Soros Family Office, Texas Pensioners Lead Rush Into Hedge Funds

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After years of losing both clients and clout in financial markets, signs are emerging that hedge funds are back in favor in the U.S.

In the past few months, investors such as George Soros's family office and the Texas pension fund have been plowing cash into hedge funds in an effort to diversify their assets after stock markets rebounded much more sharply from the coronavirus-stoked sell-off than anticipated.

Some well-known fund managers, sensing the moment, began accepting new capital for the first time in years, including D.E. Shaw & Co. and Seth Klarman's Baupost Group. Twenty-five of these funds, have pulled in about $15 billion this year, according to one prime broker. A Credit Suisse Group AG survey released this week highlighted the shift: Investors are more interested in hedge funds than any other major asset class going into the second half of the year.

The trend is nascent and tepid -- some analysts still project net outflows from hedge funds this year -- and could fade as quickly as it appeared. But it is an encouraging sign for an industry that has been mired in a long and relentless slide since its peak during the 2008 financial crisis.

"The sentiment is that the worst is behind us for now," said Kate Holleran, managing director of capital solutions at Barclays Plc. "We're hearing anecdotes of investors revising or paring back their redemption requests and taking a more business-as-usual approach."

Amid the chaos of Covid-19-induced market volatility, hedge funds have done their job. About 51% made money this year through May, while the S&P 500 index lost almost 6%, according to research firm PivotalPath, whose database represents about two-thirds of hedge fund assets.

Mediocre Returns

That hasn't been the case for much of the past decade. While some funds made money during the 2008 financial crisis, the subsequent years produced mediocre returns. The Federal Reserve kept interest rates low, crushing the volatility that traders needed to make money. Meanwhile, stocks were in the midst of the longest bull run in history.

Frustrated with underwhelming performance, pension plans and other large institutions pulled about $140 billion from hedge funds from the end of 2015 through last year, according to Hedge Fund Research Inc.

Dawn Fitzpatrick, the $25 billion Soros Fund Management's chief investment officer, is part of the change. She decided to pump $1.7 billion into hedge funds beginning in March, spying new opportunities in the industry, according to a person familiar with the firm. Last year she pulled $3.5 billion from almost 30 funds citing high fees, poor performance and the desire to manage more money in-house.

Fitzpatrick sent about $1 billion to marquee managers who had been closed, said the person, who asked not to be identified because the decisions aren't public. She focused on an array of strategies, including middle-market lending in areas where her team doesn't have expertise, the person said.

A spokesman for Soros Fund Management declined to comment or provide names of managers the firm hired.

Issac Septon, CIO at the The Observatory, a single family office, said he had increased his hedge fund exposure earlier this year by 20%, topping up existing managers and adding new funds to his roster. Most of the cash went to technology, event-driven and mortgage funds and firms specializing in Europe, he said. He redeemed from just one manager who struggled in March.

Some institutions had already planned to exit hedge funds before the pandemic and see no reason to return.

Fresno County Employees' Retirement Association voted to pull its roughly $300 million in hedge funds at the end of last year, focusing instead on equity investments, said Doug Kidd, investment officer at the $4.6 billion pension system.

"In fact, the 'Fed Put' appears stronger and more enduring than ever contemplated previously," he said. "Time will tell whether there are unforeseen consequences, but for now the Fed is telling us there is no need to hedge."

Adding Funds

Panayiotis Lambropoulos, a portfolio manager of hedge fund investments at the Employees Retirement System of Texas, disagrees, and said he expects volatility and uncertainty to increase as markets adjust to the reality of lower earnings and weaker economic growth.

The pension system has added a couple of hedge funds this year, and Lambropoulos is looking at more strategies including convertible bond arbitrage and volatility-oriented funds. A range of credit funds, from direct lending to those trading stressed and distressed securities, are also being considered.

Jens Foehrenbach, CIO at Man FRM, a division of Man Group that invests in more than 50 hedge funds, said he too is interested in credit funds, and for the first time in a while is bullish on equity hedge funds given the increased dispersion across stocks.

Even with this newfound optimism from some investors, net redemptions could continue this year, especially if stock markets start to tumble and investors need cash. A few institutions have already redeemed to raise money to run their operations or boost charitable giving.

The first hedge funds to get hit were those with weaker track records.

David Gallo told investors last month that he was closing his 13-year-old Valinor Management because several of his largest and oldest investors, predominantly hospitals, endowments and foundations, had put in redemption notices. While performance in the past 18 months had been good, the $1.4 billion firm posted "uninspiring" returns from mid-2015 through 2018, according to a client letter.

Barclays's Holleran forecasts that after $30 billion in net withdrawals in the first quarter, redemptions for the year could total $50 billion to $100 billion. The lower end of that range is the most likely outcome, she said.

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