ADVANCED TRADING

Hedge Fund Performance Expected To Climb In 2013

An improved housing market and global markets awash in liquidity are expected to be the key drivers in better hedge fund performance.

The good news for the hedge fund industry in 2012 was that it managed to stave off what would have been a third year of losses since 2007. The bad news is that 2012 was hardly a banner year for the sector, which was badly outperformed by the S&P 500.

Hedge funds -- long/short equity funds in particular -- were faced with a difficult trading environment in 2012, with problems in the housing market, upheaval in Europe and the fiscal cliff among the myriad factors working against investment managers. Despite these challenges, the average hedge fund climbed 4.89% over the first 11 months of 2012, according to Hedge Fund Research's HFRI Index. But that total pales compared with the S&P 500's gains of 14.94% over the same period.

Nevertheless, with the U.S. housing market appearing to be on the mend, and continued quantitative easing from the Federal Reserve expected to benefit stocks, 2013 should be a better year for hedge funds, according to many pundits. For instance, quantitative easing involves the Fed propping up the economy by buying mortgage-backed securities and Treasury bonds, a stimulus program that's widely expected to continue until the job market improves substantially.

"I think you'll see hedge fund outperformance in 2013, and there's a few reasons for that," says Phil Niles, the director of product development at Butterfield Fulcrum, an administrator for alternative investment firms. "Obviously, housing is a major driver in the economy and some optimism there should spill over into a broader economic rebound."

He also points to the falling unemployment rate and the Fed's commitment to low interest rates as reasons for why the economy should continue its arduous climb back from the abyss. And while Niles concedes he can see why investors have reason to question paying fees to a hedge fund after another mediocre year, he contends that most can't outperform year in, year out. "There's a lot of good things heading into 2013 that should help hedge fund managers with that outperformance and true delivery of alpha," Niles says.

With the housing recovery in full swing, Niles says hedge funds with a focus in mortgage-backed securities (MBS) are positioned to do well this year. In December, Fiserv's Case-Shiller data showed that the average U.S. home price climbed 1.2% since the summer of 2011. Meanwhile, Bloomberg News said sales of existing homes will rise about 7.2% in 2013 to 4.98 million, the highest since 2007. Bloomberg said it based that prediction on the median estimates of 15 economists and housing analysts that it surveyed.

"As the housing market continues to turn around, the MBS space is one to watch," Niles says, adding that long/short equity strategies also are positioned to do well.

Tim Ng, the managing director and head of research at investment advisory firm Clearbrook Global Advisors, agrees. He says the global markets will be awash in liquidity after the recent actions of central banks in the U.S., Europe, Japan and China, which should benefit stocks.

"Particularly long/short equity -- the stock pickers should really perform well," says Ng, whose firm has around $40 billion in assets under administration for institutional clients. "Fundamental stock pickers, those who are able to differentiate and add alpha in regard to picking industry groups, will perform well."

More Institutional Interest?

Industry experts also contend that the trend of institutional investors pouring money into hedge funds will accelerate in 2013, if the economy continues to improve.

"There's hundreds of billions sitting on the sidelines right now. A lot of people were holding off making investments into hedge funds due to things like the stagnant economy," Niles says, noting that the recent fiscal cliff negotiations and concerns about tax hikes also played a role.

"You're going to see a lot of that institutional money re-enter the market, because it's sitting in bank accounts right now," Ng says. "It's sitting in T-bills and it's doing absolutely nothing for them so they're going to start to chase some performance for that money. I think it's going to mean good things for the alternative investment community."

Ng adds that pension funds and other institutions are going to bet on hedge funds for a shot at better risk-adjusted returns and as a hedge against other long positions.

"In particular, I think you'll see that in fixed income," Ng says. "As we know with rates at historical lows, the duration risk is so high and the interest rate risk is so high, they'll have to look at alternative investments to bring them some positive returns."