THE WALL STREET JOURNAL.
JANUARY 24, 2012, 12:19 P.M. ET

Currency Funds Face Investor Ire As Returns Fade

By NEIL SHAH

After a frustrating year, hedge-fund investors are turning their backs on smaller funds specializing in niches like currency markets.

In the final months of 2011, hedge-fund investors withdrew from smaller hedge funds, which are more likely to be currency specialists, and plowed money into bigger funds that invest across many markets. The net outflow from funds managing between $250 million and $500 million was $989 million in the fourth quarter, while funds that oversee over $5 billion saw an inflow of $6.8 billion, according to Hedge Fund Research Inc.

Last year was tough for hedge funds of all shapes and sizes, particularly the summer months. Europe's sovereign debt crisis and the political battle over reducing U.S. debt made markets hard to predict. Prices of financial assets tended to move in lockstep, making it hard for money managers to diversify.

The HFR data suggest some investors may have moved cash from smaller specialist funds to bigger, more mainstream funds after the third quarter's turmoil, most likely because bigger funds often make investments across markets and are perceived as sturdier.

"In a risk-averse environment, people are more inclined to invest in generalist managers," said Kenneth Heinz, president of HFR.

Currency-fund managers, like their counterparts in other markets, struggled to latch onto trading patterns amid severe, unpredictable swings. Many funds failed to live up to their billing--that currency would beat other markets when they fell, said Robert Savage, chief executive of Track.com, a foreign-exchange research firm that caters to hedge funds.

Specialty funds can help investors like pensions diversify their hedge-fund portfolios. But extreme volatility last year hammered their performance, which echoed--or even trailed--that of bigger, more mainstream funds, damaging the appeal of specialists as unique places to invest.

These funds' lackluster performance last year raises "the question of whether they are truly unique," Mr. Savage said. "Not all FX funds will make it, but the ones that do are likely to be smarter and better performers."

Foreign-exchange managers lost over 6% on average in 2011, according to Parker Global Strategies, which invests in currency managers and tracks 18 currency programs with a total of roughly $10 billion under management. By contrast, hedge funds in general lost about 5%, according to HFR. The Standard & Poor's 500-stock index finished the year roughly flat.

Hedge-fund investors are scrutinizing their investments after a turbulent 2011.

"We are likely to make some moves," said Sam Katzman, chief investment officer of New York-based Constellation Wealth Advisors, which invests in hedge funds and has $4.5 billion under management. "We have spent a lot of time looking back at 2011 and asking who can do better in this environment," he said.

The worst of the negative sentiment on currency managers may be over, said Jon Stein, a managing director at Parker Global Strategies. Stock and currency markets have kicked off 2012 in a surprisingly buoyant mood, which has reduced market volatility and could boost these managers' performance.

Investors who stick by currency managers in bad times also tend to benefit later on, Citigroup currency analyst Greg Anderson said Monday.

Of the 77 foreign exchange-specialty funds that Citi tracks, 71 lost money in 2011, he said. However, "FX manager returns are mean-reverting," meaning they tend to return to their average, Mr. Anderson said. "Major [investor withdrawals] in 2004, 2006 and 2008 were followed by subsequent periods of strong performance."

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