1ST QUARTER ▪ 2020

HEDGE FUND UPDATE

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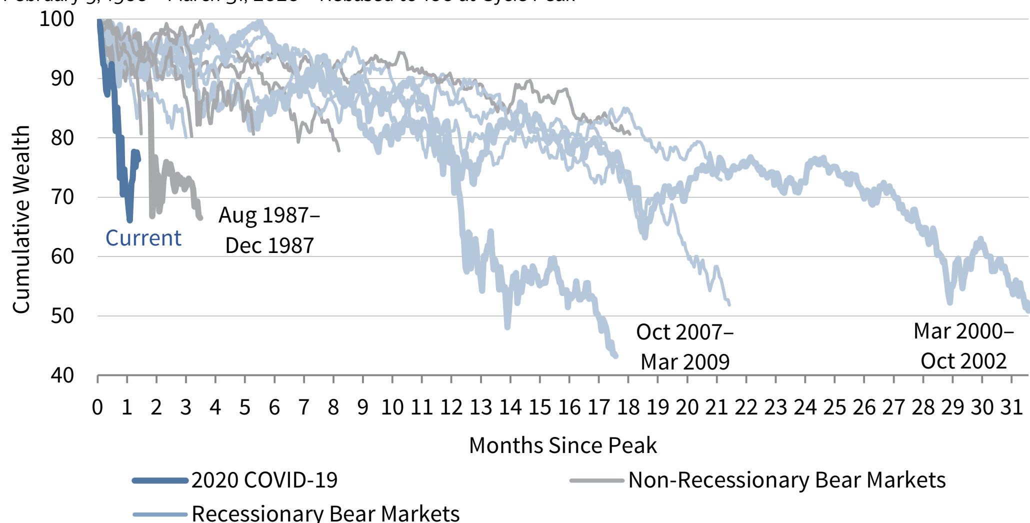
First quarter 2020 was one for the record books in terms of capital markets gyrations; sadly, it will also be remembered for both the terrible human toll and the devastating economic pain from the ongoing COVID-19 pandemic. In mid-March, just three weeks after US equities closed at a new all-time high on February 19, the longest bull market in history came to a sudden end, with the S&P 500 Index registering the fastest bear market correction since its inception. In the end, last quarter was the worst for US and global equities and the best quarter for safe-haven US Treasuries since fourth quarter 2008 during the throes of the global financial crisis (GFC). This time a global health crisis unlike anything experienced in more than a century was the root cause of the collapse in financial market liquidity and the associated surge in asset price volatility.[1]

1 For a more detailed summary of first quarter 2020 economic and market developments, please see the March 31, 2020 edition of Market Matters.

S&P 500 BEAR MARKETS

February 9, 1966 – March 31, 2020 • Rebased to 100 at Cycle Peak



Sources: NBER, Ned Davis Research, Standard & Poor's, and Thomson Reuters Datastream.

Notes: Recession-related bear markets are highlighted in light blue, occurring in 1968–70, 1973–74, 1980–82, 1990, 2000–02, and 2007–09. Recessions defined by NBER business cycle reference dates. Non-recession–related bear markets represented by gray lines, occurring in 1966, 1976–78, 1987, 1998, 2011, and 2018. Bear market defined as peak-to-trough drawdown of at least 19%. Current bear market trough occurred on March 23, 2020, and is updated through March 31, 2020, as the current cycle is ongoing.

Ultimately, the S&P 500 plunged 34% peak-to-trough and returned -19.6% for the quarter; by comparison, the MSCI All Country World Index returned 21.4% in USD terms. The worst-performing S&P 500 industry groups last quarter—energy (-50.5%), automobiles & components (-45.3%), and banks (-40.9%)—were among those most impacted by the pandemic's economic fallout. By the same token, the top performers were those industry groups best positioned to weather (and, in some cases, benefit from) the crisis—software & services (-8.9%), pharmaceuticals, biotechnology & life sciences (-9.4%), and food & staples retailing (-9.5%).

Outside the United States, Europe's STOXX 600, Japan's TOPIX, and the MSCI Emerging Markets Index lost 24.3%, 16.9%, and 23.6% in USD terms, respectively. Credit markets also came under pressure late in the quarter, as reflected by a -12.7% return for US high-yield bonds and -13.2% return for US leveraged loans. Reflecting the sharp risk-off moves and flight to quality, the US Treasury market rallied 8.2% and gold jumped 6.0% in USD terms.

Relative to losses for risk assets registering well into the double digits, hedge funds did a decent job protecting capital, with the HFR Fund Weighted Composite Index declining 9.4% for the quarter. These results were about the same as those posted during the GFC, when the average hedge fund lost 9.6% and 9.2% in third and fourth quarter 2008, respectively.[2]

Equity long/short (ELS) managers navigated the first quarter sell-off reasonably well considering the challenging environment; the HFR Equity Hedge (Total) Index dropped 12.9% for the quarter. Deleveraging by quantitative equity managers likely contributed to the sharp liquidity pullback and the viciousness of the first quarter correction. Prior bouts of market volatility this cycle (e.g., fourth quarter 2018) were characterized by sharp equity factor rotations, causing ELS funds to lose money on both sides of the portfolio. In contrast, the quality and momentum factors dominated value and size throughout most of last quarter, as reflected by the S&P 500 Growth Index outperforming the S&P 500 Value by more than 1,000 basis points, the greatest relative return spread since fourth quarter 1999, at the height of the dot-com bubble. As a result, growth-biased ELS managers tended to fare better than their value-oriented counterparts in first quarter.

The HFR Event-Driven (Total) Index plunged 15.3%, a modestly worse result than fourth quarter 2008. While event-driven hedge funds successfully navigated the rising market volatility through mid-March, they suffered sizeable losses during the quarter's last two weeks, as plunging liquidity caused both merger arbitrage and distressed credit spreads to blow out. While first quarter results for event-driven hedge funds were disappointing, a key difference this time around appears to be that managers have generally been able to maintain (and in many cases add to) their favorite positions due to better asset/liability matching in their liquidity terms, more conservative use of leverage, and stronger counterparty relationships.

2 Hedge Fund Research data are preliminary for the preceding five months.

With the HFR Macro (Total) Index returning 0.1%, global macro strategies were the best-performing hedge fund category last quarter, protecting capital just as they did during the GFC. Many global macro and managed futures managers generated gains through short exposure to commodities and long positions in fixed income.

BLACK SWAN

The COVID-19 pandemic may be the purest example of a "black swan" since the September 11, 2001 attacks.[3] In just a matter of weeks from when the novel coronavirus was first identified in early January, it overwhelmed healthcare systems, forced governments to shut down large segments of the global economy, and severely impaired financial market liquidity. The widespread fallout prompted policymakers to respond with unprecedented speed and to introduce record economic relief and stimulus measures attempting to avoid an economic depression. No doubt the COVID-19 crisis will create both short- and long-term economic losers and winners, and investors could face several more quarters of unprecedented uncertainty and heightened volatility. The longer it takes to identify life-saving therapeutics and to develop and disseminate an effective vaccine on a mass scale, the more likely it is that the pandemic will permanently change the way we live and work.[4] In such an environment, we believe the most skilled hedge fund managers with the strongest business models can thrive.

To date, hedge funds in general have weathered this crisis relatively well. In the first quarter, there were some performance outliers—both to the upside and downside—but few "blow ups" as of the time of this publication. In the coming months, we expect to see some weaker positioned hedge fund businesses wind down as investors seek liquidity from wherever it is available, particularly if markets suffer a further leg down. Yet, should hedge funds continue to protect capital as this crisis unfolds, it would remind investors of the important volatility-dampening role hedge funds can play in diversified portfolios. This would be particularly true for those hedge fund programs with allocations to managers who can successfully generate alpha in such an uncertain, choppy trading environment.

Another silver lining to this crisis is the opportunity for investors to upgrade the quality of their hedge fund programs; many hedge fund managers that were capacity constrained previously are now reopening to new capital due to market declines and the resultant opportunities they have presented. Sustained capital markets volatility should provide stable managers compelling opportunities to generate attractive returns without increasing leverage or allocating to illiquid securities. Talented bottom-up fundamental equity and credit hedge fund teams with the ability to identify and correctly position for the coming disruption should benefit, whereas quantitative-oriented strategies based on historical data may find the going more challenging. ■

3 As per Lexico.com, a black swan is "an unpredictable or unforeseen event, typically one with extreme consequences."

4 For an additional discussion regarding possible societal, economic, and investment implications of the COVID-19 pandemic, please see Celia Dallas and Kevin Rosenbaum, "Is It Time to Overweight Equities?" VantagePoint: Second Quarter 2020 (Special Edition), published on April 8, 2020.

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