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INVESTMENT MANAGEMENT

How Higher Yields and Growing Alpha Opportunities Can Lift Hedge Funds

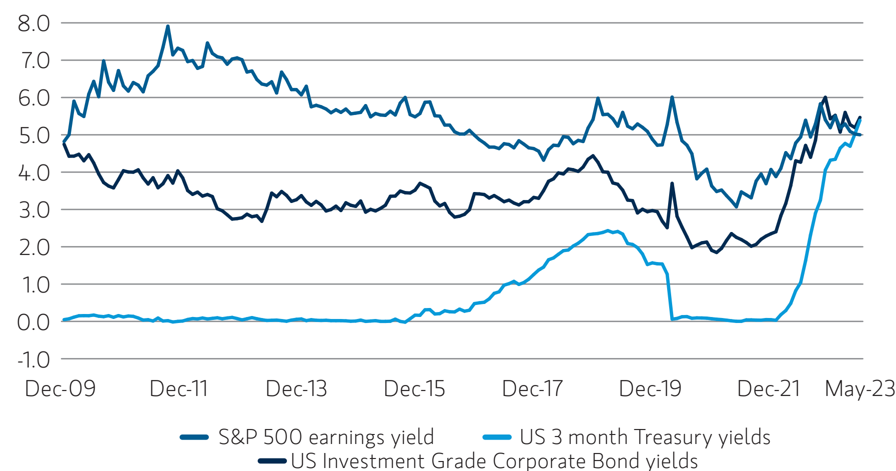
INSIGHTS | HEDGE FUNDS | September 2023

With yields on cash and short-term fixed income investments hovering near decade highs, investors must adjust to a new interest rate regime, prompting asset allocation decisions that have not existed in years *(Display 1)*.

While higher yields pose potential challenges for equities, they clearly enhance the return potential for beleaguered fixed income. And as we shall discuss, key hedge fund strategies like short selling and derivative-oriented portfolios, also gain a tailwind as rates rise.

DISPLAY 1

Rising Yields Have Created Asset Allocation Challenges that Investors Haven't Faced in Decades



Source: Pictet, Financial Times. S&P Earnings Yield, ICE BofAML US Corporate Bond Index, US 3 Month Treasury Yield. December 31, 2008–April 30, 2023.

AUTHOR

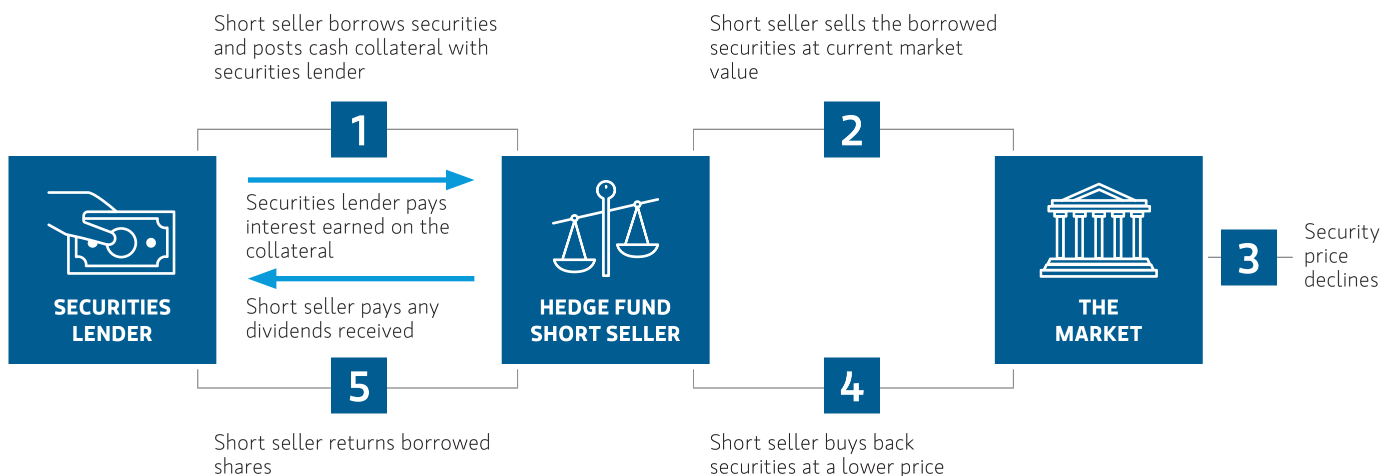
ROB RAFTER
Executive Director

KARA O'HALLORAN
Vice President

KEY TAKEAWAYS

- The resurgence of fixed-income yields over the past 18 months provides a tailwind for a number of hedge fund strategies that have significant unencumbered cash balances.
- Long/short equity and credit funds are examples of strategies earning more on their cash collateral posted for short selling. Similarly, futures and other derivatives-based strategies are earning more on cash balances in excess of their margin requirements.
- Hedge funds are also benefiting from growing alpha opportunities, thanks to a wider dispersion of returns. Following macroeconomic uncertainty that drove asset correlations higher in 2022, the focus is returning to microeconomic, asset class and issuer specifics—a boon for managers seeking to leverage their proprietary research.
- We believe these trends suggest that investors should review portfolio allocations, in light of the greater potential we currently see in fixed-income and hedge funds, relative to equities.

DISPLAY 2
The Short-Selling Process



Source: Morgan Stanley, August 2023

Improved Environment for Short Selling

Both long/short equity and credit funds directly benefit from higher yields on cash via an improved environment for short selling. Consider this example: a long/short equity fund with a 90% gross long exposure and 60% gross short exposure would have total gross exposure of 150% and a resulting net equity exposure of 30%.

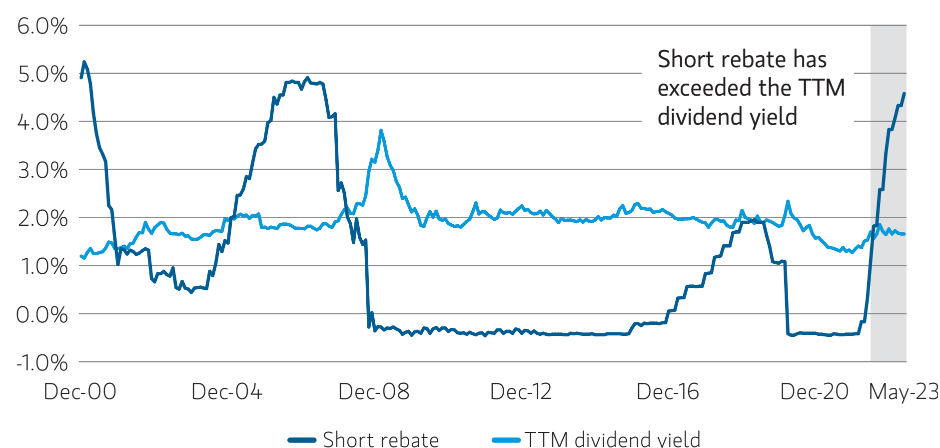
Beginning with the short book: the fund would earn a short rebate (interest on cash held as collateral for short sales) on the 60% of NAV sold short, less dividends and a spread to the risk-free rate charged by the securities lender *(Display 2)*. Thus, the hedge fund earns roughly the risk-free rate on 60% of NAV.

Moving to the long book: the 90% long exposure was fully paid for using the fund's balance sheet, leaving the portfolio with 10% of NAV in cash to earn money market yields at a positive spread to the overnight risk-free rate. Thus, inclusive of dividends received from long positions, the hedge fund may expect to earn approximately the risk-free rate on 70% of NAV. In this example, the long/short equity fund may begin with a 0.7 beta to the risk-free rate of return.

Not only has the short rebate increased on a standalone basis via higher cash yields, it also has increased *relative* to dividend yields. Short sellers are obligated to pay dividends received during the short sale period to the securities lender and, as discussed, the securities lender pays the securities borrower a yield in exchange for cash collateral. If dividends paid to the lender exceed the short rebate received, the short seller has effectively borne an excess cost, directly lowering trading returns. This dynamic, which was prevalent for much of the past two decades, has recently flipped: for the first time since 2008, a typical short rebate has persistently exceeded the dividend yield on the S&P 500, by an average of 1.7% for the last 11 months.

The benefits of the higher cash yields and increased short rebate are tangible: the average monthly return of long/

DISPLAY 3
Short Rebate Exceeds Dividend Yield for the First Time Since 2008



Source: Bloomberg. S&P 500 dividend yield. May 2023. Short rebate calculated as Fed Funds Rate less 50 basis point spread.

DISPLAY 4

Long/Short Fund Returns Have Tended to Increase Along with Fed Funds Rates

The effect of improved environment for short selling is borne out in long/short equity fund returns

EFFECTIVE FED FUNDS RATE RANGE	AVERAGE MONTHLY RETURN OF HFRX EQUITY HEDGE INDEX
Low (0%-3%)	0.14%
Mid range (3%-5%)	0.89%
High (>5%)	1.24%

Source: HFRX Equity Hedge Index. Returns measured from December 31, 1997-May 31, 2023.

short equity hedge fund managers during periods of high Fed Funds rates (defined as effective Fed Funds rates >5%) is more than 100 basis points higher than the average monthly return during periods of low Fed Funds rates.

Higher Cash Yields Feed Directly to Hedge Fund Bottom Lines

Managers of other hedge fund strategies, such as those employing futures and other derivatives-based strategies, can also directly benefit from these higher yields via increased income on unencumbered cash positions—any amount in excess of what is posted as margin.

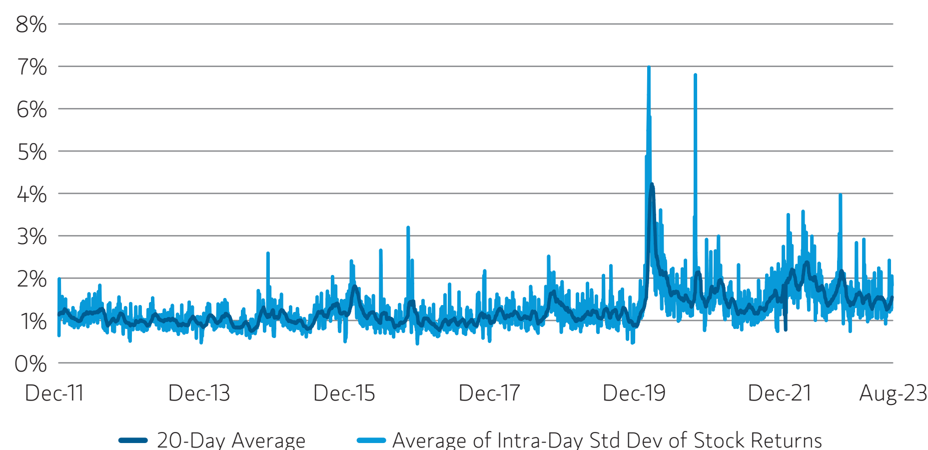
For instance, consider a global macro fund that invests largely in very liquid, over-the-counter (OTC) instruments, which are not typically subject to high margin requirements or haircut levels. These funds may hold unencumbered cash levels of 50%-70% or more of NAV, which can be invested in short-term U.S. Treasuries or other money market instruments earning high standard cash rates.

Likewise, fixed income relative value strategies with higher levels of gross exposure, such as liquid portfolios focused on government bonds and related interest rate products, tend to have unencumbered cash levels as high as 40%-60% of NAV. For these market neutral strategies, we can reasonably expect a 0.4-0.6 beta to base rates.

The tailwind of higher cash yields can be even more pronounced for funds employing purely futures-based strategies. Typically, only a small share of these funds' assets may be utilized for margin purposes, often amounting to less than 10% of NAV. The remaining 90% of NAV or more can be counted as unencumbered cash and similarly invested in short-term products earning high yields. As a minimum starting point, one can reasonably expect this type of portfolio to exhibit a beta of 0.9 or greater to the risk-free rate.

DISPLAY 5

Equity Dispersion Remains Elevated Amidst Supportive Environmental Factors



Source: Morgan Stanley Research, August 2023.

As Dispersion Rises, Alpha Opportunities Increase

Of course, investors will not be pleased with net returns that simply match what can be earned in a savings accounts; managers must deliver alpha above and beyond these cash yields. Fortunately, the new higher-rate regime coincides with greater dispersion of asset returns. In our opinion, this environment raises both the potential floor and ceiling for hedge fund returns.

For perspective, recall that in 2022, macroeconomic uncertainty gripped investors, who drove rates—and rate volatility—higher. The singular focus on macroeconomic factors also helped push cross asset correlations to extremes for much of the year, touching 47% in November.

Now, as investors assess the disparate impacts of this higher rate regime at the asset class, sector and individual issuer level, market dynamics and price movements have begun to shift from a macro to micro-orientation. In fact, we have seen cross asset correlations fall and levels of dispersion across markets and geographies rise, creating, in our view, rich opportunities for alpha generation.

Wider trading ranges at the individual asset and security level, and dispersion both within and across sectors, geographies and asset classes may support potential alpha returns from directional and relative value hedge fund strategies alike. As a matter of course,

DISPLAY 6

In 2023, Alpha has Resumed its Role as Primary Performance Driver

Rolling stock specific risk

Source: Morgan Stanley, August 2023. Share of price movement not explained by macro or style variables.

long/short trading strategies rely on precisely these types of differentials in prices, fundamentals, and performance to produce investment profits.

While certain balance-sheet-intensive and higher-gross-exposure hedge fund strategies may derive relatively less direct benefit from the greater cash yields, we believe the wider dispersion of returns is a big positive for them. For example, such strategies will likely have enhanced opportunities to generate alpha through fundamental security selection, as well as through discretionary and algorithmic trading strategies that seek to capitalize on relative value opportunities.

Alpha opportunities abound

We can see evidence for the new regime of wider return dispersion in 2023's strong equity markets. *Display* 5 shows clear alpha winners, with signs that fundamental analysis has driven stock performance to a large degree—a dynamic we expect to continue as equity dispersion and stock specific risk have broadly risen.

Similarly, credit markets have seen dispersion rise to above-average levels, as this higher rate environment creates a divergence in credit risk by issuer.

DISPLAY 7

Dispersion in the High-Yield Market Also Points to Alpha Opportunities

High yield Dispersion

Source: BofA Global Research, June 2023. Proportion of face value in the DM USD HY index marked outside +/-100bps of overall index level

A Fresh Look at Asset Allocation

The utility of fixed income or cash-like investments was called into question for much of the post-COVID era, as interest rates reached record lows and the correlation relationship between stocks and bonds that formed the bedrock of a traditional 60/40 portfolio failed in spectacular fashion.

Today, roughly two years after bottoming, short end rates are hovering at greater than 5%, prompting asset allocation trade-offs that have not arisen in decades. Stock prices face headwinds of limited corporate sales growth and capacity for margin gains, and still relatively tight equity risk premium.

Meanwhile, cash instruments and money market funds offer yields of 5% or greater and medium duration fixed income investments now offer mid- to high single digit yields spanning the credit curve. Put simply, bonds look more attractive than in recent years, on both an absolute basis and in a portfolio utility context, while, in our view, equity markets could face more pressure.

Many of the dynamics that have made fixed income look attractive again also benefit hedge funds, which enjoy the added benefit of an attractive, fundamentally driven environment with opportunity for robust alpha generation. As we move into this next phase of the cycle, we remain confident in the high potential of these alpha oriented and non-correlated strategies. We believe the time is ripe for a fresh look at the role of hedge funds in portfolio allocations.

Risk Considerations

Diversification does not eliminate the risk of loss.

DEFINITIONS

HFRI 500 Fund Weighted Composite Index: global, equal-weighted index of the largest hedge funds that report to the HFR Database which are open to new investments and offer quarterly liquidity or better. The index constituents are classified into Equity Hedge, Event Driven, Macro or Relative Value strategies.

HFRI Equity Hedge (Total) Index: Investment Managers who maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. EH managers would typically maintain at least 50% exposure to, and may in some cases be entirely invested in, equities, both long and short.

HFRI Event-Driven (Total) Index: Investment Managers who maintain positions in companies currently or prospectively involved in corporate transactions of a wide variety including but not limited to mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated, and frequently involve additional derivative securities. Event Driven exposure includes a combination of sensitivities to equity markets, credit markets and idiosyncratic, company specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative), with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

HFRI Macro (Total) Index: Investment Managers which trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top down and bottom up theses, quantitative and fundamental approaches and long and short term holding periods. Although some strategies employ RV techniques, Macro strategies are distinct from RV strategies in that the primary investment thesis is predicated on predicted or future movements in the underlying instruments, rather than realization of a valuation discrepancy between securities. In a similar way, while both Macro and equity hedge managers may hold equity securities, the overriding investment thesis is predicated on the impact movements in underlying macroeconomic variables may have on security prices, as opposes to EH, in which the fundamental characteristics on the company are the most significant are integral to investment thesis.

HFRI Relative Value (Total) Index: Investment Managers who maintain positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative or other security types. Fixed income strategies are typically quantitatively driven to measure the existing relationship between instruments and, in some cases, identify attractive positions in which the risk adjusted spread between these instruments represents an attractive opportunity for the investment manager. RV position may be involved in corporate transactions also, but as opposed to ED exposures, the investment thesis is predicated on realization of a pricing discrepancy between related securities, as opposed to the outcome of the corporate transaction.

MSCI World Index: a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

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