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## A New Decade for Hedge Funds? A Deeper Look

*By Marcos Veremis*



INVESTMENTS & WEALTH INSTITUTE®

# A New Decade for Hedge Funds?

## A DEEPER LOOK

By Marcos Veremis

Over the past several years, an oversimplified narrative has emerged that hedge funds have failed to deliver on their promise to investors—namely, value-added returns with low correlation to equity markets. That oversimplified narrative relies on a generic view of hedge funds as a single, monolithic asset class amid the recent historic rally across all risk assets. Clearly, it has caused some to question the role of hedge funds as a meaningful diversifier in portfolios. A review of evidence suggests that, in fact, a portfolio of well-selected hedge funds has over time added significant value and reduced risk in investors' portfolios. Furthermore, given the market forces at play today, hedge funds now have the potential to be even more valuable for clients.

These forces include:

- Macroeconomic uncertainty related to the coronavirus and timing of recovery
- Microeconomics of the coronavirus and its varying impact across companies and industries
- Heightened equity valuations, especially within certain market segments
- Increased realized equity dispersion and increased dispersion of earnings expectations
- Historically low fixed income yields combined with tight credit spreads, high leverage, and long duration
- Unprecedented global monetary stimulus and fiscal response

Each of these forces alone is meaningful, but in combination they are conspiring to create a significant regime

shift and its impact already is being seen in stronger returns to active management. Despite a relatively challenging environment for some hedge-fund strategies over the past decade, investors are likely to benefit now by increasing hedge-fund allocations.

As advisors consider ways to improve their clients' portfolios and generate better and positively differentiated results, they may be asking the following critical questions:

- What are the important nuances in thinking about hedge funds and their portfolio role?
- What factors have contributed to some hedged strategies' lackluster results in the past decade, especially relative to long-only asset classes—and are these likely to persist?
- Why might hedge funds be more valuable in portfolios going forward?
- What is the best way to implement these strategies in order to generate better outcomes for clients?

### HEDGE-FUND NUANCES AND THEIR ROLE IN A PORTFOLIO

First, note that hedge funds are not an asset class but rather an active-management implementation wrapper. The hedge-fund structure allows for much more flexibility than traditional investment vehicles such as long-only equity and credit funds. For instance, hedge funds can go short, utilize derivatives, invest in less-liquid debt (such as distressed or restructuring situations), pursue arbitrage trades, opportunistically hold cash, adjust gross and net exposures depending on market conditions, bet on

the course of monetary policy, and structure asymmetric payoffs.

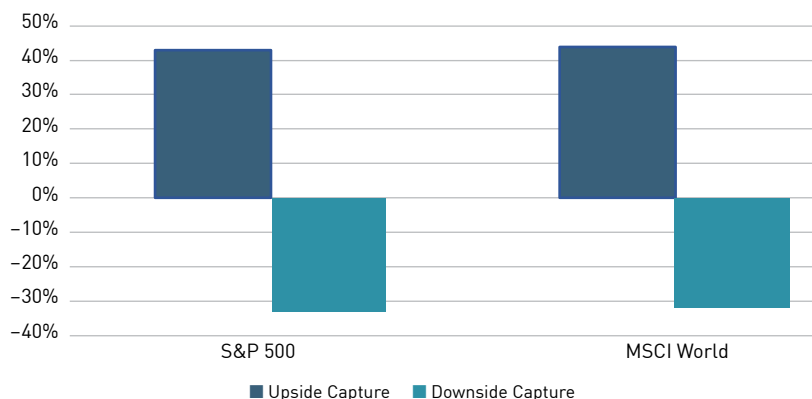
Second, not all hedge funds are equal. There is wide dispersion in hedge-fund returns, much wider than in long-only strategies, that is partially reflective of the broad and unique opportunity set available to hedge funds. However, manager skill also plays a significant role. Manager selection matters even more in hedge funds than in long-only strategies. In fact, we operate with the key belief that the average hedge fund adds no value net of fees. Thus investors need to dedicate significant resources, proven talent, and sophisticated techniques to build a top-tier portfolio of hedge funds.

Third, the incentive fee structure of hedge funds, although often criticized, attracts some of the world's best investors. These investors are more likely to produce alpha, or outsized risk-adjusted returns, relative to the market and to peers in traditional asset management.

All the above point to the unique role that a group of carefully selected hedge funds can play in a portfolio. They can provide sources of return that are different from those achieved in traditional portfolios and serve to lower the volatility of a diversified portfolio by protecting capital in market sell-offs and still participating in the market's upside (see figure 1). Reduced volatility and downside protection matter in practice because they allow investors to better plan for their spending needs and to stay the course with more directional investments during bear markets.

Figure  
1**HEDGE FUNDS HAVE CAPTURED MORE UPSIDE AND LESS DOWNSIDE**

Average Monthly Up/Down Return Capture of the HFRI Fund Weighted Composite Index



Source: HFRI Fund Weighted Composite Index (HFRI FWC), Bloomberg; Data for the period October 1, 2002, through March 31, 2021. Past performance is not necessarily indicative of future results.

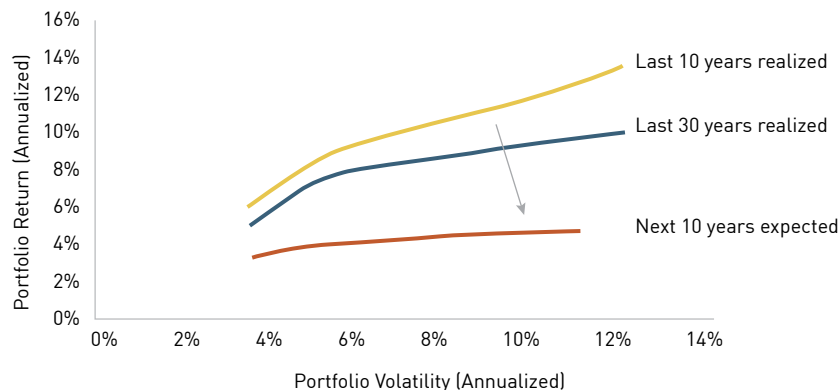
the S&P 500's Sharpe ratio for the past decade has been almost double its average since 1989. This means that, in the past decade, investors have been compensated twice as much for taking risk as they have been historically. Going forward, this is unlikely to continue.

Falling interest rates also have been a boon for government and corporate bonds, keeping lower-quality businesses afloat and limiting the number of short and distressed opportunities. Together, these factors have made it difficult for hedge-fund managers to generate alpha as they look to make money both long and short and to take advantage of dislocations from volatile markets. In other words, low volatility and low dispersion are a perfect storm working against many hedge-fund strategies. In effect, all risk assets mostly trading together in one direction have limited the opportunity set for skill-based, unconstrained strategies. That began to change in 2019 and accelerated in 2020.

**TODAY'S ENVIRONMENT IS DIFFERENT**

Looking ahead, passive investing in stocks and bonds is likely to be much more difficult. Two of the biggest challenges are record high valuations for stocks and record low interest rates for fixed income. In late 2020, for example, the forward price-to-earnings on the S&P 500 peaked at more than 26 times earnings, which is more than double its low in the later stages of the Global Financial Crisis (GFC). Meanwhile, government bond yields have continued to hover near all-time lows with many markets exhibiting negative real rates and even negative nominal rates. When we pay someone for the privilege of holding our money, it's fair to say a regime shift is underway.

Due to these factors, the next decade can and likely will be very different for passive investors. According to Morgan Stanley Research forecasts, forward-looking expected returns are 3 percent to 9 percent lower than realized returns over the past decade (see figure 2).

Figure  
2**RETURN EXPECTATIONS FOR PASSIVE PORTFOLIOS ARE VERY LOW**

Source: Morgan Stanley Research forecasts; <https://properguidance.com/november-2019-market-update-outlook/>. Note: Based on realized and expected nominal returns, realized correlation and volatility of S&P 500, UST 10Y, USD IG, USD HY, and cash, with min 0 percent, max 60 percent asset weight constraint for fixed income, min 0 percent max 80 percent for equities, and min 0 percent max 10 percent for cash. Past performance is not necessarily indicative of future results.

**A NEW DECADE FOR HEDGE FUNDS?**

The past decade has been challenging for several hedge funds, especially relative to directional equities. However, the factors that created that outcome now are changing in a meaningful way. Note that hedge funds as a group have struggled relative to the S&P 500. This has come at a time when investing in equities (mainly through passive funds) has never seemed easier. The S&P 500 has returned approximately 14 percent annualized over the past 10 years, which is substantially higher than its historic annualized return of around 9.5 percent.

This extraordinary performance has been driven by a variety of factors, most notably:

- Record flows into passive funds
- Big tech's dominance and increasing market share in the index
- Increasingly narrow market leadership, with the top 10 stocks in the S&P accounting for almost 30 percent of the index
- Historic levels of quantitative easing and record low interest rates

Not only have returns been high, but risk also has been low, potentially leading to equity risk complacency. In fact,

Given this fundamental asymmetry in traditional asset classes and potentially limited upside, hedge funds, and the non-market sources of return they can generate, become a more important piece of a diversified portfolio.

Although the headwinds for passive investing are increasing, many of the cyclical and structural challenges that hedge funds confronted during the past decade are now receding.

With the coronavirus pandemic and the unprecedented response by central banks, both volatility and dispersion are likely to remain elevated for some time. Many businesses are facing fundamental stress while others are benefitting from the dynamics of this crisis. As a result, dispersion in earnings and security returns reached very high levels in 2020 (see figure 3).

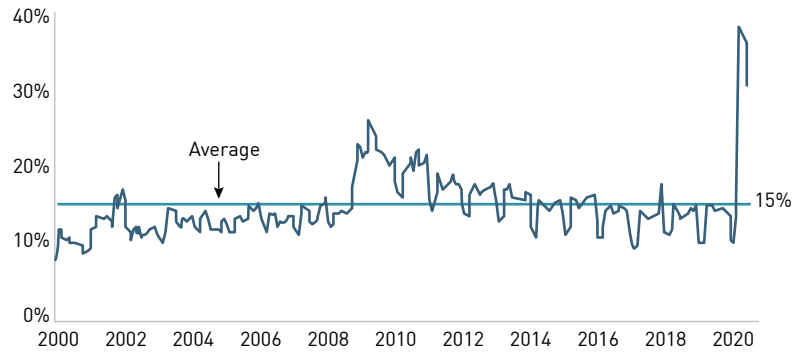
Dispersion provides great opportunities for active management and long-short strategies, and we already have seen some very strong alpha generation among hedge-fund managers since the pandemic began. According to Morgan Stanley, 2020 was the best year of long-short net alpha since tracking began in 2009.<sup>1</sup> Active management outperformance also tends to be cyclical as shown in figure 4. The many factors at play in the current environment suggest we may be at an inflection point, where active equity strategies, and especially hedge funds, are set to outperform.

In addition, as stimulus fades expect to see an excellent opportunity in distressed credit. By definition, dispersion means that some companies are doing well while others are not. Those that are not may face funding issues with some likely filing for bankruptcy or otherwise restructuring their balance sheets. The combined size of the high-yield bond and leveraged loan markets was \$2.5 trillion at the beginning of 2020 (approximately double the size it was in 2008), and credit quality was historically weak entering the

Figure 3

### DISPERSION HAS RETURNED

Median EPS Dispersion for S&P 500 Index, January 2000–July 2020

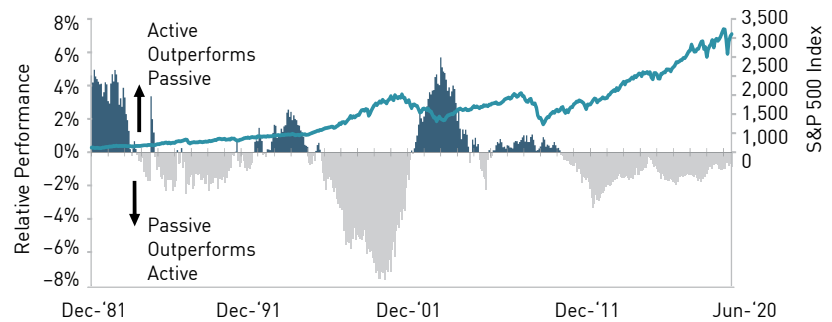


Source: Maverick Capital 2020 Second Quarter Letter. Dispersion in analyst earnings-per-share estimates. Past performance is not necessarily indicative of future results.

Figure 4

### ACTIVE MANAGEMENT OUTPERFORMANCE IS CYCLICAL

Difference in Average Three-Year Performance Between Large-Cap Active and Passive Funds

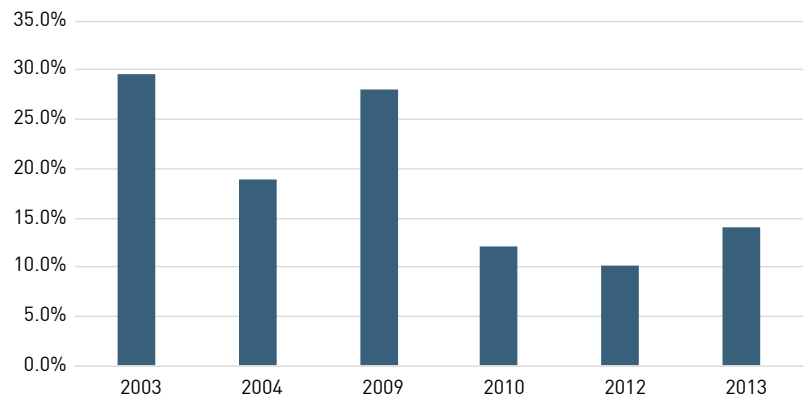


Source: Morningstar Direct, Baron Capital. The analysis is based on monthly rolling three-year returns for the period December 31, 1981, to June 30, 2020. The performance of active funds is calculated as the average three-year performance of all share classes of open-end non-index funds in Morningstar's US Fund Large Growth, US Fund Large Value, and US Fund Large Blend categories. The performance of passive funds is calculated as the average three-year performance of all share classes of open-end index funds and exchange-traded funds in Morningstar's US Fund Large Growth, US Fund Large Value, and US Fund Large Blend categories. Past performance is not necessarily indicative of future results.

Figure 5

### CREDIT STRATEGIES HAVE HAD STRONG PERFORMANCE AFTER MARKET CRASHES

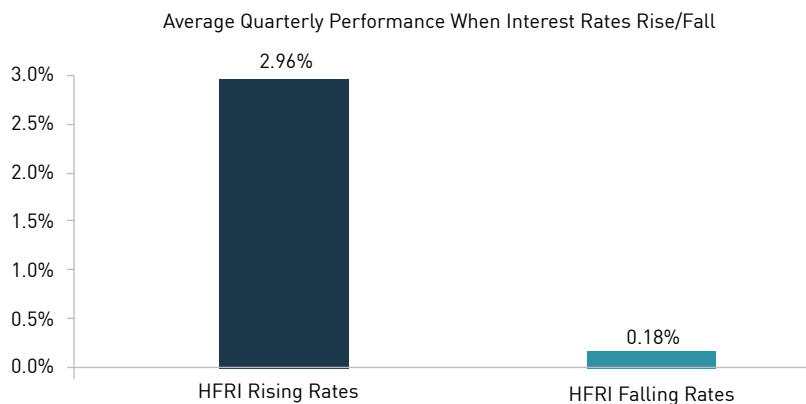
HFRI Distressed Hedge Funds—Performance After Market Crashes



Source: HFRI ED: Distressed/Restructuring Index. Past performance is not necessarily indicative of future results.

Figure  
6**HEDGE FUNDS HAVE DONE WELL WHEN INTEREST RATES RISE**

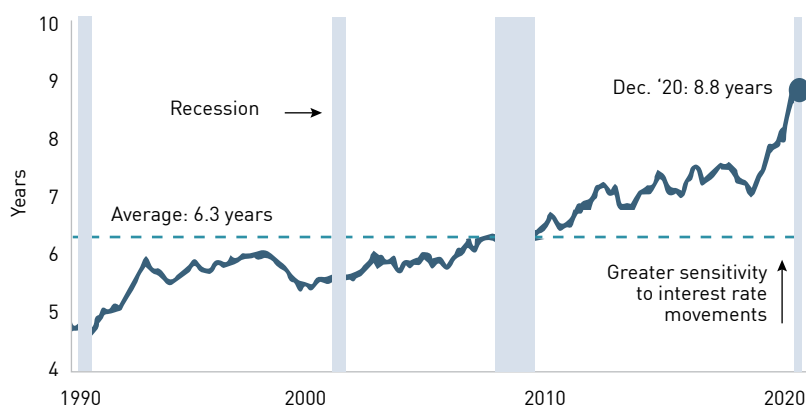
HFRI Fund Weighted Composite Index in Rising Rates Environments



Source: Bloomberg and HFR Database; Data for the period October 1, 2002, through March 31, 2021. Past performance is not necessarily indicative of future results.

Figure  
7**RISING RATES COULD HAVE DRAMATIC PORTFOLIO IMPLICATIONS**

Duration of Investment-Grade Corporate Credit Now at 30-Year High



Source: JP Morgan Asset Management, Guide to Markets 4Q 2020, Duration of investment grade is based on the Bloomberg Barclays U.S. Aggregate Investment Grade Corporate Credit Index. Past performance is not necessarily indicative of future results.

coronavirus crisis (70 percent of the leveraged loan market and more than 50 percent of the high-yield market are rated single-B or below). Numerous companies, mostly in the investment-grade space, managed to shore up their balance sheets because of the Federal Reserve's actions early in the coronavirus crisis, but this has not been the case for many lower-quality issuers and smaller companies. In addition, for some stressed companies that did manage to tap the credit markets, we expect that the day of reckoning eventually will come because leverage has increased and the road to pre-pandemic earnings may be quite long.

Any rise in inflation and interest rates resulting from enormous stimulus, pent-up demand, and crippled supply chains will only exacerbate this problem. Given these dynamics, we also expect more episodes of stress and forced selling in the structured credit space. We are therefore excited about the broad opportunity set in credit for the first time since the GFC of 2008-2009. Note in figure 5 the performance of credit strategies coming out of that period and in the years following the dot-com bubble.

Finally, rising inflation in the medium term now seems like a reasonable probability. Bank balance sheets were stronger

entering this crisis than they were in the GFC, and this time, policy is aimed more toward direct transfers to businesses and households, leading to a rapid spike in the supply of money. If we do enter an inflationary period when things rebound, interest rates finally should be expected to rise from near-zero (or negative) levels. Although stocks and bonds could suffer losses in parallel, hedge funds historically have done well in periods of rising rates (see figure 6).

Interest-rate risk for fixed income now stands at its highest level over the past 30 years (see figure 7), meaning that small increases in interest rates can have a dramatic negative impact to bond portfolios. The fixed income space does not provide the yield required by most investors at present, and it poses a much greater risk of negative returns. In addition, given the uncertainty around economic growth, Fed policy, and inflation, many global macro strategies are seeing their strongest opportunity set in years. In this environment of low interest rates, a carefully selected group of uncorrelated hedge funds could replace a portion of investors' fixed income allocations.

**IMPLEMENTING THE HEDGE-FUND ALLOCATION**

Although hedge funds can add portfolio value—and the time may be ripe for hedge-fund outperformance—thoughtful program implementation also can drive better outcomes. Investors have three main options they can use to implement a broad hedge-fund allocation:

- Select individual managers to construct a fully diversified hedge-fund allocation
- Invest in one or more multi-strategy funds
- Utilize a turnkey fund-of-hedge-funds (FoHF) solution.

There is not one correct approach. Each of these options has its merits, challenges, and varied considerations for

investors. However, given the complexity of these strategies, significant attention to this decision is required and warranted.

#### *Pros and cons of a direct multi-manager allocation approach*

The key benefits of a direct investment approach are heightened customization and the elimination of an added layer of fees charged by an FoHF. However, the challenges are numerous for firms lacking focus and resourcing.

First, to construct a direct hedge-fund program, an investor needs to complete extensive due diligence. At a minimum, an investor should select 10-15 hedge-fund managers across different strategies to achieve appropriate diversification. This is labor intensive and requires strong transparency and constant oversight into both the investment merits and operational robustness of the manager.

Second, combining multiple strategies and understanding the full extent and interaction of risks and exposures are complex tasks. Having well-developed views of how each hedge fund is likely to perform in different circumstances is difficult, especially with the flexibility that each fund has in altering its positioning.

Third, for a direct investor without scale, a lack of substantial allocations is likely to be an impediment to negotiating preferential terms, which can affect the degree of ultimate fee savings gained by choosing this approach over others.

Fourth, some of the best managers with long, proven track records are closed to new investment or have hefty minimums. Choosing to only invest with those accepting significant new capital flows also may lead to adverse selection bias.

Finally, the hidden costs of monitoring and actively managing a direct program are not always readily apparent. Investors always need to be on the

lookout for changes in their manager lineups that could adversely affect performance. This includes watching for better manager options, rebalancing, managing redemption dates, and handling other operational complexities such as multiple K-1s for tax purposes.

#### *Pros and cons of diversified multi-strategy funds*

Selecting one or more multi-strategy or platform funds to achieve broad diversification is another option. Such an approach has the merits of being more efficient and less labor intensive than constructing and monitoring a portfolio of 10-15 individual strategies, avoids the extra layer of fees involved in an FoHF, and delegates the asset allocation decisions to the multi-strategy manager.

However, several risks and considerations may not be readily apparent. For instance, capital does not always flow as fluidly as advertised between the different sub-strategies. That's because portfolio managers have a financial incentive to keep their capital allocations even if opportunities are more abundant in other strategies. The most talented managers at these firms also ultimately strike out on their own for more independence or better economics, leaving the multi-strategy manager with second-tier talent and high team turnover.

In addition, these multi-strategy funds typically also have high operational complexity, significant use of leverage, and a lack of return attribution transparency. These attributes can make due diligence and monitoring particularly challenging. As recent examples also demonstrate, single-manager risk remains significant because a rogue portfolio manager or complex derivatives, without appropriate risk management, can take down an entire firm.

Last, but not least, are two operational observations about headline costs and tax consequences. The lack of transparency and the way fees and expenses are treated operationally may mask the

all-in costs of these approaches. Tax efficiency also can decrease due to the high turnover typically associated with these strategies.

#### *Pros and cons of a fund-of-hedge-funds approach*

An FoHF approach can have a higher headline expense than the other two options, but it also can have significant benefits.

First, it is more operationally efficient for advisors, allowing more time to be spent with clients or other essential business activities with fewer line-item or headline distractions. An FoHF program also comes with immediate and purposeful diversification and with smaller minimums than building a direct portfolio. In addition, high-quality FoHF managers can provide access to some of the best managers in the space that may otherwise not be accessible to investors.

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*An FoHF can be less expensive than a direct or multi-strategy approach; at the same time, an FoHF can provide access to better managers (including closed managers) and better portfolio construction.*

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Furthermore, long-established firms can have meaningful negotiated fee reductions with their underlying managers, which could create substantial fee savings not immediately apparent to an investor. An FoHF can be less expensive than a direct or multi-strategy approach; at the same time, an FoHF can provide access to better managers (including closed managers) and better portfolio construction.

At the end of the day, this professional management, and the benefits it conveys, often can lead to higher risk-adjusted net

## RECENT HEDGE-FUND HEADLINES

The headlines for hedge funds this year have not been favorable. The short squeezes at GameStop and other stocks have harmed a handful of hedge funds. And the blow-up due to excessive leverage at the now-defunct Archegos, a family office run by a former hedge-fund manager, created more negative press.

In the GameStop-type short squeezes, certain managers failed to manage the risk of their short portfolios effectively; they suffered substantial losses and, in some cases, permanent capital impairment. However, GameStop has the distinction of being one of only 15 cases in the past decade in which short interest exceeded 100 percent of the stock's float. Some prudent

managers were caught in this recent wave of short squeezes but avoided any substantial permanent or mark-to-market losses. This is because their robust risk-management frameworks and execution discipline around crowded shorts emphasize indicators such as the number of days needed to cover a position, the short interest, the free float of a stock, and the market cap. Therefore, most managers avoided the detrimental effects of short squeezes entirely or sized positions appropriately to reflect such risks.

Note that Archegos was a family office, not a hedge fund. Its long-short equity portfolio reportedly was highly concentrated and five to 10 times the equity capital, an extraordinary amount of

leverage for such a strategy. Past hedge-fund blow-ups due to leverage have occurred mostly due to a combination of excessive leverage, illiquidity, and concentrated positions. The majority of hedge-fund managers, however, manage the risk in their portfolios appropriately and such incidents tend to be limited.

Nevertheless, successful investing with hedge funds requires diligence. Investors need to carefully underwrite managers and demand ongoing transparency on the risk management process and its execution. This includes monitoring for appropriate leverage, thoughtful position sizing, and diversifying across a number of managers.

returns than other options, with substantially less complexity.

## KEY CONCLUSIONS

- Active strategies—including hedge funds—may be poised to outperform their passive brethren for an extended period, as they have in past market regime shifts.
- This past decade has been characterized by a strong beta run for stocks and bonds fueled by low interest rates and quantitative easing.
- However, simply because passive portfolios of long stocks and bonds have worked well over the past 10 years does not mean that such strategies will be as effective over the next 10 years.
- Concerns are growing that risk complacency has reached new highs with respect to passive equity investing.
- With interest rates at all-time lows, equity valuations high, and a more uncertain macroeconomic landscape

(induced by the coronavirus pandemic and government and central bank actions), the next few years are likely to be very different than the past decade.

Hedge funds can play an important and diversifying role in investors' portfolios. They can provide access to alternative sources of return not available through traditional investment managers and use techniques to capture return sources with low correlation to traditional asset classes. Hedge funds also have demonstrated the ability to perform relatively well in market draw-downs and to generate positive returns when interest rates are rising. These features make them particularly valuable given the specific set of risks that market participants face today. A group of carefully selected top-tier managers can generate strong returns and positive alpha for investors. ●

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## ENDNOTE

1. "2020 Year-End Hedge Fund Recap + Considerations for 2021," PowerPoint presentation, Morgan Stanley (December 18, 2020). Contact the author for more information.

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