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First Quarter 2014

Hedge Fund Update

Market Results

First quarter results for most equity markets were generally positive, if muted, but the seemingly benign final numbers understated a relatively turbulent first quarter. Most major equity markets opened the year with a meaningful drawdown but snapped back aggressively in February. March produced modest returns in total, but under the surface there was an aggressive rotation away from growth and into value.

The Russell 2000® Growth Index was down 2.5% in March while the Russell 2000® Value Index was up 1.2%. For the S&P 500 Index, specific sectors that suffered during the month were consumer discretionary (-2.8%) and health care (-1.3%), while consumer staples (2.3%) and financials (3.2%) rallied. It's been very difficult to pinpoint a clear catalyst for the rotation from growth, but suggested causes include Federal Reserve Chair Janet Yellen's comments on inflation, unrest in Ukraine, and increasing evidence of a slowdown in China. Others pointed to inflated valuations in "new" technology and biotech and/or profit taking after a strong 2013. As of mid-April, the market shift appears to have been largely technical in nature as thus far earnings season has produced solid results and markets have stabilized.

Long/Short Hedge Funds

While the exact cause of the market rotation is unclear, what we do know is that hedge funds as a group were disproportionately hurt during March. The S&P 500 Index was up 0.8% but the HFRI Equity Hedge (Total) Index was down 0.3%. One subset of the hedge fund ecosystem—Tiger-related funds—had a very challenging month as a sample of 37 cubs and seeds were down an average of 3.1%.

Since the start of the post–credit crisis bull market, growth has outperformed value on a total return basis by nearly 25 ppts, so it is not surprising that some hedge funds had begun to acquire more growth names. Additionally, many of the "pricey momentum" stocks that had outstanding year-over-year performance heading into March suffered meaningful losses during the month. Holding these types of momentum stocks was one of the reasons that the Tiger complex was disproportionately hurt during March. When looking at a list of the 20 most popular Tiger Cub holdings, the median stock outperformed the broader S&P 500 by 26% over the trailing 12 months to February 28, 2014.[1] However, the median return for that same list of stocks in March was -6%.

While Tiger-related funds did suffer in March—and received more than their fair share of coverage in the popular press—Tiger-related funds were not the only ones to suffer. Goldman Sachs maintains a VIP list that tracks the 50 stocks most important to hedge funds and in March the list's delta to the S&P 500 was the fourth largest since the 2008 crisis (the three top months were September 2008, September 2011, and November 2008).

Ultimately, long-term investors should recognize that technical corrections are short-term phenomena (and often healthy to markets) and should feel confident in their underwriting of their hedge fund

[1] Holdings based on Novus Research analysis of 49 Tiger Cubs using public filings as of December 31, 2013.

managers. Talented hedge fund managers seek out dislocations and disruptions and use volatility to position their portfolios for long-term success. Outside of truly exceptional times, we do not encourage investors to focus on monthly (and even quarterly) returns.

Diversifying Hedge Funds

The same difficult economic and financial environment that has kept returns muted for diversifying strategies continued and even strengthened over the course of the first quarter. Specifically, global yield curves flattened further (for example, the spread between 30- and seven-year Treasuries flattened 25 bps from 151 bps to 126 bps), while the VIX declined from a high of 21.44 to 13.88 by the end of the quarter and rates were placid—a 33 bp range on the US five year, which ended the quarter exactly where it started at 1.75%. This environment of low rates, low volatility, flat yield curves, and range-bound currencies has not presented opportunities to initiate strategies or profitably unwind them. Central bank buying of securities under various QE regimes is largely to blame. Fund managers state that a "return to normalcy" or even the "end of financial repression" will provide the right environment. Paradoxically, the events in Ukraine provided some brief and modest "flight-to-quality" volatility.

The very same strong trends that over the course of 2013 (USD/JPY, Nikkei, S&P) were responsible for prominent macro funds generating double-digit returns in 2013 were detractors in the first quarter. Whether discretionary or systematic, returns for macro funds ranged from -8.5% to 2.5% excluding outliers in the top and bottom 10%. For multi-strategy funds, the low level of merger & acquisition activity and "events" detracted from returns. Finally, distributions from the Lehman bankruptcy are winding down. Hence the returns for the larger multi-strategy funds have generally been flat to 4.5%, excluding outliers.

At this writing, annualized growth (GDP) in the first quarter is expected to be anemic (1.0% annualized), largely due to cold weather. However, if one believes the consensus that economic activity over the remainder of the year will dramatically rebound and pick up due to wealth effects (housing and portfolios), consumer spending, and capital investment, then even modestly higher inflation expectations will drive some "normalization" of curves, volatility, and FX relationships. Hence investors should probably view the first three months of this year as a rough patch for diversifying strategies that is not likely to continue through the remainder of 2014. ■

—Q Belk and Chuck Haigh, Managing Directors

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