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Above the curve: A case for hedge funds in the current rate environment

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Introduction

Since the advent, and thereafter seemingly disappearance of COVID-19, the world has experienced waves of unprecedented levels of volatility. Restrictions on the movement of people and goods, changing supply chain dynamics and global manufacturing stockpiling, global military tensions, and sticky inflation risks have all impacted short-term volatility as the world adjusts to a "new normal" paradigm. More nuanced themes such as on- and re-reshoring, labour migration trends, trade wars, and energy supply have disrupted even modestly stable local and global markets. These disruptions have resulted in either volatility within portfolios or, in some cases, as explained below, opportunities to capitalise on price dislocations.

Contrary to the average retailer investor's toolkit of available investment products, hedge funds are not only built to sustain but also thrive during these turbulent market environments. The combination of investment tools available, directional flexibility (investing either long or short) and the use of leverage (to either increase or decrease total net exposure to the market) allows hedge funds to succinctly navigate volatile markets.

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A case for hedge funds

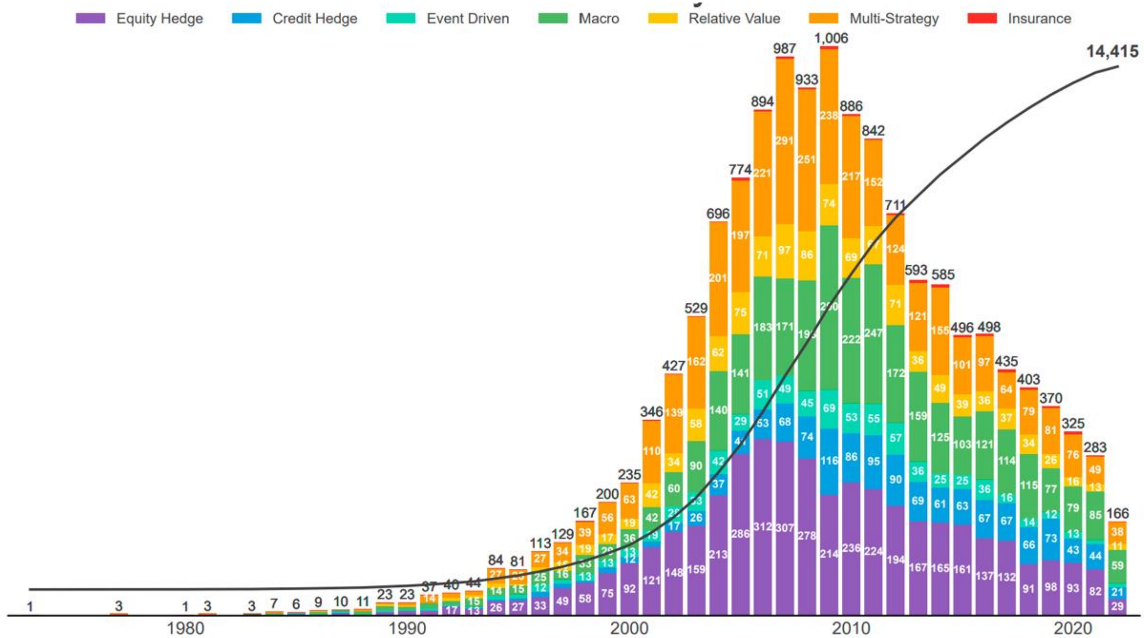
An introduction: history of hedge funds

Although there is anecdotal evidence of comingled funds available to wealthy investors during the bull run of the 1920s, like the Graham-Newman partnership famously founded by Benjamin Graham and his long-term business partner Jerry Newman and cited by Warren Buffett's 2006 letter to the Museum of American finance, the history of the modern hedge funds arose when one man identified one simple concept: market neutrality. Alfred Jones, a sociologist and journalist, bought assets he believed would rise in value relative to the market's overall performance and sold short assets he expected would decrease in price. He is credited for founding the first official hedge fund structure in 1949.

This led to the multi-trillion-dollar industry now widely known as "hedge funds", with a broadly defined goal of investing across various sectors, using a broad investment product toolkit, to achieve positive returns regardless of overall market direction. These funds are fundamentally pooled investment vehicles, similar to unit trusts, but have the ability to use leverage and aren't restricted to directional bias (i.e. the fund manager can "long" a stock that the manager forecasts will increase in value, as well as "short" a stock the manager forecasts will decrease in value).

Interest in hedge funds began to take off in the 1960s, following a 1966 Fortune magazine article highlighting that Jones's fund outperformed the best mutual fund over the prior five years by 44%, even when fees were considered. After this, many new hedge funds were established, and in 1969, the first fund-of-hedge-funds was launched, which allowed investors access to a group of hedge funds through one investment vehicle. Hedge funds continued to grow during the 1970s to 1980s, but it was in the 1990s that the sector boomed. After the dot-com bubble burst in the early 2000s, institutional investors such as pension funds, insurance companies, and sovereign wealth funds made their first investments in hedge fund products, as the concepts reliably protected investors during substantial market drawdowns. However, the GFC in 2008 proved challenging as managers over-levered and acted on their own accord; many funds closed following heavy losses, investors withdrew assets, and, subsequently, AUM declined significantly.

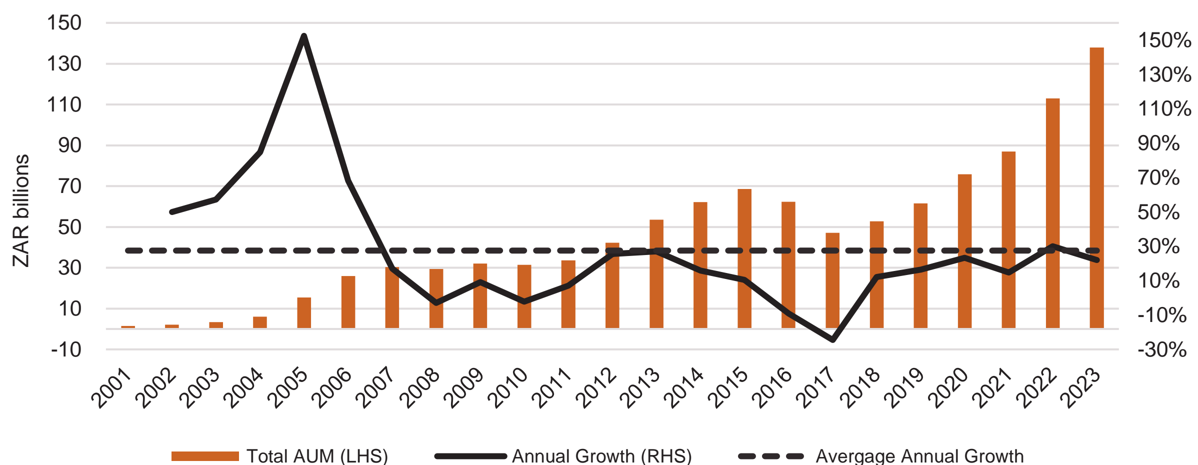
Global growth of hedge funds



(Source: Bloomberg Hedge Fund Database 2022)

The 2010s continued these major changes in regulation as the industry shifted to obtain (and regulators acted to protect) more individual investor capital. Despite increased scrutiny from regulators, hedge funds rebounded nicely from the GFC, proving their worth as value-enhancing investment products, with industry assets exceeding US$2tn again in 2011, exceeding US$3tn as of 2019, and currently estimated to be c.$4,5tn. Today, hedge funds focus on providing a solution rather than a product, hedge funds are more broadly understood, and the industry evolves into a more definitive part of an investor's overall portfolio.

South African hedge fund AUM growth

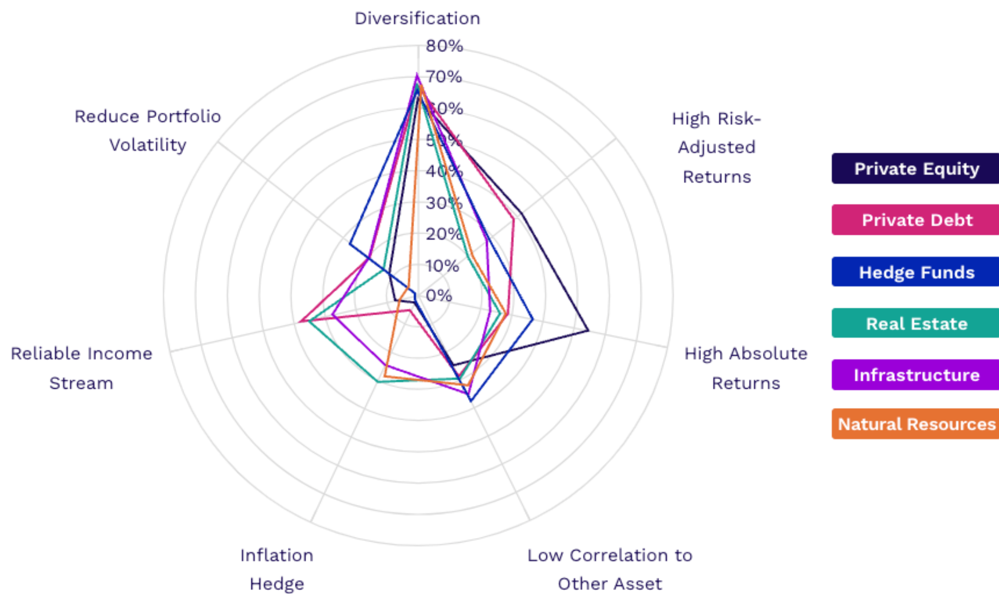


(Source: ASISA, Fairtree. March 2024)

Why invest in hedge funds?

The benefits of investing in hedge funds vary by strategy. For example, equity strategies can provide high returns driven by a manager's ability to pick stocks with lower exposure to market risks. By contrast, macro strategies offer investors diversification benefits as managers operate across multiple markets. As the industry has evolved, so too have the reasons for investing in hedge funds. The most frequently sighted benefit of investing in hedge funds is the uncorrelated nature of the return series, which in a wider portfolio construction adds a diversification benefit to an overall portfolio, thereby improving portfolio risk-adjusted returns.

Why investors invest in asset classes



(Source: Preqin. Data as of December 2022)

Building a case for hedge funds

For most of the previous decade (2010-2020), the hedge fund industry generally faced headwinds to generate alpha as subdued volatility led to fewer trading opportunities and a near-zero interest rate environment hindered the process of asset price discovery, essentially driving market returns through Beta exposure. Following the global financial crisis (GFC) of 2008-2009, low inflation and meagre economic growth led to dovish global monetary policies and more generous fiscal policies. As a result of 'easy money' and historically low interest rates, volatility was dampened in most asset classes.

Since the pandemic in 2020, there has been a material increase in inflation that has led to a mostly coordinated attempt by central banks to raise interest rates, which has had the expected effect of increasing volatility across most asset classes. While interest rates and volatility are certainly higher now than in the decade following the GFC, they are reasonable when measured against longer timeframes. Will the world return to an environment of low inflation, low interest rates, and low volatility, or are we heading for a new macro paradigm of "higher for longer"? We have witnessed several structural factors stemming from policy choices that will lead to sustained higher inflation, rates and volatility over the medium to long term.

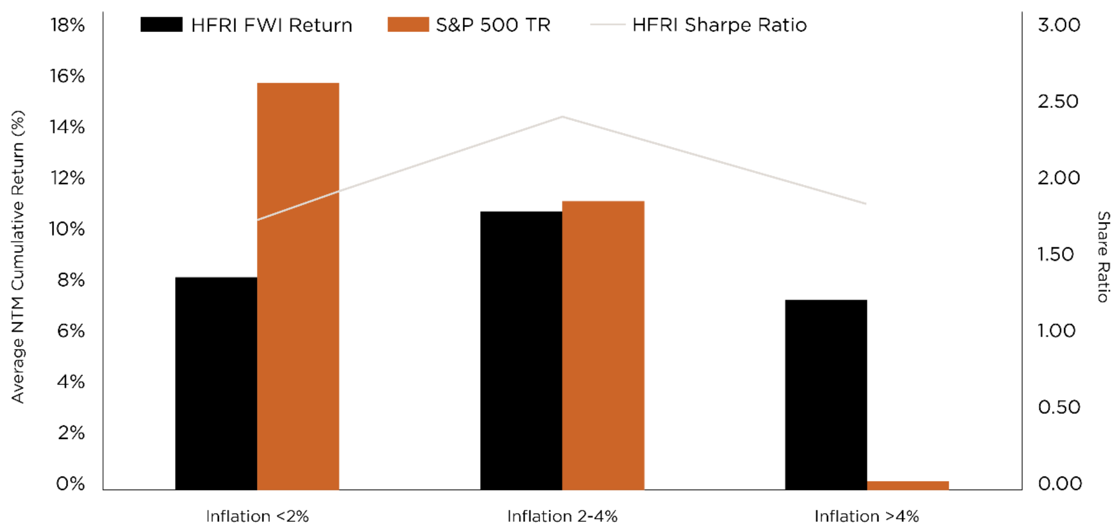
Central banks, although successful in keeping inflation at and below target levels during the prior decade, were wrong in characterising the post-pandemic inflation surge as “transitory” and late in responding to it, with monetary policy setting moving from being proactive to reactive. Even today, central banks are discussing oncoming rate cuts while inflation remains significantly above target levels. On the other hand, fiscal policy has become more proactive and less austere, evident through fiscal policy expansion while the Fed was tightening. Foreign policy has also played a role in that it has become more nationalistic. Trade tariffs and sanctions against major economic and political powers have accelerated the deglobalisation process, forcing major trading partners to rethink production processes and supply chains, often at a higher cost. Policies to decarbonise and greenify the global economy will lead to higher demand for key commodities, including copper, oil and steel, and electricity demand. Some of these commodities have experienced a slowdown in investment and face a tight supply outlook. Finally, shifting demographics could lead to a higher inflationary world as the global share of consumers rises relative to the share of producers.

Productivity gains from artificial intelligence (AI), immigration influx, and China's excess production capacity may mitigate price pressures. However, it’s too early to judge if these trends will be sustainable and structural in nature.

During periods of elevated inflation, central banks are mandated to bring consumer prices down to their target rate. As a result of tightening monetary policy, interest rates typically increase, causing a repricing of assets across markets. These changes, in turn, introduce opportunities due to dislocation and dispersion, on which astute hedge fund managers can capitalise. The "higher for longer” macro-outlook has already been adopted by market participants, with the market pricing the terminal rate over the next three years to reach 4% around June 2026 before rising again. The Fed’s estimate of the neutral rate has remained close to 2.5% (the rate at which the economy will maintain full employment and target inflation), but we are seeing early signs that it may rise over coming quarters.

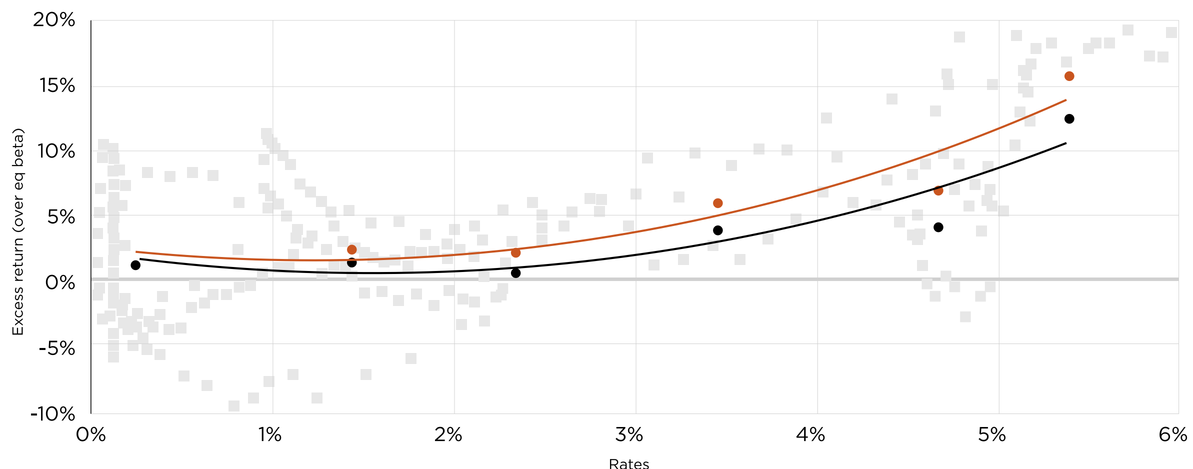
Historically, when equity and fixed income volatility has increased, hedge fund alpha generation has improved. Since 1990, across periods of above-average inflation, hedge funds generated an annualised return of 7.1%, above public equities and traditional fixed income, which generated 3.4% and 4.0%, respectively.

Hedge fund outperformance in higher inflationary environments



(Source: Bureau of Labour Statistics, Bloomberg, HFRI, analysis from 1990 – 2022)

Excess hedge funds return during different rate regimes

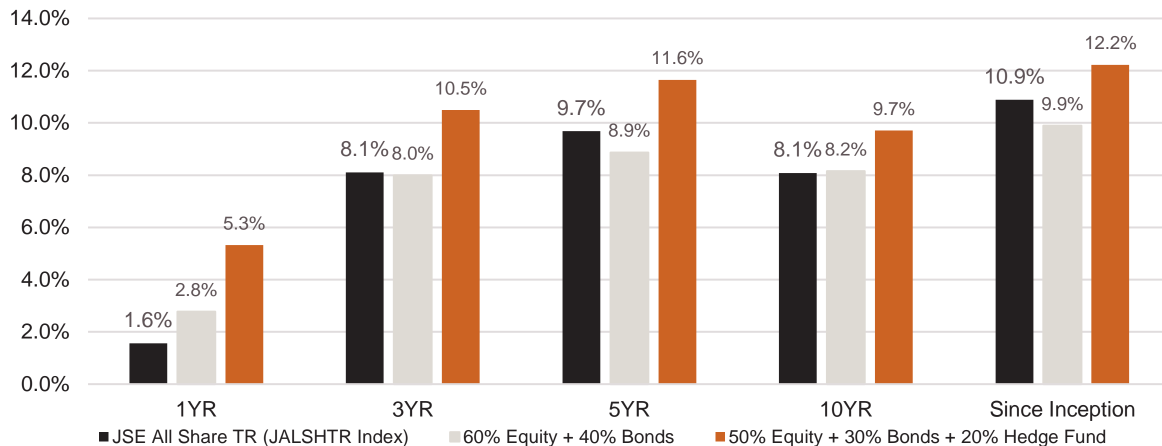


(Source: J.P Morgan AM, Jan 2023, net of fees. Approximation as % over equity beta. Treasury bill returns monthly averages)

Hedge fund exposure on a portfolio level

When considering investing in hedge funds, the question should be asked in conjunction with overall portfolio construction. However, it is important to understand whether the allocation adds value over time (whether increased return, and/or increased diversification, and/or drawdown management) or if it merely increases overall portfolio costs. We investigated this question by using the historical data of a longstanding in-house multi-strategy hedge fund as a proxy for the broader hedge fund universe, the JSE All Share Total Return Index (JALSHTR), and the JSE All Bond Total Return Index (ALBTR). We compared a traditional 60/40 “Balanced Fund” (equities and bonds) to a portfolio which includes a 20% exposure to hedge funds (i.e., 50% equity, 30% bonds, 20% hedge fund). Over every time period, the portfolio with hedge fund exposure outperformed both the JSE All Share and the balanced portfolio, and since inception (Aug 2010) cumulatively by c.120% over the entire period (end of March 2024) as performance compounds (to note, after all hedge fund fees).

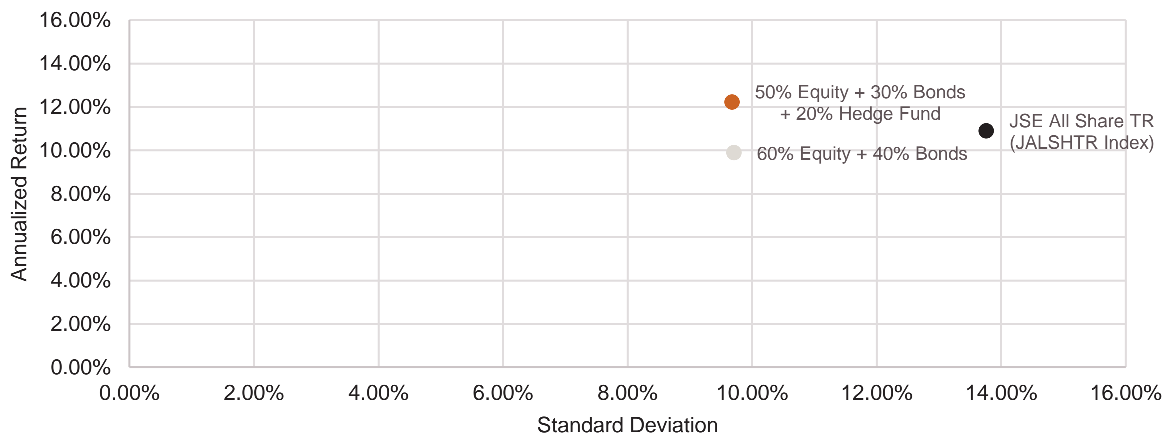
Impact of adding hedge fund exposure to a portfolio



(Source: Fairtree, Bloomberg. March 2024)

In addition to the return outperformance, we also tested the common misconception that adding hedge funds exposure would add an additional layer of risk. Continuing from the above example test case, the portfolio with hedge fund exposure would have generated both lower volatility (standard deviation) and a smaller maximum single point of pain (max drawdown). Depicting this visually and as a concluding summary, the portfolio with the hedge fund exposure would have delivered the highest return at the lowest risk.

Higher returns at lower volatility



(Source: Fairtree, Bloomberg. March 2024)

Conclusion

Ultimately, each investor needs to determine their level of risk tolerance and ultimate investment return expectations given their investment duration timeline. However, over time, hedge funds have proven to be adept at generally increasing overall portfolio performance, and given the current “Sea change” rate environment we find ourselves in (à la Howard Marks) perhaps the time has come for retail investors to ask whether it is the right time to navigate course towards adding hedge fund exposure to a diversified portfolio.

Glacier Research would like to thank Kurt van der Walt and Micheal-John Dippenaar for contributing to this week's *Funds on Friday.*

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MCom (Financial Risk Management), CFA

Kurt van der Walt started his career in 2009 at Swiftcover Insurance in London (Division of AXA Insurance, UK) as a quantitative pricing analyst in the actuarial team, where he was responsible for pricing models and systems automation. Kurt then joined a London-based quantitative high frequency trading hedge fund, GSA Capital, as an analyst supporting the Treasury, System Automation and FX Trading functions. Upon his return to South Africa, Kurt worked as a hedge fund analyst at RisCura Analytics before joining Fairtree in 2013. Kurt is the Portfolio Manager of a range of multi strategy hedge fund portfolios, as well as being responsible for Risk Management and Quantitative Risk Modelling across the business.

Micheal-John Dippenaar
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BCom Hons (Financial Analysis)

Michael-John (MJ) is currently part of the Multi-Strategy Hedge Fund team, responsible for asset allocation across a range funds. MJ obtained his BCom (double major in Investment Analysis & Financial Management) from Stellenbosch University in 2015 and subsequently his BCom Honours in Financial Analysis in 2017. In 2016 he attended the Summer Institute for General Management at Stanford Graduate School of Business. MJ joined Fairtree in 2019, forming part of the Real Estate Private Equity, and Operational Real Estate teams, based in SA and the UK. MJ was part of the team co-responsible for deal origination, financial analysis, due-diligence, structuring, and reporting, and lead the group's capital expenditure analysis on existing properties. Prior to this, MJ gained valuable experience in private markets and venture capital, raising capital from private and corporate investors, and co-founded a technology start-up in South Africa.

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