Mercer

Hedge Fund Outlook 2023

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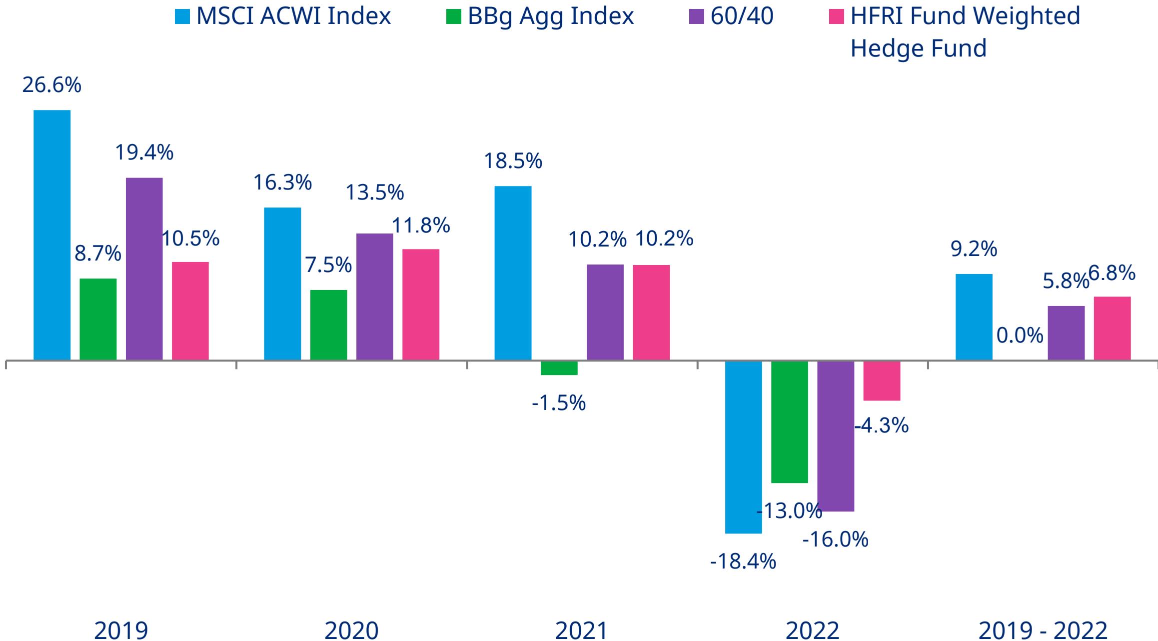
In light of the current environment and the strong relative performance of hedge funds recently, we thought it timely to revisit our outlook on the opportunity set across the hedge fund landscape. 2022 represented not just a pivot from more than a decade of "emergency" monetary measures post the Global Financial Crisis (GFC) but a seismic shift, with inflation reaching levels not seen in 40 years, forcing the hand of central bank policy to reverse course from a similar multi-decade trend. Geopolitics has also taken an unfortunate about-face, adding to uncertainty and fragility. There remains a wide range of outcomes around resulting expectations, but there is a good chance that we have entered a new era of greater macro-economic and geopolitical uncertainty where diversifying asset classes such as hedge funds that are less correlated with traditional asset classes can provide meaningful diversification and serve to dampen drawdowns, as we saw in 2022.

In our 2021 paper, Hedge Funds' Phoenix Moment[1], we highlighted our positive outlook and the improved performance of hedge funds more broadly, which we began to see in 2019 and was further confirmed over 2020. Our view then was based on expectations that the flames of accommodative policies sustained post-GFC, and with a further dousing of kerosene during the COVID pandemic, would soon be extinguished or at least die back to embers. Out of the ashes, we expected increased dispersion, volatility, and macro uncertainty, resulting in a resurgence in hedge fund investing. That view has largely proven correct on a relative basis.

Figure 1. Calendar-year performance of hedge funds versus equities and bonds



Source: Refinitiv, Mercer calculations. Hedge funds are represented by the HFRI Fund Weighted Hedge Fund (USD) Index. The 60/40 portfolio is represented by 60% MSCI AC World Total Return Index (USD) and 40% Bloomberg Barclays Global Aggregate Total Return Index (USD).

[1] https://insightcommunity.mercer.com/research/60456c339307e900240a1482/Mercer_2020_Hedge_funds_phoenix_moment

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Over the trailing four-year period ending December 2022, a generic blend of hedge funds (as reported by HFR) has outperformed a 60/40 blend of equities and bonds by approximately 1% annualized net-of-fees. This outperformance results from a combination of double-digit returns during 2019, 2020, and 2021 and significant relative outperformance during a challenging 2022 (limiting losses to 25% of the global equity drawdown). As is now well-known, the broad pivot in global interest rate policy has recently turned naïve portfolio diversification on its head, effectively offsetting the prior two years of performance in fixed income. This poses a significant challenge to portfolio construction if equity-bond correlations remain positive in an environment marred by greater inflation risk. In our opinion, the dramatic shift in the environment has delivered an opportunity set similar to that of the 2000-09 period, where hedge funds delivered attractive performance and diversification.

Our macro outlook is not too unfamiliar. We expect a de-coupling of global monetary policy in an effort to balance growth and inflation. Interest rates in developed economies may remain higher for longer. A recession in developed markets seems likely (perhaps too much so), leaving questions on how long, how deep, and how global. Inflation, even if brought under control, is likely to be closer to targets or higher than in the past, with persistently higher inflation volatility than in the past decade being the most likely outcome, in our view. The recent historical US dollar strength may decline or reverse on a relative basis, which we already saw signs of towards the end of 2022. Geopolitics continue to be challenged and fragile, and the world may become less interconnected and more factionalized, potentially slowing decades of globalization and weighing on corporate margins. Broadly speaking, liquidity is likely to be erratic, with some surprises along the way. Private market activity may slow, both in terms of commitments and distributions. This suggests to us that the dynamics mentioned earlier – increased volatility, dispersion, and macro uncertainty will be sustained if not increased, all of which are generally better for hedge funds. In short, the hedge fund phoenix is rising.

Below, we highlight some of the major hedge fund strategies in light of our current outlook.

- **Global macro** – these strategies seek to profit by being on the right side of policy shifts and economic implications, both on a relative or directional basis. A more normalized interest rate and inflation environment may prove fruitful for systematic strategies that seek to capitalize on sustained momentum and trends in either direction, though sharp reversals can be harmful. Discretionary macro strategies, on the other hand, are generally more nimble and dynamic in navigating change and pivots. Taken together, the two approaches offer significant diversification benefits to a portfolio and we expect macro strategies will be critical in navigating through the environment ahead. Unencumbered cash levels now receive some return benefit, providing a slight tailwind for those strategies that use derivatives.
- **Downside mitigation** – these strategies seek to provide offsetting convexity benefits to short volatility risks. Typical hedge fund strategies include tail risk hedges, volatility, and some trend-following strategies, however, implementation and approach ultimately determine any convexity benefits. Given the uncertainty and risks ahead, we think it is important to maintain an added layer of mitigation and diversification through a mix of disciplines. We also note that the current downturn has been relatively orderly. Any negative surprises could have capitulation impacts, reinforcing the need for defensive strategies.

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- **Event-driven** – without argument, we are in a period of significant change, and this will have direct and lateral impacts at the individual corporate level. These opportunities tend to be long-biased and longer duration, resulting in some participation during downturns but potentially ushering in a multi-year opportunity set depending on the situation. A looming recession, wage increases and higher inflation should result in more discerning capital allocation decisions, which should present opportunities across soft and hard catalysts. M&A activity may slow given the rise in financing costs and cross-border challenges, but for those firms in a position of strength and with a need for growth, acquisition may remain an economical option. Arguably, we have entered the age of engagement and activist investors are well placed to unlock value through leadership changes, governance improvements and now ESG and diversity enhancements. Recent regulation in both the US and Japan may improve activist measures moving forward. Lastly, the combination of higher inflation, higher rates for longer and slower growth should provide stressed/distressed opportunities as companies seek to refinance debt. We note our expectations of heightened liquidity risks when entertaining new event-driven opportunities.
- **Relative value** – strategies mostly benefit from spread compression or widening. Higher volatility and dispersion across asset classes, regions, and markets should persist as a result of current macro dynamics. Relative value strategies should have a broader arbitrage opportunity set. However, as these strategies depend on greater use of leverage, we suggest caution, given the current tighter financing environment combined with our outlook on liquidity, either or both of which could lead to unpleasant left tail risks.
- **Security selection** – we expect a normalized interest rate environment to lead to more rational investment decision-making, which better incorporates fundamentals and risk/reward, and forces sensible opportunity cost considerations. Strategies that invest long and short in individual opportunities based on underlying fundamentals and with discipline across credit or equities are likely to have an improved alpha opportunity set combined with a positive cash rebate[2], which had been a drag on performance for any portfolio that maintained a level of shorts/hedges.

The above observations are largely positive across the hedge fund landscape. We do note, of course, that our expected dispersion across markets and opportunities will reflect on managers' and investor outcomes. Manager selection, strategy selection and sizing will be critical to success. Another key takeaway is that while our outlook appears clear to us, the timing and magnitude of impacts are uncertain, further justifying a diversified blend of hedge fund strategies.

[2] Cash rebate is the interest earned on short sale collateral resulting from the borrowing and lending required to effectuate short selling.

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In another paper, Investing in Hedge Funds[3], we outlined three core benefits offered by hedge funds: diversification, asymmetry and a quality return profile. Arguably, the need for those portfolio benefits has been relatively low and, in some cases, penalizing over the decade of 2010-19, for reasons we have discussed previously. We continue to believe a successful hedge fund program can generate a cash +3-4% net return. When cash returned zero, the outcome was pedestrian; with current cash rates, the expected return is attractive on an absolute basis and exceptional in risk-adjusted terms. In light of recent market challenges and performance, investors have been sharpening their pencils, fine-tuning their allocations, and increasingly looking to future-proof portfolio robustness and resilience. These are rational and sound actions given a broadly accepted view that we have emphatically entered a new era. In our opinion, investors will need every tool and strategy at their disposal to navigate the challenges ahead. We are more confident than ever that hedge funds, with their nimble and unconstrained frameworks, could potentially deliver on their core benefits mentioned above, but more importantly deliver added alpha as well as optionality in what could be a more volatile market environment with more frequent exogenous shocks.

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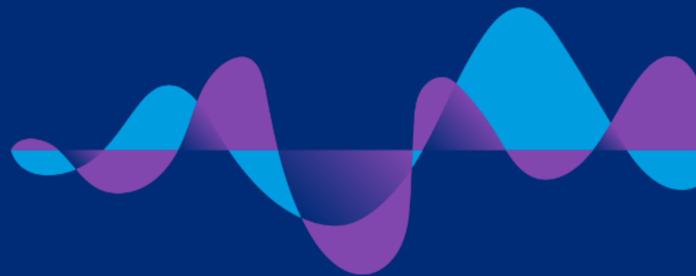

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[3] https://insightcommunity.mercer.com/research/609a0b95a66240001de9c84e/Mercer_Investing_in_hedge_funds_Why_Hedge_Funds

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