The Return of Volatility: Renewed Value For Hedge Funds?

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"Our most significant opportunities will be found in times of greatest difficulty."

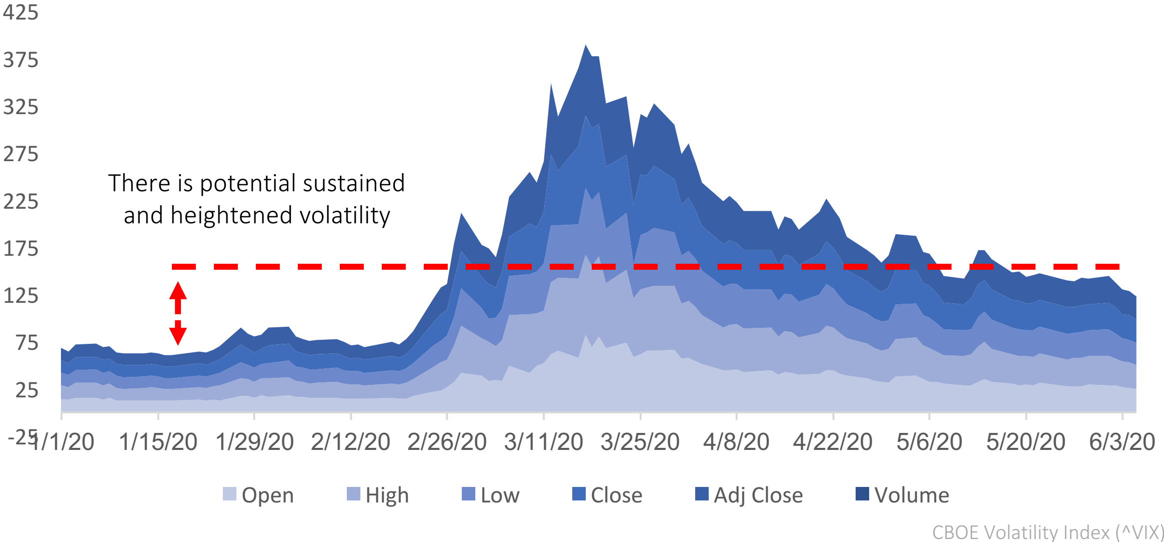
- Thomas S. Monson

Benjamin Graham is credited with creating one of the earliest hedge funds in the 1920's. Warren Buffett, among others, has noted that the father of value investing understood the importance of mitigating risk through the use of investment vehicles. Hedge funds have since been around in one form or another for decades, moving to the forefront of investing in the 1970's and gaining renewed attention in the late 1980's. By 2008 the worldwide hedge fund industry had almost $2 trillion in AUM; today that total remains over $3 trillion, despite the global financial crisis of 2008 and several years of substantial headwinds.

Hedge funds by their very nature, and naming convention, imply a hedge against risk; investors typically expect some level of positive absolute return with downside risk control. And hedge funds can play a very important role in any investor's portfolio. The non-correlated aspect of these portfolios typically provides an opportunity for greater diversification and additional alpha; in short, the potential for downside protection and greater upside enables skilled hedge fund managers to play a valuable complementary role in a portfolio holding equity and bonds. However, until very recently, the market has been on an incredible bull run, and the value of hedge funds has been called into question, as cheaper, long-only equities have provided exceptional returns with very little volatility for the past ten years.

Enter COVID-19. The market, as measured by the S&P 500, lost -19.6% in the first quarter of 2020, and volatility has been at levels not seen since the global financial crisis—on some days or weeks, at levels the market has never experienced in its history. The challenges that have overwhelmed global markets have once again highlighted the advantages of hedge funds and reinforced why investors were originally attracted to the asset class. The events of the past several weeks have provided investors with renewed confidence in this asset class; the returns and risk mitigation that a majority of these strategies have provided corroborate their value as an alpha source, a diversifier and a differentiator. Recent returns have further allowed investors the ability to "see" the value that hedge funds provide in a volatile and uncertain environment, as all-long indexes declined anywhere from 28 – 35% over the month of March, while equity hedge funds, as measured by the HFRI, declined 12% during that same period of time.

Volatility has played a key role in the dialogue relative to the merits of hedge funds. Historically, during times of average or higher than average volatility (as measured by the S & P 500), hedge funds have done very well, and the reverse has typically been true during periods of lower volatility. The chart below demonstrates the volatility environment that had characterized the past decade—which largely had been a detractor from hedge fund performance—versus the current environment, which has seen increased levels pandemic-related volatility. The events of the past few months have driven volatility to new heights and it is likely that we may now see an extended period of higher volatility in the markets. That should bode well for hedge fund returns.

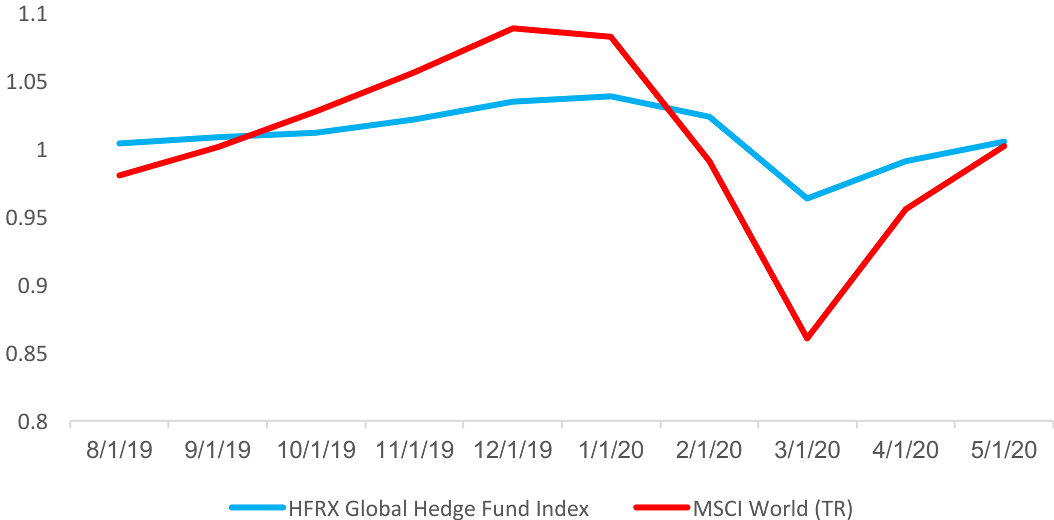


This higher volatility environment raises the question of how best to take advantage of this volatility in the form of real returns for a portfolio. Compound interest is a key consideration. Albert Einstein has been credited with stating "The strongest force in the universe is compound interest." He may well be right, as the benefit of compounding on the upside can be material over time, however, compounding in negative space can materially detract from long term returns. Therefore, it is critical to attempt to manage the volatility that is present in a portfolio. Hedge funds can help.

As expressed below, the growth of a $1 million portfolio is shown over a 10-year period. That portfolio is shown experiencing 5% volatility, 15% volatility and 25% volatility. The results are striking. Over time, a lower volatility portfolio produces the greatest real return to the portfolio with a much smoother ride and nearly three times the annualized returns of the highest volatility portfolio. Though higher volatility portfolios see excellent returns in some years, strong downcycles significantly inhibit long-term growth.

History repeatedly shows that while equity markets can trade above average levels of valuation for long periods of time, markets can also experience significant volatility that takes them well below these averages, often without much warning. Abrupt downside volatility, the likes of which we are experiencing today, poses a challenge to investors allocating solely to traditional asset classes. Hedge funds' "edge" versus conventional money managers is their ability to: 1) concentrate positions in highest conviction ideas, 2) express those ideas long and short, and 3) actively manage exposures to dampen volatility and mitigate the downside. In short, hedge funds make a whole lot of sense.

Hedge Funds as a Portfolio Ballast During the COVID-19 Crisis

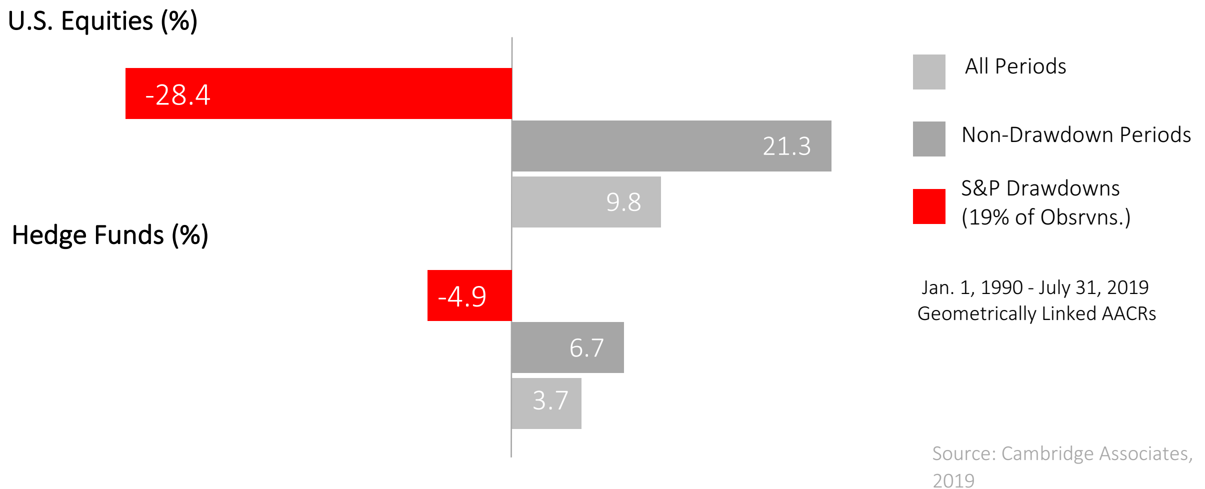


Source: Bloomberg

Periods of market dislocation showcase the value that hedge funds can provide as a diversifier and an asset class that potentially provides an "anchor to windward" during periods of extreme market stress.

The chart below contrasts the average annual returns of the S&P 500 and those of equity hedge funds during non-drawdown versus drawdown periods. This period includes the 2000 tech crisis and the 2008 Global Financial Crisis and does not include the most recent period of market dislocation. That said, it is noteworthy that during market downturns, the S&P 500 experienced a drawdown resulting in returns of -28%, while during those same periods, hedge funds returned slightly less than a -5% rate of return. That level of protection during market stress is critical to helping a diversified portfolio manage through the volatility.

Hedge Funds Limit Downside Volatility



According to Eurekahedge, "more than 90% of the hedge fund managers were able to outperform the global equity market during the month of March 2020, exemplifying the downside protection afforded by hedged strategies as opposed to long-only portfolios."

Though hedge funds typically showcase their advantage during periods of market stress, over time their returns have been commendable. While they can help protect from larger losses in down markets, they can also capture a notable amount of the upside during market rallies. As a result, hedge funds can provide superior risk adjusted returns over time.

Hedge funds have a role to play in a well-diversified portfolio. And the conditions that have perpetuated a multi-year headwind for many hedge funds are starting to break down, with the possible result being a multi-year tailwind for the space.

Moving forward, we expect markets to continue to face above average volatility for an extended period of time, as investors digest the effects of COVID-19 on the global economy, on the markets, and on their long-term financial programs. Also, with interest rates globally near zero or negative, the expected benefit of high quality bonds to a portfolio that holds equities is significantly less than the benefit that bonds have had historically.

With an impressive history of helping to protect and build investor wealth, Optima brings 30+ years of experience allocating to a wide variety of hedge funds and hedge fund strategies. Access to a carefully selected group of hedge funds with proven track records can provide much needed diversification—and downside protection—to investors' asset allocations. Overall, we believe that alternative investments will become increasingly important for investors seeking diversification and greater "balance" in their portfolios.

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