Volatility is Back: The Case for Hedge Funds Now

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OPTIMA

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Volatility is back in the equity markets, with 2020 shaping up to be one of the most volatile years in global markets since World War II. Earlier this year, the S&P 500 suffered a sharp -34% correction but rebounded to all-time highs by mid-year—only to face another round of steep losses in the month of September. The COVID-19 pandemic, the resulting economic crisis, civil unrest, a Supreme Court vacancy, and a contentious presidential election have all contributed to volatility in the markets and the uncertainty investors are grappling with.

As we look ahead, we expect markets to continue to face heightened volatility for an extended period of time. In the U.S. presidential election, both parties are focused on voting integrity, and President Donald Trump has even suggested that if he were to lose the election, he might contest the results. A delayed call of election results could result in further civil unrest, potentially dragging into mid-December and possibly into 2021.

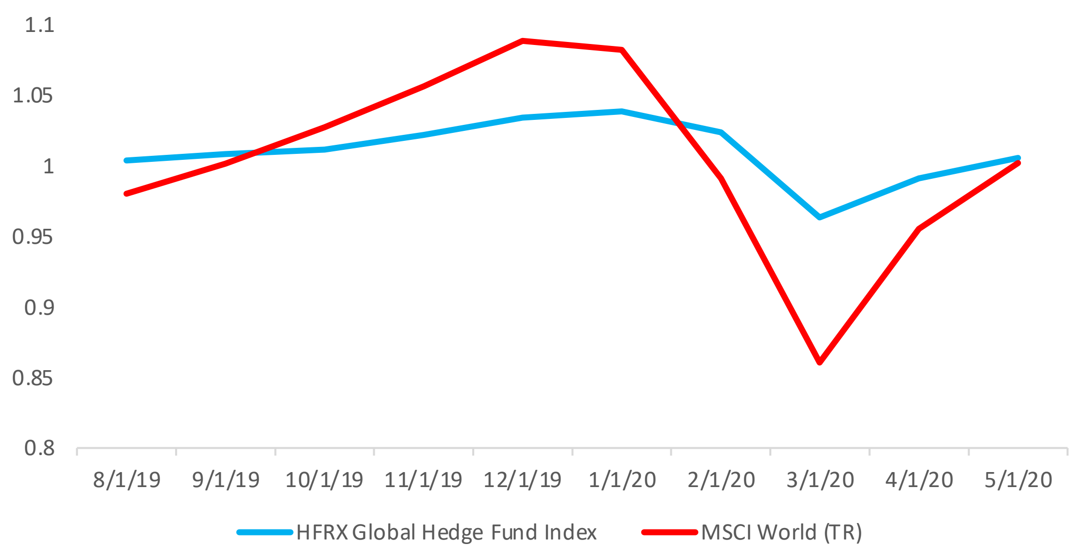
The combination of America's fatigue and ongoing concern around a second wave of COVID, coupled with continued economic uncertainty and political infighting, could be the catalyst to send volatility soaring for a sustained period of time.

As such, it appears that volatility is likely to be a mainstay for the foreseeable future, and that has reignited investors' interest in hedge funds. And hedge funds can play an important role in investors' portfolios due to their potential to provide downside protection and dampen volatility. 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.

A higher volatility environment works well for hedge funds, making them an important—and effective—option for investors looking to generate upside while maintaining a defensive posture during more difficult markets.

The challenges facing global markets in 2020 have highlighted the advantage of hedge funds and have reinforced why investors were originally attracted to the asset class. In Q1 2020, while all-long indexes declined anywhere from 20–32%, equity hedge funds (as measured by the HFRI) declined by only 9%. As equities largely recouped their losses in the following months, hedge funds saw meaningful participation in a renewed bull market. In September, a particularly volatile month, the S&P 500 was down 3.9% while equity hedge funds were up 0.2%.

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

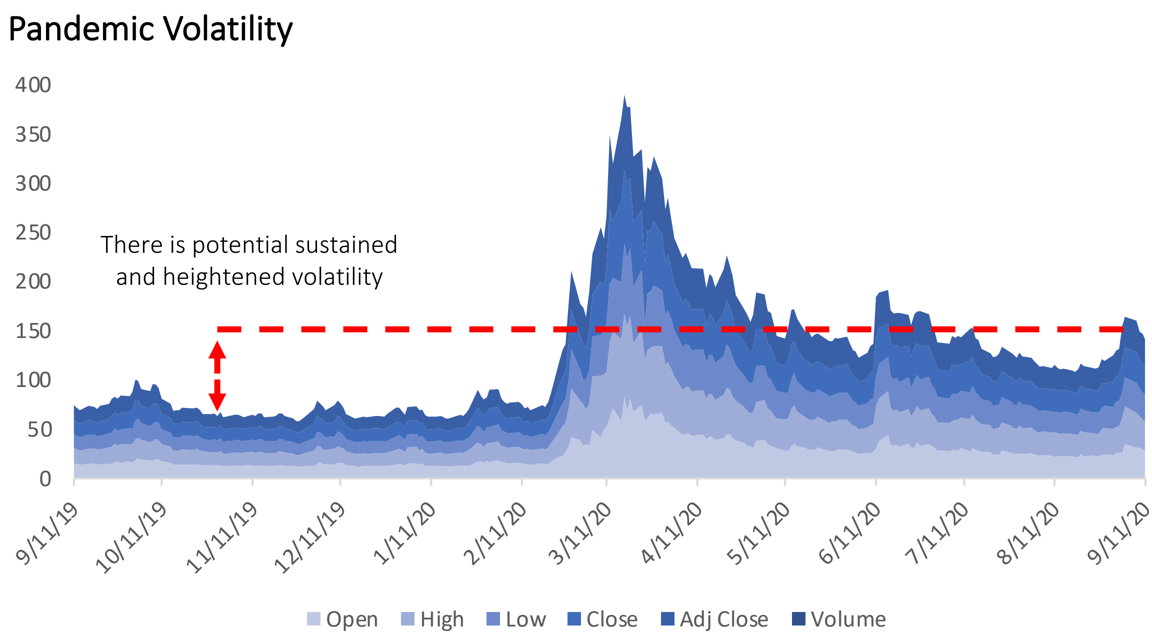


Source: Bloomberg

The returns and risk mitigation that many hedge fund strategies have provided corroborate their value as an alpha source, a diversifier and a differentiator—important characteristics as markets concentrate substantially in tech stocks along with prices near all-time highs.

While participation in stable bull markets is important, volatility has long played a crucial 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 of volatility.

The events of the past several months have driven volatility to new heights and it is likely that we may now see an extended period of sustained higher volatility in the markets. That should bode well for hedge fund returns.

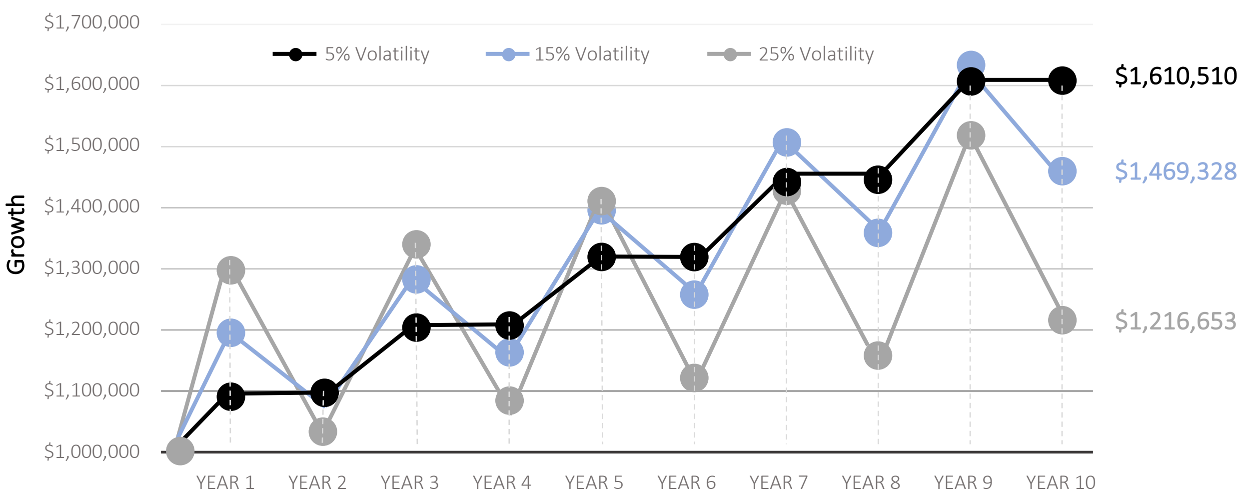


CBOE Volatility Index (^VIX)

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. It is often useful to think about this in the context of an elementary consideration: Compound interest. 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, what is often overlooked is that 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. Minimizing the duration and magnitude of any downside, therefore, minimizing the impact of any negative period in the markets to your portfolio returns is critical to long term success.

Volatility Can Detract from Long-Term Returns



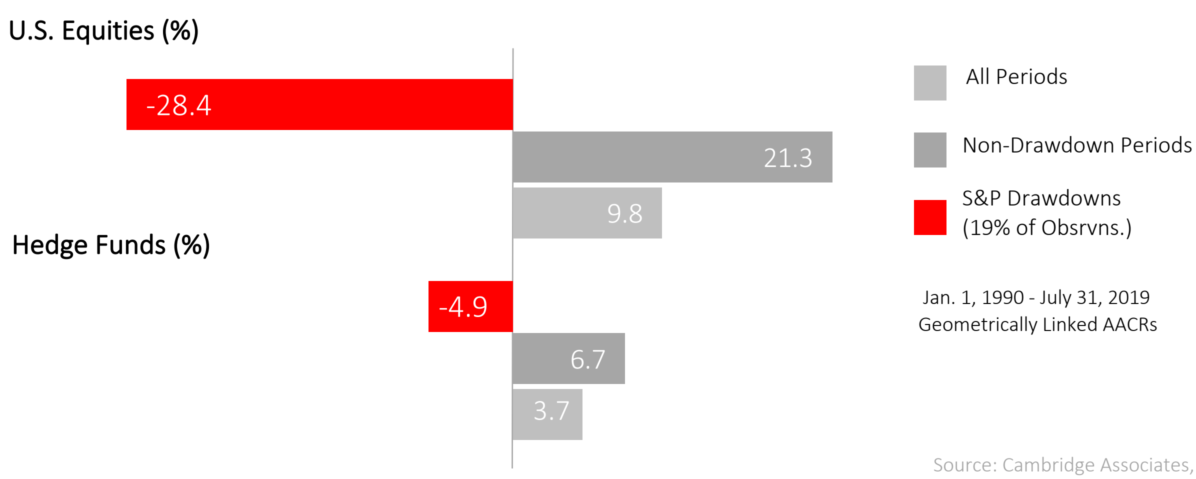
Source: Morningstar Direct

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.

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



Source: Cambridge Associates, 2019

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—often generating alpha in bull markets. 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.

Preparing for a Volatile Tomorrow

Looking ahead, we expect markets to continue to face heightened volatility for an extended period of time. The charged political climate and presidential election could be a major source of turbulence—alongside the continued uncertainty around the development of a COVID vaccine and a precarious economic environment. Further, with interest rates near zero or negative on a global scale, and a Fed committed to that level on US rates for at least 36 months, the expected return on high-quality bonds is significantly less than the benefit those instruments have historically provided.

As a consequence, hedge funds are now seeing a resurgence in popularity, as institutional investors look for strategies that provide a buffer against downside volatility—while also maintaining upside potential.

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—for investors preparing for a volatile future.

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