Hedge fund investment jumps in part on prospect of inflation

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Asset owners significantly increased the pace of hedge fund investment in the first half of 2021 as they sought returns as well as diversification to protect portfolios from the potential of higher inflation, a rise in interest rates and higher volatility.

Analysis of Pensions & Investments' reporting of hedge fund activity found in the first half of 2021, hedge fund hires totaled $3 billion compared with $1.7 billion in the six months ended Dec. 31. Most of the investments went to single hedge funds.

Terminations fell in the first half of 2021 to $70 million vs. a total of $3.7 billion in the second half of 2020, which was highlighted by the $40 billion Connecticut Retirement Plans and Trust Funds, Hartford, terminating three hedge funds-of-funds managers totaling $2.4 billion.

Hedge fund inflows year-to-date May 31 totaled $39.1 billion with $12 billion coming in the month of May, data from eVestment LLC, Marietta, Ga., showed. In contrast, eVestment reported hedge fund industry outflows of $59.3 billion in all of 2020.

Money managers and investment consultants said the specter of potential macroeconomic changes ahead is pushing some institutional investors to seek safe havens, one of which is hedge funds.

"The No. 1 topic institutional investors want to talk about is inflation, but what they really are talking about is their bonds. All institutional investors will be impacted if inflation rises because those bonds will go down in price a lot," said Luke Ellis, CEO of Man Group PLC, London, in an interview.

"If the Fed raises rates, the front end of the yield curve pushes up, or if they don't raise rates, the bond market will sell off. Whether or not the Fed is directly responsible for interest rate increases, yields will be going up," and that is challenging for bond portfolios, he said.

The solution for a growing number of investors is to turn to hedge funds as a fixed-income substitute with a likely mix of low-net equity, credit and macro funds, Mr. Ellis said, noting that Man Group is seeing "very strong engagement with investors globally" regarding the use of hedge funds as a fixed-income substitute.

Man Group managed a total of $127 billion as of March 31.

Sources also said positive hedge fund performance in 2020 amid the COVID-19 pandemic likely persuaded more institutional investors to resume hedge fund investing in a variety of strategies in the
second half of 2020 and to increase investment in the first six months of June 30. That's expected to continue for the remainder of this year.

Data provider Hedge Fund Research Inc., Chicago, reported that the HFRI Fund Weighted Composite index returned 10% year-to-date June 30, compared with 11.8% for the full year of 2020. In a quarter-to-quarter comparison, the HFR index returned 5.8% in the first three months of 2021 and 4% for the second quarter.

LACERA invests $850 million

Among asset owners making large allocations to hedge funds was the $69.6 billion Los Angeles County Employees Retirement Association, Pasadena, Calif.

LACERA's board of trustees approved $850 million for direct investments in four hedge funds in the year ended June 30.

The move was part of the winding down of two hedge funds-of-funds strategies that totaled $983 million in 2019 and now are an aggregate $91 million, said Chad Timko, senior investment officer who is responsible for the $2.4 billion risk-mitigation hedge-fund portfolio, which is part of the fund's $14.9 billion total risk-mitigation portfolio.

In the first half of 2021, LACERA split a total of $500 million evenly between discretionary global macro managers Brevan Howard Asset Management LLP and Caxton Associates LP and $100 million was invested in an Asia-focused relative-value multistrategy fund managed by AM Squared Ltd.

In the second half of 2020, LACERA awarded $250 million to Stable Asset Management LP for investment in a hedge funds emerging manager program separate account.

Mr. Timko stressed that with the change to direct hedge fund investment, "LACERA's portfolio continues to emphasize risk mitigation objectives and return profiles with a low sensitivity to equity markets."

The $66.8 billion Maryland State Retirement and Pension System, Baltimore, earmarked a total of $850 million for investment in five hedge fund managers from the system's $5.7 billion absolute-return portfolio, confirmed Gregory C. Kasten, managing director of the absolute-return portfolio, in an interview.

In the first six months of 2021, the system committed $250 million to an Asia-focused multistrategy fund managed by BFAM Partners Ltd. and $150 million each to long/short equity strategies managed by Avidity Partners Management LP and Yiheng Capital Partners LP. In the second half of 2020, the system allocated $250 million to Kirkoswald Capital Partners LLP and $100 million to Pharo Management Inc. Both managers run discretionary global macro strategies.

Mr. Kasten said most of the changes in the portfolio in 2020 involved "reshuffling exposures and tactical shifts" and the addition of new managers to take advantage of COVID-19 investment opportunities.

Because the current market environment has good opportunities for hedge funds in 2021, Mr. Kasten said "we have a couple more hedge funds to add before we're done."

Proved their value
"Hedge funds proved their protective value for institutional portfolios in the first quarter of 2020 and then captured meaningful upside (gains) in the last three quarters. They've also gained a lot of momentum so far this year," said Tristan L. Thomas, managing director of portfolio strategy for the hedge fund team of 50 South Capital Advisors LLC, Chicago, in an interview.

50 South Capital launched a hedge fund-based fixed-income complement fund seven years ago that worked well in 2020, resulting in a 12% gain in assets under management and advisement. The strategy has been even more popular this year with an 83% growth in AUM/AUA year-to-date July 1 mostly from net inflow, to $220 million as of June 30, data from the company showed.

"People are looking at their return bogies in fixed income and wondering how they're going to meet their targets," Mr. Thomas said. He said the fixed-income complement strategy continues to attract a high level of interest and hires from asset owners. He declined to identify investors in the fixed-income fund.

50 South Capital, a manager of alternatives funds-of-funds, had $11.1 billion in AUM/AUA with 27% invested in hedge funds as of July 1.

Clients of Cliffwater LLC are, for the most part, sticking with their current hedge fund portfolio construction, but some have added low-beta hedge-fund strategies funded by lowering their fixed-income portfolios "on the margin," said Thomas K. Lynch, a New York-based senior managing director of the alternatives consulting firm, in an interview.

Given the likely macro scenario of rising volatility, interest rates and inflation globally and the fact that "fixed-income spreads can't stay as low as they are," Mr. Lynch said low-beta and sovereign-bond relative-value strategies that allow the hedge fund manager to choose between different countries' debt should do well going forward.

Cliffwater advises institutional investors on a total of $20 billion in hedge fund investments.

**Capstone's strong year**

Capstone Investment Advisors LLC, New York, which specializes in volatility and tail-risk strategies, is having a strong year as large investors seek uncorrelated returns, defensive strategies and substitutes for fixed income, said Paul Britton, the firm's CEO, in an interview.

"Owning fixed income over the last 30 or 40 years provided portfolio diversification and returns, but fixed income isn't providing the utility it used to," Mr. Britton said.

Hedge fund managers whose strategies aren't necessarily a neat fit as a fixed-income substitute said they are also seeing strong demand from asset owners.

Schonfeld Strategic Advisors LLC, New York, a multimanager hedge fund firm, for example, has seen "very strong demand and investment" from asset owners this year, said Ryan A. Tolkin, CEO and CIO, in an interview.

"Hedge funds navigated the events of 2020 relatively well and provided a tailwind going into 2021," Mr. Tolkin said, noting that investor demand last year was for the firm's long-short equity strategy while its quantitative fund is most popular this year.

Schonfeld Strategic Investors ran $8.8 billion as of July 1 of which 70% was for institutional investors.
Despite the interest managers said they are seeing from asset owners, "modest inflows into hedge funds are likely this year, given the percentage of hedge funds that already is part of many institutional portfolios," said Samuel M. Diedrich, a New York-based managing director and head of absolute return and credit strategies at OCIO manager Partners Investment Management Group LLC, in an interview. "The argument for the use of hedge funds as a fixed-income substitute is very valid, but I think it's more likely that inflows in this and other hedge fund strategies will come from new hedge fund investors rather than existing investors," he said.

Partners Capital managed $40 billion in OCIO mandates as of March 31, of which $7.9 billion was in hedge funds.

Hedge fund allocations rose in the first half of 2021, as investors sought returns and diversification to offset low fixed-income returns.