1ST QUARTER ▪ 2019

HEDGE FUND UPDATE

Every major global equity market rallied during first quarter 2019, recovering much of the prior quarter's losses and reversing its sharp factor rotation and volatility spike in just a few short weeks. In response to a weakening macroeconomic picture, the US Federal Reserve indicated it would not raise interest rates for the rest of 2019, boosting the S&P 500 Index to its largest quarterly gain in a decade. Not only did the S&P 500 recover last year's losses, the index ended each of the last three months higher than it began and approached its all-time high, previously set in September 2018. In short, the market environment during first quarter 2019 was "risk-on."

The S&P 500 Index returned an astounding 13.6%, and all major market sectors were positive for the quarter. The worst-performing sectors were healthcare (6.6%) and financials (8.6%), while all other sectors produced double-digit gains. In contrast to fourth quarter 2018, small-cap equities fared better than large caps, with the Russell 2000® Index increasing by 14.6%. Similarly, growth equities outperformed value stocks by more than 400 basis points.

Emerging markets equities underperformed developed markets stocks in the first quarter, but the MSCI Emerging Markets Index still produced a gain of 9.9%, compared to increases of 12.2% and 11.0% for the MSCI All Country World Index and the Stoxx 600 Index, respectively.

Hedge funds fared well last quarter—the Hedge Fund Research Composite Index appreciated 5.7%—but could not keep pace with the popular market benchmarks, nor would we expect them to in such a bullish market environment. At a strategy level, the HFR Macro (Total) Index gained 2.6%, the HFR Equity Hedge (Total) Index increased 7.8%, and the HFR Event-Driven (Total) Index appreciated 4.2% for the quarter. According to Goldman Sachs Prime Services, returns for each of the four major fundamentally oriented hedge fund strategies (Equity Long/Short, Event Driven, Credit, and Macro) were positive in each month of the quarter across the United States, Europe, and Asia.

In the fourth quarter 2018 edition, we discussed the external factors impacting long/short equity manager performance. Our focus continues to be on fundamental equity long/short managers, but now from an internal perspective. The overall strategy performed well during first quarter 2019, capturing more than 60% of the strong gains generated by the MSCI All Country World Index. While the extreme market action of the last two quarters occurs infrequently, this type of trading environment can provide useful insight into portfolio manager behavior and psychology. Analyzing portfolio management decisions, as opposed to stock selection or external factors, though interconnected, can help improve future manager selection.

Evaluating intra-month portfolio management decisions is important in an environment where deleveraging events and factor rotations are occurring more often, and where position crowding remains elevated. If a manager did not perform as expected, why did this occur? Often, fundamental equity long/short managers that claim to be long-term investors do not behave as such. Business pressures can interfere with prudent portfolio management decision making. Business quality or team stability issues can be harbingers of future judgment errors. How long has a manager's performance been below its high-water mark? Is the business above its breakeven profitability level at the current assets under management?

Simply put, fundamental equity long/short managers should maintain stated exposure and risk parameters so they are positioned to take advantage of forced selling by other market participants. To be successful, they must maintain a consistent approach even when markets behave irrationally. Of course, six months is a short period, but extreme market environments offer a critical backdrop for revisiting and enhancing an investor's hedge fund manager selection process. ■

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