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Volatility is Back: The Case for Hedge Funds Now

After a decade of relative market stability, volatility is back, and it looks like it's here to stay. In early 2020, the COVID-19 crisis drove the S&P 500 to a -34% loss and fueled a subsequent rollercoaster that led to all-time highs, sharp drawdowns and deep uncertainty. Since that time, numerous extraneous factors have contributed to sustained volatility in the markets, from political instability to short squeezes, mania around cryptocurrency, and increased IPO activity as a result of SPACs. Regardless of the catalyst, one thing is clear: heightened volatility is likely to be a mainstay in the markets for the foreseeable future.

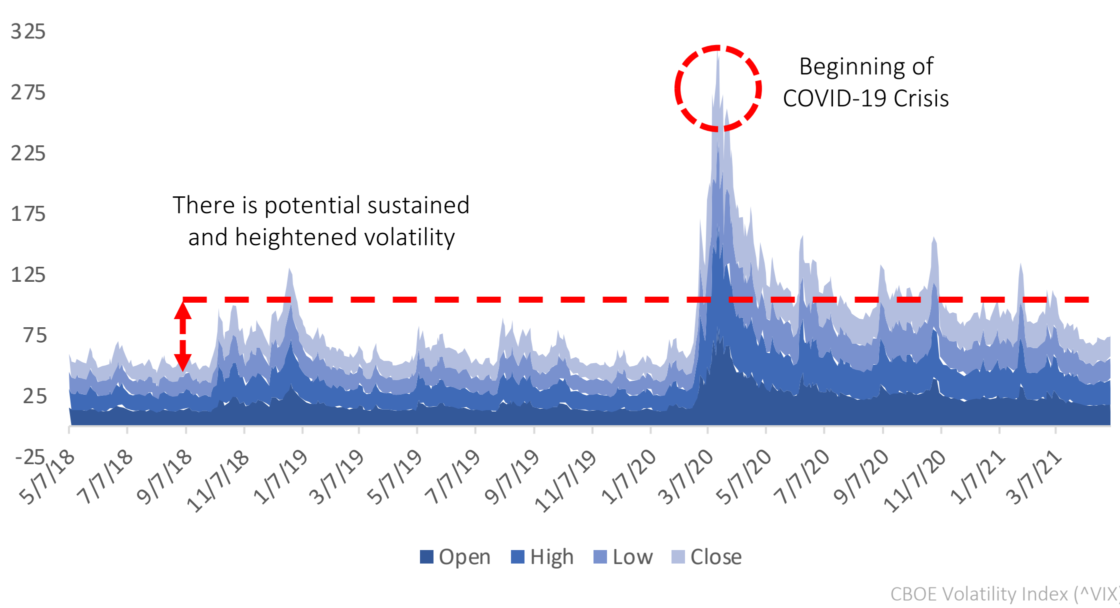
And that has reignited investors' interest in hedge funds. In addition to heightened volatility, this renewed interest has come along with extremely low interest rates and higher valuations in equity markets, a dynamic that does not seem to be abating. Investors recognize that hedge funds can play an important role in their portfolios due to the potential to provide downside protection and dampen volatility; typically coupled with an uncorrelated return stream, hedge funds often offer an attractive risk/reward profile. Hedge funds, by their very nature and naming convention, imply a hedge against risk—and investors generally expect some level of positive absolute return with downside risk control.

The challenges facing global markets since Q1 2020 have highlighted the advantage of hedge funds and have reinforced why investors were originally attracted to the asset class. Historically, during times of average or higher than average volatility (as measured by the S&P 500), hedge funds have done very well, and the reverse has typically been true during periods of lower volatility.

A higher-volatility environment works well for hedge funds, making them an important—and effective—option for investors looking to generate upside while maintaining a defensive posture during more difficult markets.

The chart below demonstrates the volatility environment that had characterized the past decade—which largely had been a detractor from hedge fund performance—versus the current environment, which has seen increased levels of volatility. The COVID crisis drove volatility to new heights, and we may now see an extended period of sustained higher volatility in the markets. That should bode well for hedge fund returns.

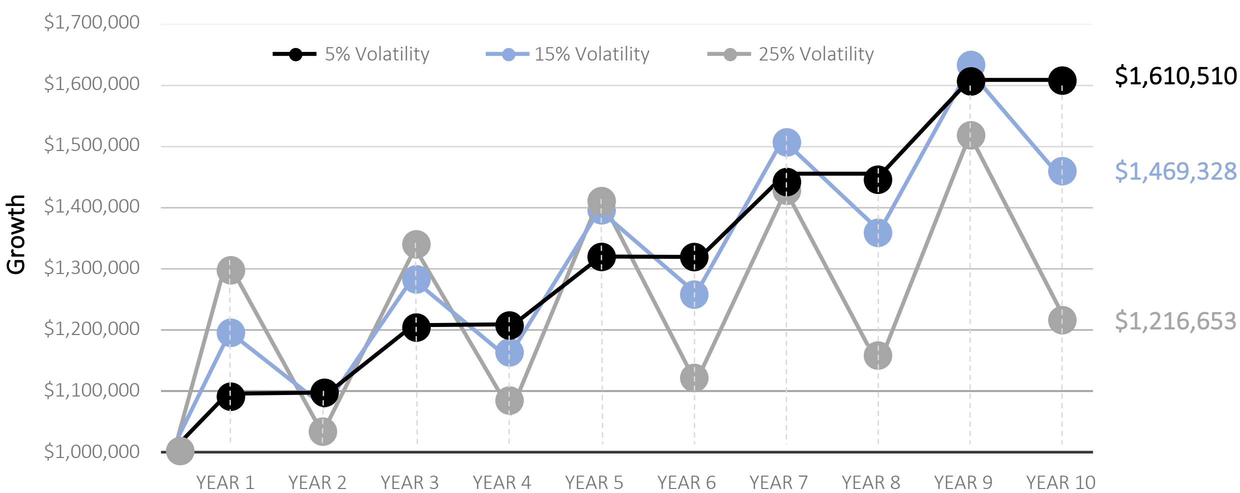
Hedge Funds as a Portfolio Ballast During the Initial COVID-19 Crisis



This higher-volatility environment raises the question of how best to deal with volatility in the form of real returns for a portfolio. It is often useful to think about this in the context of an elementary consideration: compound interest. Albert Einstein has been credited with stating "The strongest force in the universe is compound interest." He may well have been right, as the benefit of compounding on the upside can be material over time; however, what is often overlooked is that compounding in negative space can materially detract from long-term returns. Therefore, it is critical to attempt to manage the volatility that is present in a portfolio. Hedge funds can help.

As expressed below, the growth of a $1 million portfolio is shown over a 10-year period. That portfolio is shown experiencing 5% volatility, 15% volatility and 25% volatility. The results are striking. Over time, a lower volatility portfolio produces the greatest real returns with a much smoother ride and nearly three times the annualized returns of the highest volatility portfolio. Though higher volatility portfolios see excellent returns in some years, strong downcycles significantly inhibit long-term growth. Minimizing the duration and magnitude of any downward volatility, therefore, also decreases the impact of any market drawdown to your portfolio returns. This is critical to long term success.

Volatility Can Detract from Long-Term Returns



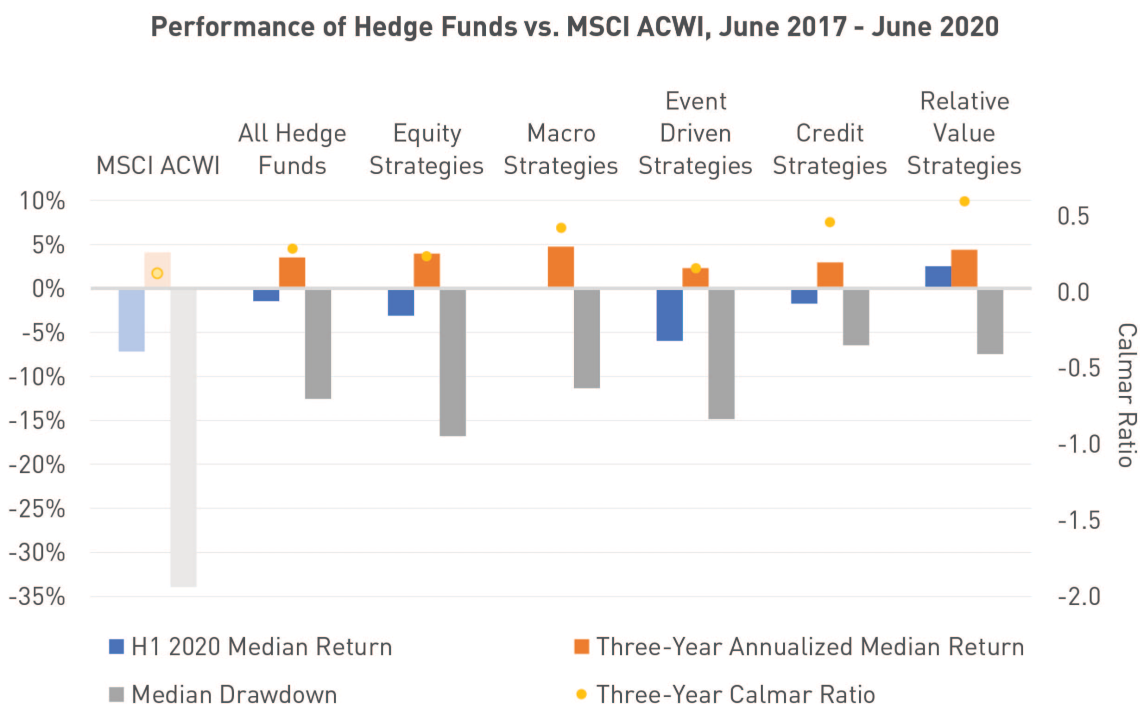
Source: Morningstar Direct

History repeatedly shows that while equity markets can trade above average levels of valuation for long periods of time, markets can also experience significant volatility that takes them well below these averages—often without much warning. Abrupt downside volatility, the likes of which we are experiencing today, poses a challenge to investors allocating solely to traditional asset classes. Hedge funds' "edge" versus conventional money managers is their ability to: 1) concentrate positions in highest-conviction ideas, 2) express those ideas long and short, and 3) actively manage exposures to dampen volatility and mitigate the downside. In short, hedge funds make a lot of sense!

Periods of market dislocation showcase the value that hedge funds can provide as a diversifier and an asset class that potentially provides an "anchor to windward" during periods of extreme market stress.

The chart below contrasts the downside volatility of hedge funds against that of the MSCI All Country World Index from 2017 through the first half of 2020, including the onset of the COVID crisis. It is noteworthy that the median drawdown for the MSCI ACWI is about twice as much for that of the nearest hedge fund, and multiple times that of other hedge fund strategies like Relative Value and Credit strategies. That level of protection during market stress is critical to helping a diversified portfolio weather periods of heightened market volatility.

Hedge Funds Limit Downside Volatility



Source: Preqin Pro

According to Eurekahedge, "more than 90% of the hedge fund managers were able to outperform the global equity market during the month of March 2020, exemplifying the downside protection afforded by hedged strategies as opposed to long-only portfolios."

Though hedge funds typically showcase their advantage during periods of market stress, over time their returns have also been commendable—often generating alpha in bull markets. While they can help protect from larger losses in down markets, they can also capture a notable amount of the upside during market rallies. As a result, hedge funds can often provide superior risk adjusted returns over time.

Conclusion

Hedge funds can play an important role in a well-diversified portfolio, providing differentiated returns and limiting downside volatility. The headwinds that many hedge funds faced over the past decade have begun to reverse, with renewed volatility potentially jumpstarting a multi-year tailwind for the space. Volatility has two sides, however, and investors must seek to participate in the upside while protecting on the downside. Add to this historically low interest rates, continued economic uncertainty and high valuations, and hedge fund exposure may be more important than ever.

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