June 2020

The Real Value of Hedge Funds Today

By Dixon Boardman

COVID-19 has dominated the news over the past few months, triggering immense volatility and market disruption as the world shut down and subsequently started to reopen. In fact, this is the most volatility and uncertainty that I—and many of my colleagues—have seen in some time. I believe that markets will remain very unsettled for an extended period of time.

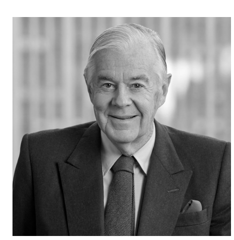
Because hedge funds (or at least certain types of hedge funds) historically have provided diversification and dampened the downside during times of volatility and uncertainty, I believe that the role of hedge funds is more important than ever.

The past 10 years were a period of relatively low volatility characterized by liquidity-driven momentum and low interest rates. This pushed investors to embrace greater and greater risk by piling into technology growth stocks: in particular the ascendant FAANG stocks (Facebook, Amazon, Apple, Netflix and Google), whose combined market value is now in excess of $3 trillion. Given their size and strong growth, these stocks accounted for a significant portion of the equity markets gains.

These conditions were not ideal for hedge funds which, by definition, aren't long-only; they're long and short, and the short side was particularly difficult over the past decade. For that matter, the long side was also challenging, as stock picking—and value investing in particular—lagged relative to the indices, which were dominated by growth stocks in the technology sector. Those hedge funds that were long the FAANGs often outperformed, and those that were not, didn't. Though hedge funds generally underperformed the indices during this period, by and large they did make money for investors—just not as much money as the indices. This wasn't just a hedge fund problem—it's worth noting that many long-only managers underperformed the indices, as well!

Now, I believe that this cycle is changing.

Dixon Boardman is the Founder and Chief Executive Officer of Optima and the Vice Chairman of the Forbes Family Trust. Since 1988, Optima has been a pioneer in the hedge fund space, navigating across diverse market environments while provided its clients access to differentiated opportunities. Optima's partnership with the Forbes Family Trust brings together award-winning expertise, experience and innovation to alternative investments.



In addition to heightened volatility in the markets, we are seeing certain managers who were invested in the FAANGs beginning to strategically reallocate toward value stocks, signaling a potential new cycle of greater volatility and differentiation among stocks. In conditions like these, hedge funds should be able to add more value than they have over the last decade. The wind may finally be at their back.

However, there are hedge funds and there are hedge funds—they encompass a wide range of strategies, from very defensive market-neutral funds to highly aggressive macro traders. Not surprisingly, recent returns have varied widely within the hedge fund industry, especially given how extraordinary the behavior of the equity markets has been over these past few months. We have witnessed an unprecedented and precipitous decline—the fastest in history—followed by an equally sharp rebound. This whipsaw action of the markets has been a challenge not just for hedge funds but for all asset managers.

Looking forward, it's incredibly difficult to predict the next move in the markets because the range of potential outcomes is quite wide—the global economy has not faced such a pandemic in 100 years. My friend, Howard Marks, put it quite well: "These days, everyone has the same data regarding the present and the same ignorance regarding the future."

So, how do we at Optima treat this heightened uncertainty? To start, we have re-doubled our efforts in due diligence, research and analysis. In my role, it's critical to be highly selective about managers and to have a very real understanding of their ability to manage risk. This is a corny phrase, but I use it all the time: "There are old pilots, and there are bold pilots, but there are no old, bold pilots."

Nevertheless, we also believe that volatility creates investment opportunities. One strategy that makes sense to us in this environment is a well-diversified mix of macro and market neutral strategies, which can produce stable, meaningful returns. Hedge fund strategies like this might bring you mid to high single-digit returns with low standard deviation: which is especially attractive given the low yields on U.S. Treasuries. Though this may not be the first strategy that comes to mind when one thinks of hedge funds, it is an area where I see real need—and potential for success.

I also believe there are several attractive niche opportunities. Long-short specialists with expertise in healthcare should be well positioned regarding the opportunities in the wake of COVID, and continued economic growth in China and India is expected to be favorable for managers who focus on the region.

In my opinion, this should be a golden age for hedge funds. At a time when extraordinary market volatility and uncertainty demonstrate the increasing need for alternatives, we are well positioned to help investors move forward with confidence.

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