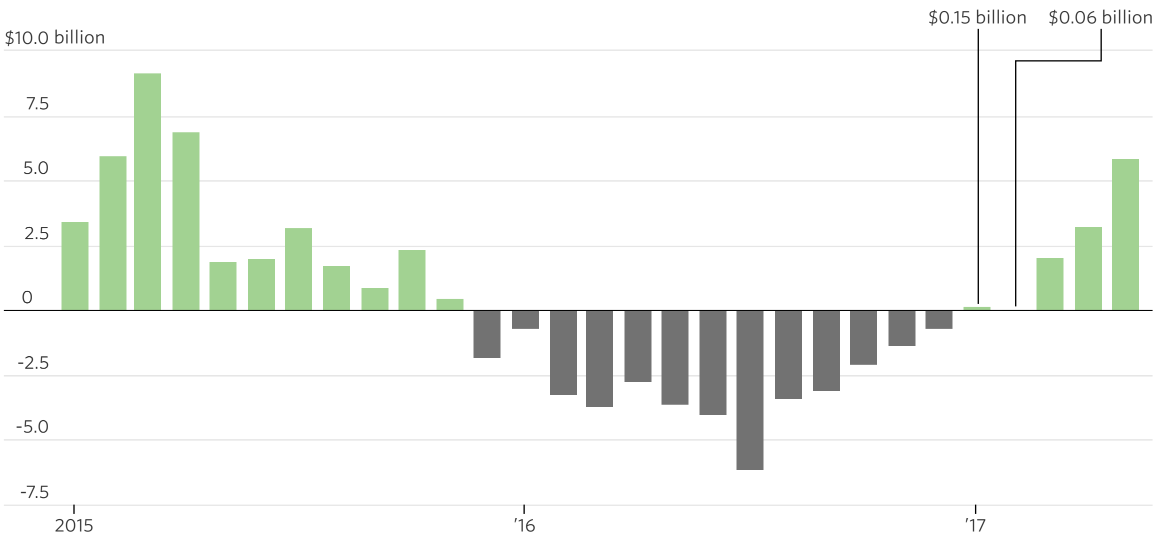
HEDGE FUNDS

Hedge Funds Flock to Europe, Thinking Worst Is Over

Bets on equities in Italy, France and Spain have given some global hedge funds 20% returns this year

Cash Is Flowing Back Into U.S. Funds That Invest in European Stocks...

Monthly flows into and out of U.S.-domiciled funds investing in European stocks



Source: EPFR Global

THE WALL STREET JOURNAL

By Laurence Fletcher and Gregory Zuckerman

July 4, 2017 5:30 a.m. ET

After the presidential election last year, many hedge-fund managers called the U.S. a great moneymaking opportunity. It turns out Europe is the place to be.

Bets on stocks in Italy, France and Spain—long laggards compared with the U.S.—have given some global hedge funds returns of more than 20% so far this year. The average hedge fund has managed only 3% through May, according to the most recent data from Hedge Fund Research.

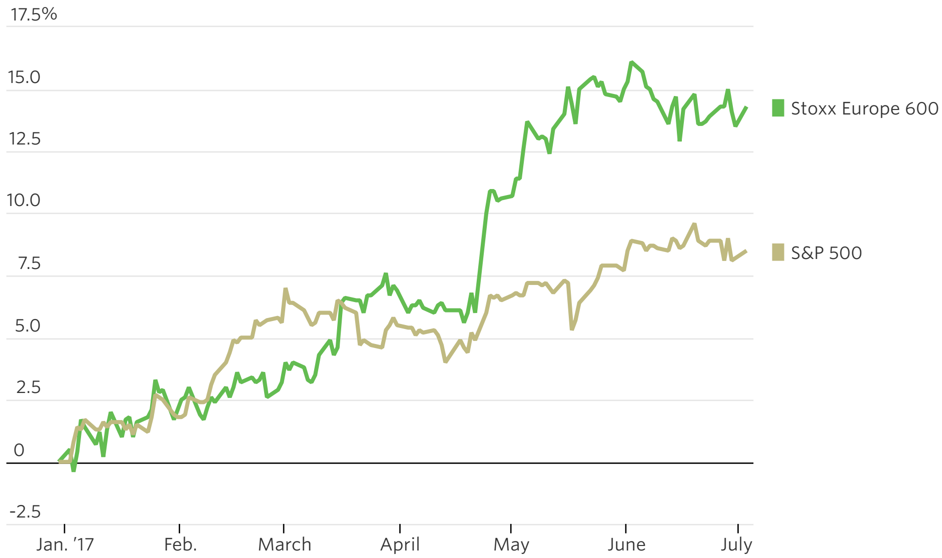
"We've been quite aggressively long Europe in the last year," said Pieter Taselaar, founder of Greenwich, Conn.-based Lucerne, which manages $750 million in assets. Its main fund is up 20.5% this year through June 15, according to a person familiar with the matter.

A sustained rebound in Europe, should it come to pass, would reshape global markets. Most European bourses remain mired below their 2007 peaks. The euro and the British pound have been slumping for a decade.

Eurozone GDP growth hit its second-highest level since 2011 in the first quarter at 0.6%, beating U.S. GDP growth of 0.4%. The European PMI, a survey of manufacturing activity, reached a 74-month high last month. Growth is solid not only in Germany but also in the onetime trouble spots of Spain and Portugal.

...As Europe's Benchmark Index Outperforms Its U.S. Counterpart.

Percentage change so far this year, in U.S.-dollar terms



Source: Thomson Reuters

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Markets have reacted to the economic growth, relative political calm and a sense that the worst of Europe's sovereign-debt crisis is behind it. In local-currency terms the S&P is outpacing the Stoxx Europe 600, but after accounting for the euro's rise a dollar investor would have done much better in the European index, making 13.8% versus 8.5%.

Earlier this year Lucerne started to add significantly to exposure in France, Spain and Italy, said Mr. Taselaar, while reducing exposure to Scandinavia, considered a haven in difficult times. The fund bought stocks such as Italian bank UniCredit , up 26% this year, and French house builder Kaufman & Broad , up 11%, the person said.

Mr. Taselaar expects European economic growth to be between 2% and 3% in the next two to three years, as demand rebounds and companies begin to invest more. Investments that perform well in better times and in countries that had been struggling are places "where we see 50% returns right now," he said.

Yet foreign investors who have pounced on previous glimmers of hope in Greece and elsewhere have been repeatedly singed. Some them are cautious this time, fearing the rebound is just temporary.

A Nestle production facility in Broc, Switzerland. The company is under pressure from activist investor Daniel Loeb. PHOTO: MICHELE LIMINA/BLOOMBERG NEWS

They point to familiar concerns such as inflexible labor-market rules across Europe, an aging population, constraints on government spending and the still-unknown impact of Brexit on European growth.

A study by J.P. Morgan Chase & Co. showed that the 29 largest active equity mutual funds with global mandates—predominantly U.S.-based—haven't added euro-zone shares this year as a group.

Bullish hedge funds say European markets will climb further once the skeptics come around. Besides, they say, a sustainable recovery is less important for hedge funds, which can quickly exit positions if desired.

“It appears the mood in Europe is improving, the economic data is showing strength, corporate earnings are exceeding expectations,” said Robert Duggan, partner at New York-based SkyBridge Capital, which invests $11.4 billion in funds. Mr. Duggan said that he has been adding to holdings in funds that bet on European stock events and that some of these have gained 10% to 20% this year.

Some investors who are optimistic on European shares and the euro say billionaire fund manager Daniel Loeb’s move on Nestlé SA is a fresh sign the Continent has become a prime destination for global investors.

Mr. Loeb’s Third Point hedge fund acquired a $3.5 billion stake in the Swiss food-and-cosmetics giant and demanded changes from it.

“We are seeing more opportunities in Europe because of strong and improving economic data, a trend that will likely continue now that the French elections have passed without incident,” Mr. Loeb wrote to investors in late April.

Mr. Loeb added that “we have been more focused on improving global growth than on the ‘ Trump trade,’ ” referring to the idea that certain investments would benefit from Donald Trump’s election. His main hedge fund rose 9.9% through the end of May, a person who had seen the numbers said.

Also profiting recently is Chris Hohn’s European activist fund TCI, which has more than $20 billion in assets. Its main fund, which has a large allocation to Europe, is up around 23% this year through May with big bets on rising stock prices, said people who had seen the numbers.

Among stocks to have fueled gains at TCI, which takes a small number of very concentrated bets, is Spanish airports operator Aena, which has risen 29% this year.

Another hedge fund that has benefited from European investments is Lansdowne Partners, which has around $19 billion under management. Lansdowne has gained 15.6% in its European Equity fund this year, a person who had seen the numbers said, and 13.5% in its smaller Princay fund, which profited from buying French stocks that sold off around the time of the election.

The gains are striking in a hedge-fund industry that is once again struggling to eke out returns. On average, hedge funds are up just 2.7% this year to June 29, according to Chicago-based data group HFR.

—Jon Sindreu contributed to this article.

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