2022 Market Outlook

Hedge Funds in 2022: Changing With Changing Risk

In 2022, we believe the most notable trends will be the continuation of ones that gathered strength in 2021: Higher volatility levels in both the equity and fixed income markets leading to wider dispersion in performance of stocks, bonds and off-the-run investment opportunities. The main volatility drivers were—and continue to be—the triumvirate of headlines that became all-too-familiar: Tightening of monetary policy by the U.S. Federal Reserve, increasing inflation, and the uncontrolled growing spread of COVID-19. Hedge funds performed well through this volatility (Display 1).

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Risk management seen as key to hedge fund success in 2022

In contrast, risk markets in prior years were mostly driven by accommodative Fed policy and fiscal stimulus, creating an ideal environment that lifted all boats and beta returns. Hedge funds, which limit market risks and seek to generate alpha, underperformed.

But rising volatility and performance dispersion create a fertile field for hedge fund managers, who found their footing again in 2021, as shown by alpha production in Display 2. The rolling two-year average annualized alpha has been positive all year and is the highest it has been since January 2018. One needs to go back to August 2011 to find prior periods of such strong and consistent alpha production.

The changing nature of risk

We believe that the biggest challenge to hedge funds in 2022 will be the changing nature of market risk. Hedging unwanted market exposure has always been key to protecting alpha, but doing so has become more complicated and nuanced.

For example, the impact of “risk on/risk off” episodes has typically been effectively hedged with the S&P 500 Index, largely because factors like growth, momentum and value have had reasonably consistent—and predictable—performance during such periods.

But the same has not held for “COVID on/COVID off” episodes. Investors have had to rapidly switch between the prospects of the economy opening up and shutting down, and the related impacts on stocks from labor shortages, supply chain dynamics and so forth. Performance factors underwent large
shifts in direction and magnitude, and as a result, the S&P 500 became too blunt a tool for hedging in that environment. Factor exposures associated with hedge funds have been behaving very differently than the market, as can be seen in the last few days of November 2021 (Display 3).

The Omicron scare
We saw the impact of this in the wake of the Omicron scare of November 2021, when managers with good security selection lagged the quick rebound in the S&P 500. For effective risk management, managers have to know how a basket of principal factor risks maps onto their portfolios. Many clearly didn't have a refined understanding of this “map” in the evolving COVID on/COVID off world, which likely led to overhedging or other uneven factor exposures.

Another clue comes from the relative performance of classic long/short managers in comparison with multi-portfolio manager platforms. We believe that the multi-PM platforms generally can have a structural advantage for risk management.

Assuming the platforms devote sufficient resources and expertise to that function, they potentially can manage risk across more dimensions and continually develop the map connecting factors to positions. Even after accounting for their higher-cost pass-through structure, the after-fee results of the Platform Peer Group (Display 4) and their respective investment profile compare favorably.

COVID is hardly the only likely source of volatility in 2022. The Fed’s tapering is potentially a major source, given the conflicting currents the central bank may have to navigate, with inflation prints coming in over 6% and the 10-year U.S. Treasury around 1.5% as of December 2021. An accelerated tightening policy could slow growth, especially if there is a parallel drag from COVID developments, and no one—including the Fed—really knows the optimal rate level for slowing inflation without harming the recovery.

The economy has been shaped by super-easy money for a long time. Even an increase of 75 basis points in 2022, as contemplated by the Fed, is a big adjustment, and it is a big leap of faith to assume it will be a smooth one.

Implications for 2022
Our outlook for more volatility and dispersion in performance for 2022 has a number of implications:

• SECURITY SELECTION is likely to play a larger role in alpha generation, given the expected start/stop nature of the markets and related choppiiness that is likely to disrupt sector trends and broader thematic investing. By the same logic, the intrasector opportunity set looks promising as a source of idiosyncratic return independent of

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1 Normalized returns is the statistical process of standardized returns by using the prior 22 trading day returns to calculate the average and standard deviation and applying the Z-Score = (x-average)/standard deviation methodology.
COVID on/COVID off, inflation or other macro influences. As noted earlier, long/short strategies that are supported tightly by risk management, tend to preserve alpha better (Display 4).

- **DIVERSIFICATION OF ALPHA SOURCES** becomes especially important because dispersion is a double-edged sword that increases both the number of opportunities and the chance of bad calls. Controlling intermanager correlations is critical—it ensures risks do not overlap and helps minimize losses from bad calls.

- **PROMISING STRATEGIES** for us include global macro, with managers agile enough to capture the value of the cross currents in today’s environment, with a short-term, tactically oriented approach.

Select commodity strategies fall in this category, such as taking advantage of quick-shifting currents in supply and demand in metals, livestock and agricultural markets, or even relative value trading in the oil markets between West Texas Intermediate and Brent Crude. However, pure price moves are only part of the story, as specialists can also maximize calendar spreads, contract rolls and physical delivery features.

Less appealing strategies include long-bias credit risk, where spreads are at historically tight levels, and mortgage arbitrage—a sector hindered by a limited upside and the fact that duration typically lengthens as rates rise.

- **USING HEDGE FUNDS AS DIVERSIFIERS** in classic 60/40 stock/bond portfolios can help address a fundamental problem with bonds in 2022: Most fixed-income sectors are long duration. For example, with a duration of 6.6 years, the Bloomberg Aggregate Index would lose over 6% of its value with each 1% increase in rates, and would be unlikely to provide much of a hedge for equities in that scenario. As absolute-return vehicles, hedge funds typically have a low beta to equities and rates, and thus may be an attractive hedge complement for bonds in 2022.

- **CRISIS RISK OFFSET STRATEGIES** deserve consideration by investors seeking protection from tail risk events. Such hedging strategies seek to deliver positive returns during loss scenarios while reducing outright costs in normal markets. They can also provide the requisite diversification needed to allow for continued exposure to desired risks. Some risk offset programs are designed to even provide liquidity during times of significant market crisis.

**Changing with changing risk**

The volatility and dispersion of returns we expect in 2022 suggest that security selection will be a key driver of returns. But this environment will demand more from managers. We believe success will also require sophisticated portfolio construction, supported by a nuanced understanding of hedging as factor exposures change in the COVID on/COVID off world. In our view, investors would benefit from considering hedge funds constructed with diversified alpha sources and a strong risk management process.

### Display 4

Multi-PM platforms have outperformed classic long/short hedge funds.

**Last 5 Years (ended November 2021)**

<table>
<thead>
<tr>
<th>PLATFORM PEER (&gt;$10B AVERAGE)</th>
<th>HFRI EQUITY HEDGE (TOTAL) INDEX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return</td>
<td>11.7%</td>
</tr>
<tr>
<td>Volatility</td>
<td>5.2%</td>
</tr>
<tr>
<td>Sharpe</td>
<td>1.93</td>
</tr>
<tr>
<td>Annualized Alpha</td>
<td>9.1%</td>
</tr>
<tr>
<td>Beta</td>
<td>0.06</td>
</tr>
</tbody>
</table>

DEFINITIONS

HFRI Equity Hedge (Total) Index: Investment Managers who maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. EH managers would typically maintain at least 50% exposure to, and may in some cases be entirely invested in, equities, both long and short.

HFRI Event-Driven (Total) Index: Investment Managers who maintain positions in companies currently or prospectively involved in corporate transactions of a wide variety including but not limited to mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated, and frequently involve additional derivative securities. Event Driven exposure includes a combination of sensitivities to equity markets, credit markets and idiosyncratic, company specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative), with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

HFRI Fund Weighted Composite Index (“HFRI Fund Weighted”): The HFRI Fund Weighted Index is a global, equal-weighted index of single-manager funds that report to HFRI Database. Constituent funds report monthly net of all fees performance in USD and have a minimum of $5 million under management or $10 Million under management and a twelve-month track record.

HFRI Macro (Total) Index: Refers to the HFRI Macro (Total) Index, sponsored by Hedge Fund Research, Inc. Macro funds trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity markets.

HFRI Relative Value (Total) Index: Investment Managers who maintain positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative or other security types. Fixed income strategies are typically quantitatively driven to measure the existing relationship between instruments and, in some cases, identify attractive positions in which the risk adjusted spread between these instruments represents an attractive opportunity for the investment manager. RV position may be involved in corporate transactions also, but as opposed to ED exposures, the investment thesis is predicated on realization of a pricing discrepancy between related securities, as opposed to the outcome of the corporate transaction.

Sharpe Ratio: a risk-adjusted measure developed by William F. Sharpe, calculated by dividing the Fund’s excess return relative to the risk-free rate (defined as the rate of return of the Citi Three-Month U.S. Treasury Bill Index) by the standard deviation of the Fund’s return.

Volatility: A statistical measure of the tendency of a market or security to rise or fall sharply within a period of time – usually measured by standard deviation.

Alpha: The excess return of an asset not explained by systemic (market) risk.

Beta: Represents the Fund’s volatility relative to the market. A statistical measure of the tendency of a market or security to rise or fall sharply within a period of time, usually measured by standard deviation. Higher levels of volatility correspond with higher levels of risk. See also Standard Deviation.

RISK CONSIDERATIONS

Investing entails risks and there can be no assurance that any strategy will achieve profits or avoid incurring losses.

Persons considering an alternative investment should refer to the specific fund’s offering documentation, which will fully describe the specific risks and considerations associated with a specific alternative investment.

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