

4TH QUARTER • 2019

# HEDGE FUND UPDATE

Major global equity markets enjoyed healthy gains in fourth quarter 2019 and generated double-digit returns for the full calendar year, in stark contrast to the broad-based declines experienced in 2018. The US equity market—as measured by the S&P 500 Index—enjoyed its best calendar year return since 2013, closing 2019 just below a new all-time high set on December 29. Three 25 basis point (bp) rate cuts by the Federal Reserve during 2019 helped investors to shrug off ongoing trade tensions between the United States and China, the impeachment of President Donald Trump by the US House of Representatives, and multiple Brexit delays. As with global equities, US corporate bonds enjoyed above average returns in 2019, yet US Treasuries and gold—traditional safe havens—produced healthy gains as well, perhaps reflecting central banks' unexpected policy reversal in response to an increasingly uncertain macroeconomic backdrop.

The S&P 500 Index returned 9.1% in fourth quarter and 31.5% for the full calendar year, bouncing back from the fourth quarter 2018 correction with not a single down quarter in 2019. Last quarter, all major S&P 500 economic sectors produced positive returns apart from real estate (-0.5%). Information technology (IT) and healthcare each rallied 14.4% to pace fourth quarter sector performance, followed by a 10.5% gain for financials. Aided by its fourth quarter rally, the IT sector returned a staggering 50.3% last year, driven by the 89% surge of Apple, its biggest constituent, as growth stocks outperformed value counterparts by 959 bps last year on a broad market basis despite a brief value resurgence last quarter. Similarly, while US small caps (25.5% for the year) edged large caps last quarter, 2019 marked small caps' third straight year of underperformance.

Non-US equity markets (6.2% for the MSCI All Country World ex USA Index in local currency terms) could not keep pace with US stocks' fourth quarter run and lagged by more than 1,000 bps on the year. European equities underperformed other non-US markets last quarter but fared the best over the full calendar year: the Stoxx 600 Index appreciated 6.1% in the fourth quarter and 26.8% in calendar year 2019. By comparison, Japan's Nikkei 225 Index returned 8.7% and 18.2%, and the MSCI Emerging Markets Index gained 11.8% and 18.4% over the same periods, respectively.

Hedge fund performance also bounced back last year, finishing 2019 on a high note. The Hedge Fund Research (HFR) Fund Weighted Composite Index appreciated 3.5% during fourth quarter and finished up 10.4% in calendar year 2019. There was notable performance dispersion at the underlying strategy level last quarter, as the HFR Equity Hedge (Total) Index and the HFR Event-Driven (Total) Index appreciated 5.7% and 2.9%, respectively, while the HFR Macro (Total) Index experienced a 0.5% decline. For the full year, all three core hedge funds strategies—Equity Hedge (13.7%), Event-Driven (7.5%), and Macro (6.2%)—generated positive absolute returns in 2019 after posting losses in the prior year.

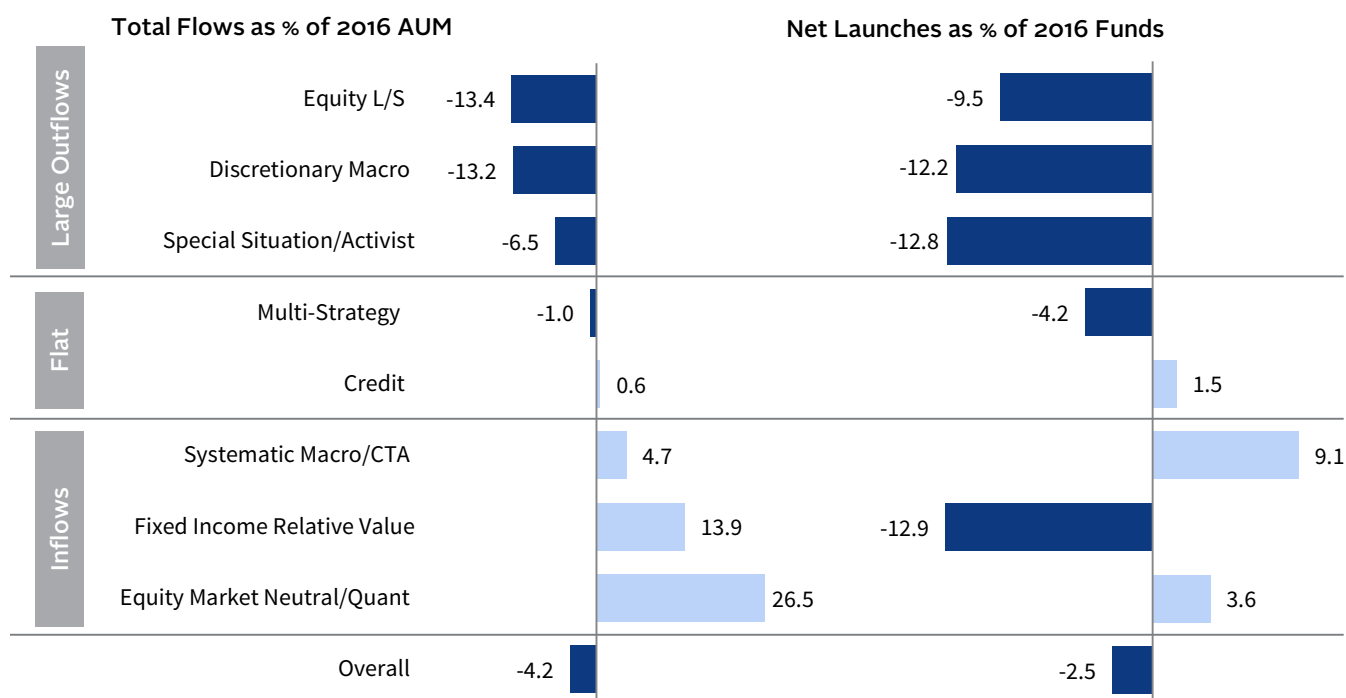
### HEDGE FUND INDUSTRY EVOLUTION

Investors should not expect hedge fund returns to keep pace with a greater than 30 percentage point gain by the S&P 500 in a given calendar year; however, hedge funds must deliver risk-adjusted excess returns (“alpha”) net of fees over a full-market cycle considering the premium fees and reduced liquidity they’ve been able to command. While hedge funds fared better in 2019, disappointing alpha generation at the overall industry level in recent years has resulted in a large disconnect between limited partners’ (LPs) performance expectations and hedge fund fees and terms.

With hedge fund alpha having steadily deteriorated this cycle, the industry has suffered cumulative net outflows since 2016, with closures exceeding launches and fundamental-oriented strategies suffering the brunt of the exodus.

### FLOWS VS NET LAUNCHES OF HEDGE FUND STRATEGIES

2016–19 • Percent (%)



Sources: Barclays Strategic Consulting Analysis and Hedge Fund Research, Inc.

Notes: Four largest strategies (Equity L/S, Discretionary Macro, Multi-Strategy, and Credit) combined represent > 75% of HF AUM. Data for 2019 are through second half 2019.

While there are several plausible explanations for why investors have been fleeing fundamental hedge fund strategies, we will highlight two very real structural reasons: (1) a smaller pool of capital mandated to invest in hedge funds and (2) the emergence of cheaper alternatives.

Many institutional investors have adopted a more holistic approach to managing their overall portfolios. Today, there are fewer dedicated pools of institutional capital whose investment policies explicitly target an allocation to hedge funds than in years past. With institutions finding more compelling opportunities outside the traditional hedge fund industry, the pie available to hedge fund general partners (GPs) is shrinking. In addition, assets managed by institutional fund-of-hedge funds (FOHF) managers are now a fraction of their size a decade ago. Many FOHF businesses have either shuttered or evolved into an OCIO or bespoke investment advisor model aimed at catering to clients looking for total portfolio solutions cutting across asset classes, investment strategies, and vehicle structures.

Given LPs' shifting total portfolio management approach, fundamental hedge fund strategies, such as equity L/S are increasingly competing with less expensive active long-only managers that have been more proactive in cutting fees, even cheaper systematic factor index products, and plain vanilla equity index beta that is essentially available for free. In many cases, the alpha generated by fundamental hedge fund strategies just hasn't been sufficiently attractive to retain investor capital.

It is true that US equities remain in the longest bull market in history, underpinned by the longest modern economic expansion, and the current environment certainly "feels" late cycle. Moreover, a large equity market correction and/or a sustained period of below average equity returns could meaningfully impair institutional portfolios, an outcome that a thoughtfully constructed portfolio of hedge funds could help to mitigate. Yet, LP sentiment toward the hedge fund industry seems at an all-time low and unlikely to recover in the near term. To combat these headwinds, GPs should consider offering LPs significant fee concessions and must also find ways to operate profitably with structurally lower assets under management. In addition, hedge fund portfolio managers need to focus their complete attention on managing risk and delivering compelling investment results above all, rather than embarking on a cross country marketing trip or developing a new product offering. We are seeking this kind of commitment from hedge fund GPs and are encouraging them to offer creative fee structures where the bulk of their compensation hinges upon generating positive risk-adjusted excess returns. ■

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