# The Value Proposition for Allocations to Hedge Funds

## Jefferies Capital Intelligence

Multi-decade high inflation triggered a central bank tightening cycle and ongoing concerns about the impact of monetary policy. Investors are curious how hedge funds will navigate broader uncertainty in this environment.

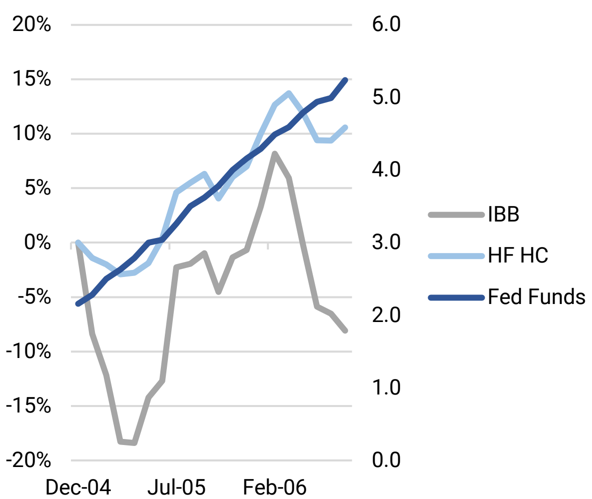
Jefferies Capital Intelligence team took a deep dive into the performance of hedge funds amid various periods of economic turbulence in the US, particularly during periods of rapid rises in the Fed Funds Rate. Findings show that in periods of elevated volatility and significant market drawdowns, hedge fund managers consistently outperform their benchmarks, across investment strategies and sector specialization.

## Periods of Federal Reserve Rapid Rate Hikes

### January 2005 – July 2006: Spotlight on Healthcare & Technology

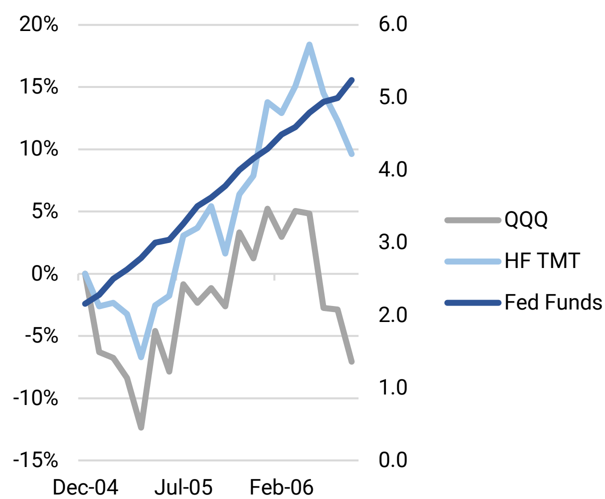
As the Fed Funds Rate rose from 2.2% to 5.2%, many sector-focused hedge funds outperformed their respective indices.[1] Healthcare fund managers outperformed the iShares Biotechnology ETF by a wide margin.[2] This period was defined by significant volatility in the biotech space, with IBB's volatility hovering at 19%.[3] Healthcare managers delivered better risk-adjusted returns with a volatility of 6%.[4] Technology managers also outperformed the QQQs. Amid a period of sustained choppiness for the technology index, tech hedge fund managers outperformed the benchmark by 1700 bps, with a volatility of 10% relative to the benchmark's 15%.[5]

**Healthcare Hedge Funds vs IBB**



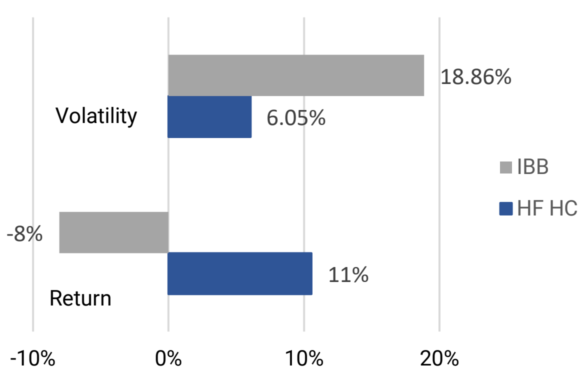

*Source: Jefferies, FactSet, HFR, FRED*

**Technology Hedge Funds vs QQQ**



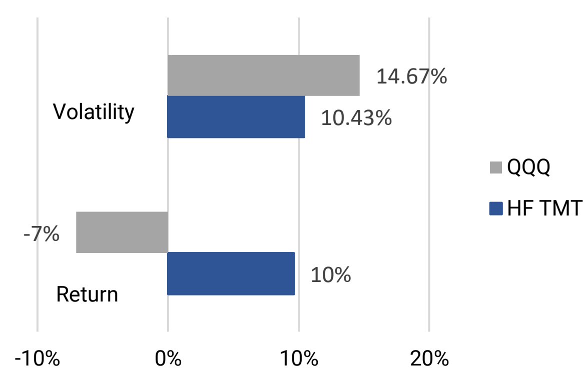

*Source: Jefferies, FactSet, HFR, FRED*

**Healthcare Volatility & Returns**
January '05 – July '06




*Source: Jefferies, HFR, eVestment*

**Technology Volatility & Returns**
January '05 – July '06




*Source: Jefferies, HFR, eVvestment*

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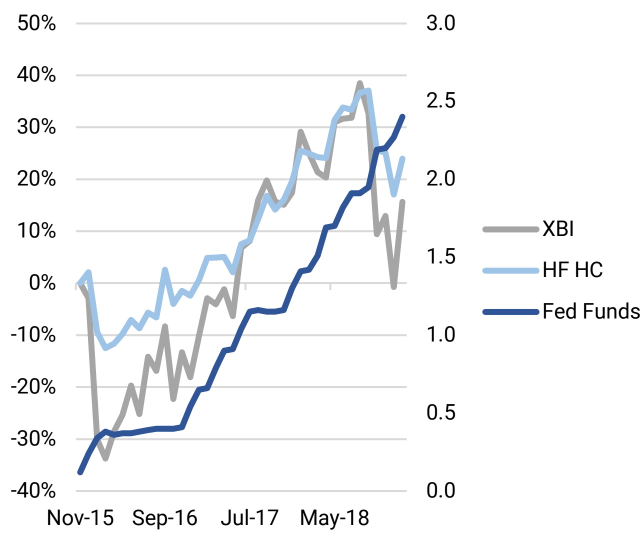
## Periods of Federal Reserve Rapid Rate Hikes

### November 2015 – January 2019

The Fed initiated an increase in the Fed Funds Rate, which may have contributed to a sharp selloff in biotechnology stocks. Healthcare fund managers sustained a fraction of the drawdown.[6] Even as the biotech industry recovered in the face of interest rate hikes, healthcare hedge funds remained resilient and outperformed the XBI benchmark, once again, amidst a broader drawdown.

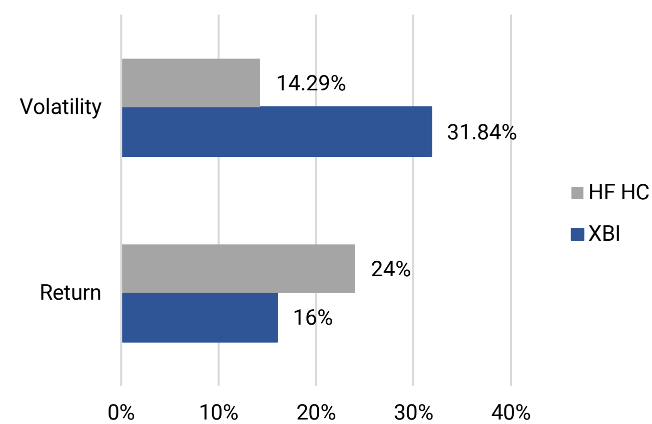
**Healthcare Hedge Funds vs XBI**




*Source: Jefferies, FactSet, HFR*

**Healthcare Volatility & Returns**

November ‘15 – January ‘19

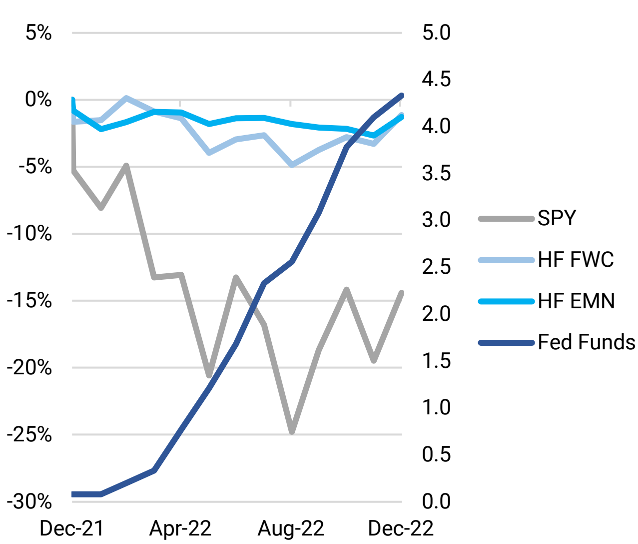



*Source: Jefferies, HFR, eVestment*

### January 2022 – January 2023

Investors faced crosscurrents that challenged financial markets, as higher inflation and tighter financial conditions weighed on confidence. In 2022, hedge fund managers achieved strong, risk-adjusted returns and downside protection through one of the most challenging markets in a decade, resulting in last year being one of the best years of outperformance.[7]

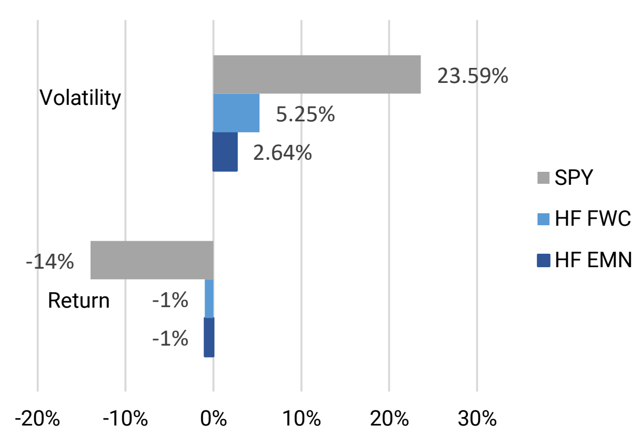
**Hedge Funds vs SPY[8]**




*Source: Jefferies, FactSet, HFR*

**Hedge Fund Volatility & Returns**

January ‘22 – January ‘23



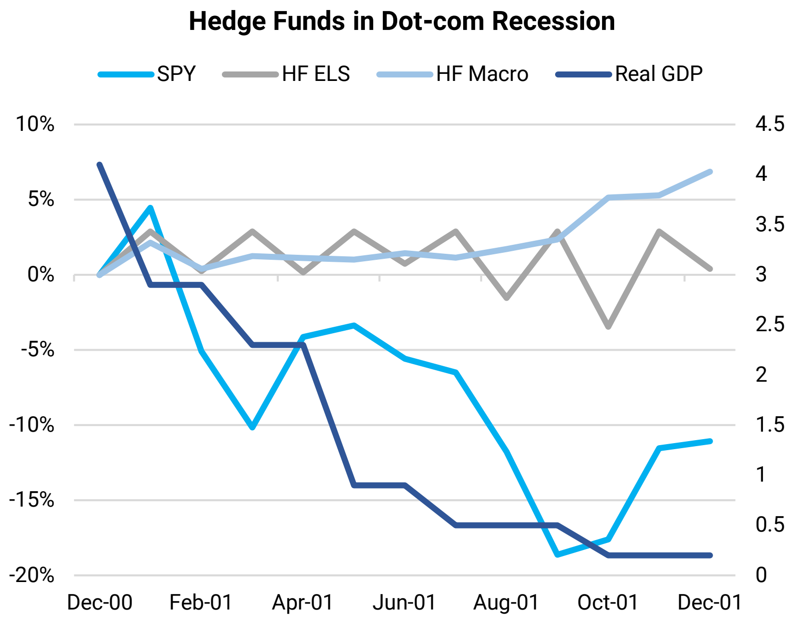

*Source: Jefferies, HFR, eVestment*

## Periods of US Economic Recessions

We also looked into Macro hedge fund performance across recessionary periods. In the two we explored, Macro funds provided uncorrelated, positive risk-adjusted returns.

### Dot-com Recession

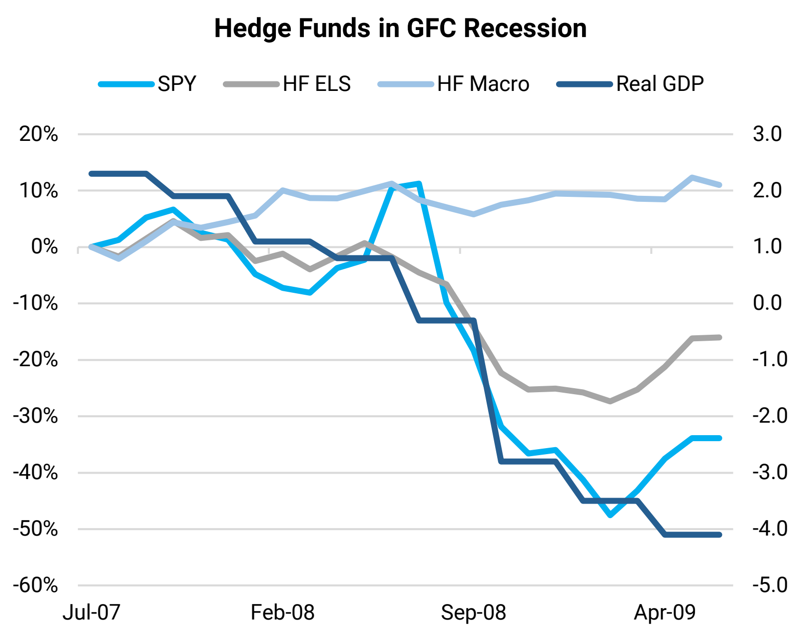
- During this period in 2001, Macro and Equity Long Short hedge fund managers outperformed the indices. Both hedge fund strategies delivered strong, risk-adjusted relative and absolute returns. Macro funds returned 7%, Equity Long Short gained 40 bps, the Dow lost -7%, the S&P 500 fell by -11%, and the Nasdaq dropped -33%.[9]



Source: Jefferies, FRED, HFR

### Great Recession

- Over this two-year period, Macro and Equity Long Short funds provided better risk-adjusted returns relative to the US indices. Macro gained 11%, ELS returned -16%, the Nasdaq lost -26%, the S&P 500 fell by -34%, and the Dow lost -36%.[10]

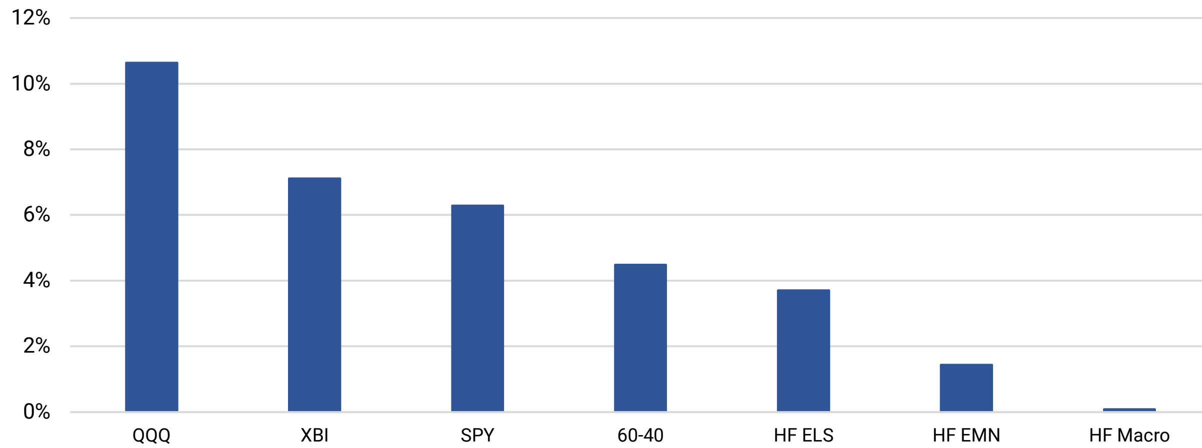


Source: Jefferies, FRED, HFR

## Periods of Positive Stock-Bond Correlation

Historically, equity and credit markets have typically shown opposite responses to inflation. More specifically, credit markets can act as a gauge that informs equity investors of macroeconomic risks and investor sentiment. Stock and bond correlation turned positive in 2022 and this shift may have affected the tradeoff between expected return and portfolio risk.[11] The correlation trend that was established in early 2022, continued in 2023. With easing inflation data in January, investors appeared to position themselves for the end of the Fed hiking cycle. Long-dated rates fell sharply, and financial conditions loosened. This rate volatility was soon followed by a sustained, downward move in the Volatility Index. In the short term, VIX and the S&P 500 Index tend to move inversely.

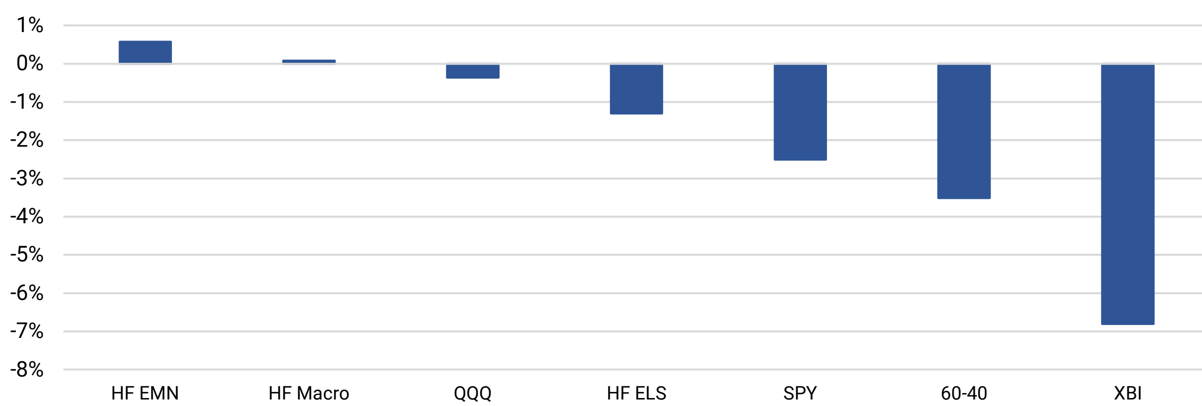
**Hedge Funds vs Other Indices**
January ‘23




*Source: Jefferies, FactSet, HFR*

In February, market participants appeared to be surprised by a series of stronger-than-expected inflation data and positioned themselves with the expectation that the Fed would take the terminal rate higher and sustain it for longer. Long-dated rates had a rapid upward move, which tightened financial conditions. This interest rate volatility was soon followed by an increase in the Volatility Index.[12] In the short term, VIX and price movements of the S&P 500 often show inverse price action.

**Hedge Funds vs Other Indices**
February ‘23




*Source: Jefferies, FactSet, HFR*

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## The Case for Investing in Hedge Funds During Periods of Transition

We look at hedge fund performance during episodes of transition, particularly during periods of accelerating rate hikes, economic recession, and positive stock-bond correlation.

With the Fed engineering a tightening cycle and initiating a period of transition, markets may expect persistent, elevated volatility.[13] Hedge fund managers that capture upside returns, but protect capital when markets are down, aim to outperform in a difficult investing environment across cycles.

## 5 Reasons Why Allocators Invest in Hedge Funds

- **Active Risk Management** through portfolio construction and hedging
  - Hedging may generate better risk-adjusted returns than a 60-40 portfolio[14]
- **Capital Preservation** by adjusting exposure levels during drawdown periods
  - Hedge funds may aim to capture ~50% of the downside move[15]
- **Alpha Generation** through strategies that provide greater returns than the indices
  - Hedge funds are typically designed to seek out market inefficiencies to generate returns[16]
- **Lower Correlation** to broader equity markets which may reduce portfolio volatility
  - Fund managers can toggle their exposure levels to reduce correlation to markets
- **Diversification** through various investment strategies and asset classes
  - The median number of positions for ELS funds is ~50 longs & ~40 shorts[17]

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## CONTACTS

**Leor Shapiro**
Global Head
Capital Intelligence
+1 212.336.6267
lshapiro@jefferies.com

**Shannon Murphy**
Head of Strategic Content
Capital Intelligence
+1 212.336.1139
shannon.murphy@jefferies.com

**Gregory Desroches**
Strategic Content
Capital Intelligence
+1 212.708.2606
gdesroches@jefferies.com

## FOOTNOTES

[1] FRED https://fred.stlouisfed.org/series/fedfunds
[2] The iShares Biotechnology ETF "IBB" was selected as a healthcare hedge fund benchmark during 2005 – 2006, instead of the SPDR S&P Biotech ETF "XBI", due to a lack of available data for XBI, in these years.
[3] Jefferies Capital Intelligence
[4] Ibid
[5] Ibid
[6] Ibid
[7] HFR https://www.hfr.com/news/hedge-fund-capital-rises-to-conclude-volatile-2022-as-managers-position-for-risk-uncertainty-in
[8] In the third chart on the second page, the SPDR S&P 500 ETF was selected as a benchmark relative to HFR's Fund Weighted Composite "FWC" and Equity Market Neutral "EMN" Index to illustrate the breadth of outperformance from hedge funds. In 2022, technology and healthcare managers both outperformed their benchmark, QQQ and XBI, respectively.
[9] HFR, FactSet https://www.hfr.com/family-indices/hfri-500-hedge-fund-indices
[10] Ibid
[11] Schroders https://www.schroders.com/en-us/us/intermediary/insights/regime-shift-what-it-means-for-strategic-asset-allocation/
[12] FactSet
[13] Federal Reserve Bank of Richmond https://www.richmondfed.org/publications/research/econ_focus/2022/q3_federal_reserve
[14] Schroders https://www.schroders.com/en-us/us/intermediary/insights/regime-shift-what-it-means-for-strategic-asset-allocation/
[15] Mercer https://www.mercer.com/content/dam/mercer/attachments/global/gl-2021-why-hedge-funds.pdf
[16] CFA Institute https://www.cfainstitute.org/en/research/cfa-digest/2007/11/hedge-funds-past-present-and-future-digest-summary
[17] Jefferies Capital Intelligence

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