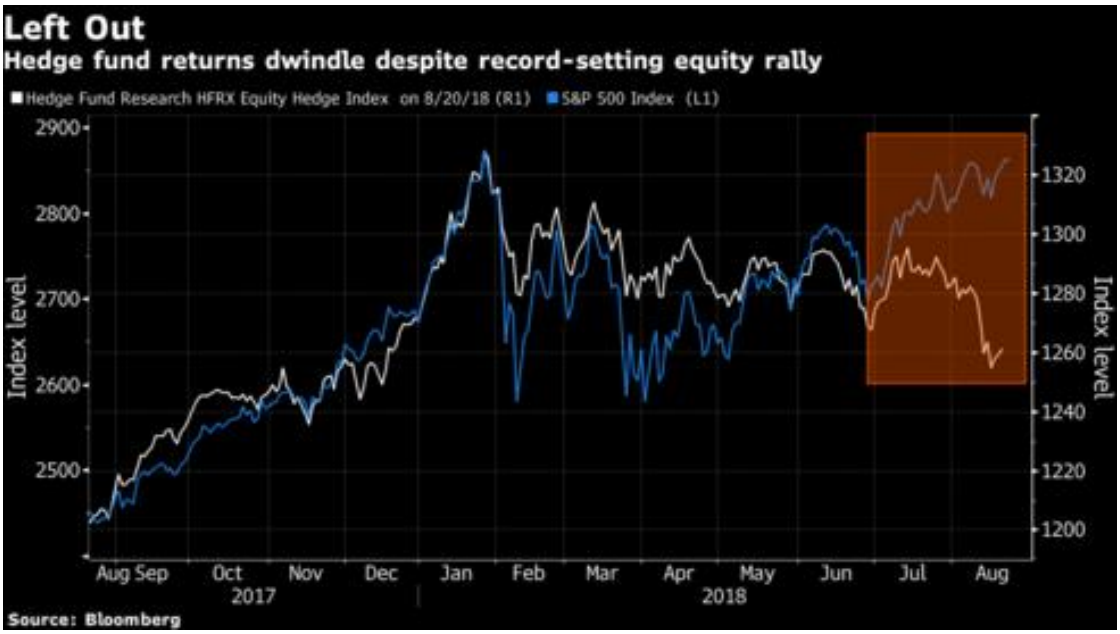
U.S. stocks are vaulting back to all-time highs. But the smart money isn't celebrating.

Instead, they're nursing pain. Hedge funds have seen returns dwindling even as the S&P 500 Index marches forward in what has become, by some measures, the longest bull market ever. An index tracking the performance of funds focusing on equities has fallen in five of the past six weeks, wiping out gains for the year, according to Hedge Fund Research data compiled by Bloomberg.

How is that even possible? Blame it on a defensive stance and bad-luck bets. Net leverage, a measure of risk appetite among hedge funds, has fallen to the lowest level this year. While the posture would have curbed losses during a market selloff, right now it's prevented managers from reaping bigger gains.

Also hurting are their favorite stocks, notably tech giants such as Facebook Inc. that have suddenly stopped working. Meanwhile, their bearish wagers backfired, with the most-shorted stocks jumping for a third week in four.

“The consensus was that earnings growth will slow down in the second half of the year. That’s why they scaled back from positioning in hopes there will be a downturn,” said Benjamin Lau, chief investment officer of Apriem Advisors in Irvine, California, where the firm oversees more than $700 million. “The momentum for earnings growth, revenue growth is quite strong. Those kind of upside surprises led to some pains.”



The agony is the latest lesson in the costs of turning cautious too early. While everything from a trade war to emerging-market turmoil threatens the nine-year equity rally, it has still paid to stay bullish with earnings rising the fastest since 2010.

Obviously, the defensive measures could still end up working. Hedge fund clients at Morgan Stanley have reduced their net long exposure to equities to the lowest level since last October. A similar measure from Goldman Sachs on its clients fell to a 14-month low.

The S&P 500 climbed 0.9 percent over past five days to close at a record of 2,874.69. Up in all but one week since June, the index has extended its 2018 gain to 7.5 percent. The Dow Jones Industrial Average added 0.5 percent over the week while the Nasdaq 100 Index advanced 1.5 percent.

With the S&P 500 trading near 21 times earnings, or about 20 percent above its 10-year average, the case for going all-in has weakened, according to Lamar Villere, a portfolio manager who helps oversee about $2 billion at St Denis J Villere & Co. in New Orleans. His funds held 10 percent of money in cash, versus a historic range of 2 percent to 5 percent.

“We’re looking for ideas to put the cash to work, but until we find the right value, we won’t buy,” he said. The elevated cash level “is not because we decided to take risk off consciously,” he added.

The importance of picking the right stocks is growing as the spread of equity returns widens to levels not seen the start of the bull market. Since January, the best of the 24 industries in the S&P 500 have topped the worst by 49 percentage points, a gap that exceeds any year at this point since 2009.

Facebook has been one big alpha destroyer lately. Ownership in the social-media company rose to a record in the second quarter, with 28 percent of the funds tracked by Goldman holding a stake. On average, the stock accounted for 4 percent.

Shares of Facebook tumbled 19 percent on July 26 after disappointing results and have since barely recovered.

Other hedge-fund favorites didn't do well either. The Goldman Sachs Hedge Industry VIP ETF, tracking the most popular stocks, had risen 1.1 percent in the past month, compared with a 1.9 percent gain in the S&P 500. It's a turnaround from the first half of the year, when the basket beat the market by almost 3 percentage points.

As the market rallied on, short positions got squeezed. Ironically, stocks targeted by short sellers performed better. A Goldman Sachs basket of most-shorted stocks has jumped more than 8 percent, poised for the best month since November 2016.

The pain was most obvious in health-care, where hedge fund longs were flat this month through Aug. 17 while their shorts rallied 5.6 percent, according to Morgan Stanley.

All are taking a toll on fund performance. The Hedge Fund Research HFRX Equity Hedge Index is now down 0.6 percent this year. At Morgan Stanley, its long-short fund clients saw their year-to-date returns almost halved over the last four weeks.

The general bearishness among hedge funds is a contrarian sign that the bull market has further to go, according to Ernesto Ramos, head of equities at BMO Global Asset Management that oversees $252 billion in Chicago.

“That people are not as long as they have been suggests there is room for money to come to the long side of it,” he said. “Earnings are coming in very strong. As the market keeps going up, they’ll fall into trying to catch up.”

— With assistance by Melissa Karsh

Link: https://www.bloomberg.com/news/articles/2018-08-24/hedge-funds-in-pain-watching-record-s-p-500-rally-they-ve-missed