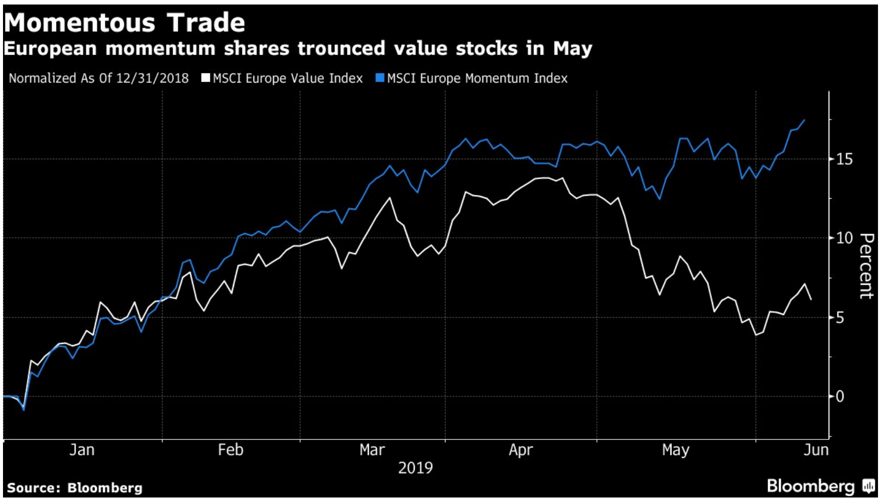
Hedge Fund Manager Willing to Play 'Idiot' Shuns Trendy Stocks



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(Bloomberg) -- Defensive investors are stoking fashionable stocks at a rate rarely seen over the past three decades -- all while snubbing the cheapest shares. A hedge-fund manager besting most of his peers is joining a chorus of Wall Street voices warning something has to give.

Federico Riggio, who runs the 318 million euro ($360 million) Kairos Pegasus Fund SA, is sticking with Europe's scorned value shares while warning that so-called momentum equities are getting dangerously overheated.

Last month's bloodbath in value versus momentum even has a bright side, according to the manager -- it's laying bare fresh dislocations just begging to be exploited.

The likes of Morgan Stanley and Sanford C. Bernstein are cautioning that momentum has become more crowded and worryingly expensive on the back of this year's fiery outperformance. Barclays Plc is putting their necks out saying value can stage a tactical rebound even if the market craters thanks to its record discount.

Riggio's fund, which focuses on regional equities "that are cheap and wrongly perceived as bad-quality businesses,'' slid 2.8% in May.

Meanwhile, momentum soared to a near-record 17% outperformance versus cheaper stocks thanks to its bet on defensive equities, according to Morgan Stanley.

“I prefer to be seen as an idiot in the short-term but sticking to the principles of our investment style and criteria because this is the only way to have a good return over the long-term,” said Riggio, whose fund is up 10.2% this year, about double the return of the Hedge Fund Research HFRX Equity Hedge Index.

“Too much of a crowd is going into momentum. I’m staying in companies that I believe are underpriced for the profit and growth that they deliver.”

Mounting U.S.-China trade tensions helped push investors into stocks bearing defensive characteristics last month, boosting momentum’s exposure to sectors such as health care and food and beverage, according to Morgan Stanley.

Momentum now has a “big overlap’’ with the quality and low-volatility factors, the bank’s strategists wrote in a note.

But the search for safety is looking dangerous. Momentum’s valuation in Europe has swelled to the 99th percentile, and crowding has upped the risk of a “big unwind’’ should performance wither, Morgan Stanley said. Bernstein quants led by Inigo Fraser-Jenkins say momentum “could become vulnerable,’’ while Societe Generale SA’s quant model is now underweight the factor.

Riggio, whose fund sits within the Julius Baer Group Ltd.-controlled Kairos Investment Management Ltd., used the May dip to buy shares that were “totally destroyed” by momentum investors, such as U.K. gaming companies.

There’s not much to tempt investors into value shares just yet. After adding to losses last month on the heels of a lackluster start to the year, the investing style is testing its vanishing cohort of believers once more. The likes of Bernstein abandoned their bullish call at the end of last month as the performance gap between the cheapest and priciest companies widened.

Still, JPMorgan strategist Marko Kolanovic has come out swinging, saying value stocks could rally as much as 20% in the short term should a trade agreement between the U.S. and China materialize.

Barclays points out that value in Europe is trading at the biggest price-to-earnings discount versus growth on record, and recommends energy and mining stocks as top plays, while shunning banks.

Yet that’s what has allowed Riggio’s hedge fund to beat peers despite a slump in cheaper stocks this year: holdings like Eurobank Ergasias SA, a Greek lender which is up 60%.

“We think we have a better risk-reward in trying to go and find long-term dislocations, the dislocations that fewer people are looking at because they have less time and patience,’’ the manager said.

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