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HEDGE FUNDS ARE EXPERIENCING A RENAISSANCE

Hedge funds are coming back in style. Having faced an extended period of low investor confidence and net capital outflows, the hedge fund industry is now experiencing a renaissance.

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The most hated bull market in history

Nearly every business and investment discussion include an update on just where are we in the business cycle. Is the cycle long in the tooth and likely to soon see the wheels come off a near-record long US economic expansion and equities bull market? Alternatively, perhaps the recovery from the great recession and financial collapse was so slow and liquidity-driven that historical measures of cycle maturity are inappropriate. Many are concerned about a flattening Treasury yield curve—a classical signal of late cycles—even as other economic vital signs remain robust and healthy.

The passive investment industry has terrific momentum right now with inflows seemingly breaking records daily. Of course, passive index funds are attractive because they are low cost. Since the global financial crisis, buying the index has paid-off handsomely because the economic and monetary environment was very supportive. In this backdrop of "free money", equity markets have climbed and climbed, and investors have piled more and more money into the same stocks; this is a potentially toxic combination because naïvely buying an index is not investing based on fundamentals. It is speculating, pure and simple.

The "most hated bull market in history" has been driven mainly by extraordinary accommodative monetary policy globally. That particular cycle has ended, and we now face a host of different challenges that will be propelled by an unwinding by the Federal Reserve, higher interest rates and rising inflation (not to mention the potential for Trump-inspired trade wars and geopolitical risks). With so much entrenched uncertainty right now, we think that an absolute return strategy is a sensible route for investors.

There is a significant correlation between the length of the bull market and the severity of the losses in the first year immediately following its end; typically, the longer the bull market, the higher the losses. While the declines do vary greatly, the average loss in the year following the end of a bull market is -16% (S&P 500). Therefore, when this particular bull market ends, it is sensible to assume that the loss will be higher than the average loss.

It's difficult to make money on shorts when markets are rising in unison

We are at an advanced stage of the economic and market cycle and it is therefore normal for investors

to seek greater diversification on asset classes that are less tied to price lists. In fact, hedge funds aim to protect capital, offering asymmetric returns compared to the main asset classes. Moreover, because of the expansive monetary policies that have lasted for years and low yields, the bond universe offers limited opportunities and, on the contrary, could be vulnerable in the event of increases in interest rates that are more sudden than expected. Hedge funds are therefore proposed as an alternative for investors looking for higher returns without wanting to increase the equity component.

Hedge funds are often constructed with expectations of performing well whether broader markets rise or fall. Hedge funds usually shine brightest when volatility is high and global markets aren't trading in sync—that's when active managers may have the most impact on generating returns. When global markets correlate, it's harder for active managers to outperform their benchmarks.

Some hedge funds take positions that aim to limit downside exposure. Those have a cost, like an insurance policy, and don't pay off in rising markets. Other funds take short positions in investments they expect to fall in price. It's difficult to make money on shorts when markets are rising in unison. These conditions are changing. Since the US presidential election in late 2016, while broad market indices have been heading higher, individual securities have posted a wider range of returns, allowing some hedge fund managers to seize opportunities.

Rebound in hedge fund performance

Last year brought a rebound in hedge fund performance and 2018 continued that trend. While volatility was near multiyear lows at the start of the year, macroeconomic factors—like rising global inflation, increased political uncertainty and divergent monetary policies—have contributed to increased volatility and lower correlation levels between individual securities.

Both can be positives for hedge funds. Now that the "melt up" environment appears to have subsided, we believe hedge funds will have the opportunity to produce attractive results from both long and short positions. As always, manager selection will remain a critical component in allocation decisions as there will likely be greater dispersion among returns due to an increase in volatility as the market cycle progresses.

Experience shows that, in the previous cycles of US rate hikes (1994-1995, 1999-2000 and 2004-2006), hedge funds proved to be the most performing asset class, offering a valuable complement to traditional investments in stocks and bonds. As part of a well-diversified portfolio, alternatives can help reduce volatility and offer returns that are less correlated with market performance.

Within the different hedge funds strategies, we continue to favour long/short equity funds. While they faced months of challenging transversal stock rotations, we expect their environment to improve for several reasons. First, the peak in the economic momentum suggests that future stock rotations could be more macro/cyclical driven.

These are easier to capture for such funds. Second, the return of volatility is a strong positive, the lack of which plagued the strategy for months while forcing to raise leverage. Third, after moving in a pack, the differentiation across quant factors is resuming. Fourth, the lack of rationality, visible over the last EPS seasons, between stock returns and the quality of their earnings, is unlikely to repeat. Finally, we see more short opportunities, a noticeable improvement for neutral styles.

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