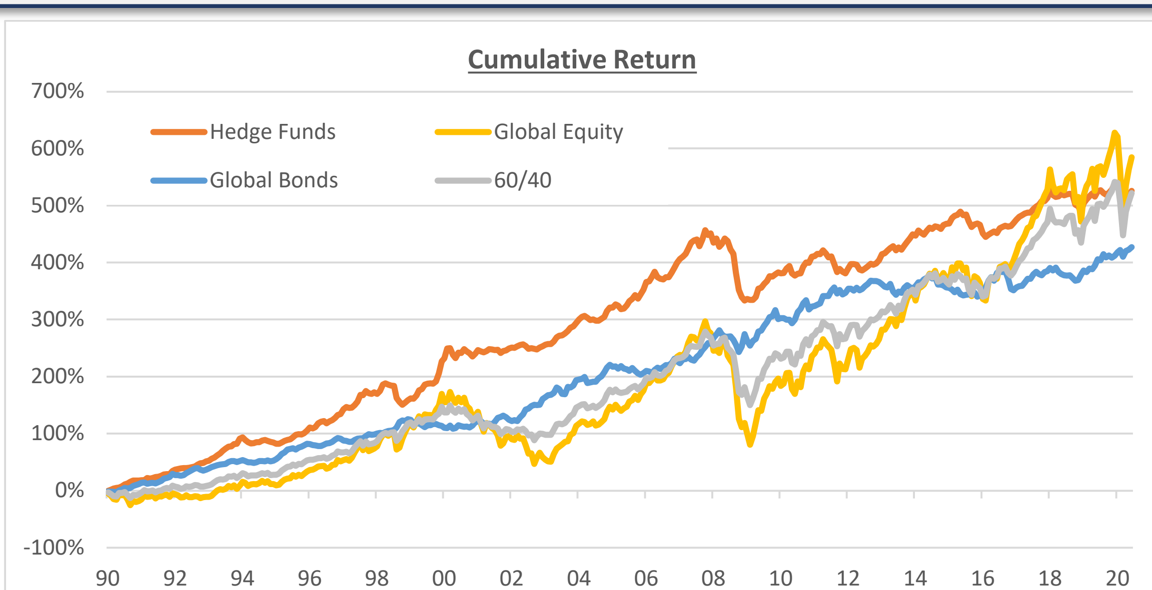
The Case for Hedging & Tactical Strategies

Quick take:

- Hedging and Tactical ('H&T') strategies incorporate differentiated methods of generating returns and often have lower levels of correlation to traditional asset classes.
- Such strategies have struggled to keep up with 60/40 balanced portfolios comprised of long-only stock and bond strategies over a decade-long bull market for both asset classes.
- This translates to a current environment with low interest rates and high equity market valuations, contributing to a challenging forward-looking opportunity set for 60/40 portfolios.
- Despite fighting headwinds over the past decade, H&T funds have performed well over the past 30 years and the forward-looking environment appears more favorable for these strategies.
- Diversification benefits combined with a more advantageous opportunity set contribute to a compelling case to ensure H&T strategies are part of your balanced portfolio.

Hedging & tactical strategies incorporate differentiated methods of generating returns. These strategies include, but are not limited to merger & arbitrage, collaring, convertible arbitrage, long/short equity & credit, and risk parity. There is a high degree of diversity within the H&T asset class and each strategy type can bring unique attributes to a portfolio. Collectively, H&T strategies have offered investors impressive levels of risk and return since the HFRI Fund of Fund Composite Index's inception in 1990 as seen below.

Hedge funds have demonstrated impressive risk and return characteristics over long periods of time



	Global Equity	Global Bonds	60/40	Hedge Funds
Annualized Return	6.5%	5.6%	6.4%	6.2%
Standard Deviation	15.2%	5.3%	10.0%	5.6%
Max Drawdown	-54.5%	-10.1%	-36.8%	-22.2%

Source: Bloomberg monthly return data from 1/1/1990 through 6/30/2020; Hedge funds are represented by the HFRI Fund of Funds Composite Index, global equity is represented by the MSCI All-Country World Index (ACWI), Global Bonds are represented by the BBgBarc Global Bond Aggregate Index, and 60/40 is 60% MSCI ACWI and 40% BBgBarc Global Bond Aggregate.

H&T strategies typically have lower correlations to traditional asset classes such as stocks and bonds. As a result, they can have powerful advantages when added to a balanced portfolio which includes lowering risk while preserving return potential.

Over the past decade, there have been several factors that have limited the results of many H&T funds. At the same time, these factors have enhanced the performance of long-only equity and fixed income strategies which supported 60/40 portfolios. Recent events and the government response to the coronavirus crisis have created a compelling backdrop for H&T strategies while traditional long-only asset classes face new challenges. It is often difficult to resist the urge to chase winners and shed losers, but periods of dramatic out- or underperformance tend to be cyclical in nature and eventually revert. For instance, hedge funds have outperformed 60/40 portfolios during two of the last three decades while also having superior volatility and drawdown characteristics over all three decades.

Hedge funds outperformed 60/40 portfolios in two of the last three decades with less risk

The 1990s (January 1990 – December 1999) – Hedge Funds outperform 60/40 with less volatility

	Global Equity	Global Bonds	60/40	Hedge Funds
Annualized Return	10.4%	7.9%	9.6%	12.6%
Standard Deviation	14.1%	4.8%	9.3%	6.0%
Max Drawdown	-21.5%	-6.1%	-11.8%	-13.1%

The 2000s (January 2000 – December 2009) – Hedge Funds outperform 60/40 with less risk

	Global Equity	Global Bonds	60/40	Hedge Funds
Annualized Return	1.0%	6.5%	3.5%	4.0%
Standard Deviation	17.1%	6.3%	11.1%	5.7%
Max Drawdown	-54.5%	-10.1%	-36.8%	-22.2%

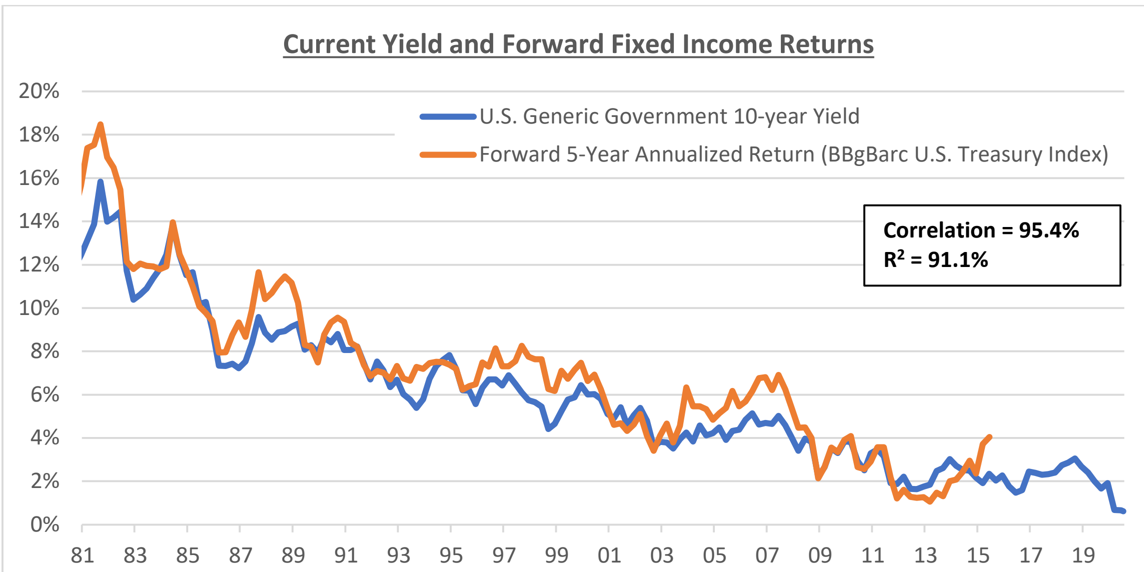
The 2010s (January 2010 – December 2019) - Hedge Funds lag 60/40 with less risk

	Global Equity	Global Bonds	60/40	Hedge Funds
Annualized Return	9.4%	2.5%	6.8%	2.8%
Standard Deviation	13.2%	4.6%	8.7%	3.9%
Max Drawdown	-20.3%	-7.7%	-12.2%	-7.7%

Source: Bloomberg monthly return data from 1/1/1990 through 6/30/2020; Hedge funds are represented by the HFRI Fund of Funds Composite Index, global equity is represented by the MSCI All-Country World Index (ACWI), Global Bonds are represented by the BBgBarc Global Bond Aggregate Index, and 60/40 is 60% MSCI ACWI and 40% BBgBarc Global Bond Aggregate.

Many investors look to fixed income as the ballast in their diversified portfolios. Luckily, stability has come with attractive levels of total return over the past 30-years as rates have steadily ground lower. While falling rates have provided a meaningful tailwind for fixed income assets, we now find ourselves with near-zero yields for high-quality government securities and nearly no room to go lower.

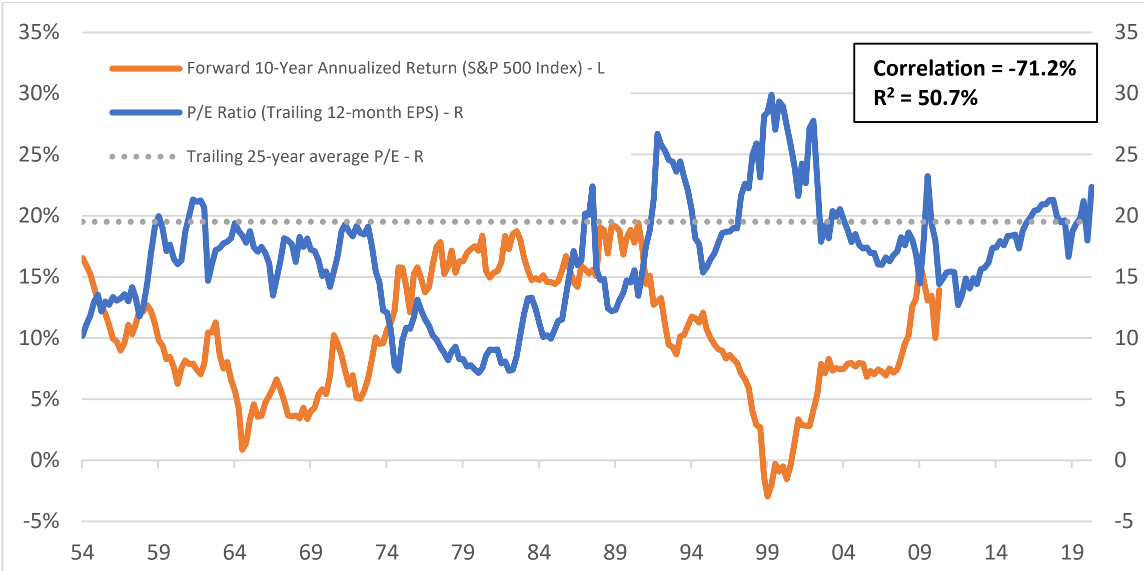
Low starting yields are likely to translate to low future returns for fixed income



Source: Morningstar and Bloomberg as of 6/30/2020

As the above chart demonstrates, starting yields have a more than 95% correlation to forward 5-year total returns for U.S. government bonds. This principle can also be applied to most areas of the fixed income market. This suggests that forward-looking fixed income returns will likely be modest. H&T strategies often invest in fixed income securities but have broader mandates and flexibility to tactically shift the duration and credit exposure in-line with the opportunity set. These expanded capabilities are an important advantage in navigating our current near-zero interest rate world.

Investing at higher equity market valuations also contributes to lower long-term forward returns



Source: Morningstar and Bloomberg as of 6/30/2020

Equities, on the other hand, often serve as the growth engine for portfolios. Many major global equity markets have had a remarkable run following the 2008 financial crisis up until recent turbulence related to the coronavirus crisis. Even with recent volatility, broad equity market valuations are elevated. Historically, higher starting equity market valuations have translated to lower forward-looking medium-to long-term returns.

Additionally, many of the equity-oriented managers within the H&T space have a value-orientation and can invest globally versus solely in the U.S. A value-oriented investment style focuses on owning securities trading at low valuations relative to the market and a security's own history. This style of investing is within one of the longest and most extensive periods of underperformance relative to growth since the late 1990s. This has only been exacerbated year-to-date when companies with high valuations have logged considerable gains while the cheapest portions of the market have had meaningful losses. International markets are also in the midst of a similar period of extensive underperformance relative to U.S. counterparts. History has demonstrated there tends to be a reversion to the mean over time, creating a compelling case for the laggard. A reversal of either (or both) of these factors could offer an advantage to many of these strategies in the future.

Conclusion: H&T strategies offer important diversification and drawdown reducing benefits when combined with traditional stock and bond holdings. The same environment that poses challenges for long-only stock and bond strategies could prove more beneficial to H&T funds with wider mandates and different methods of generating returns. Both of these factors reinforce the value H&T strategies can bring to balanced portfolios and why you should consider an allocation to the asset class.

H&T strategies can be accessed through a variety of vehicles that vary in liquidity, fees, and transparency. These include private vehicles (hedge funds and private equity), mutual funds, and ETFs. Private vehicles, often in the form of limited partnerships, tend to have the highest fees, the lowest level of transparency but the highest degree of alpha potential. ETFs are on the other end of the spectrum for each of these factors with mutual funds falling in the middle. While each fund type has its merits, Summit believes active management fees are justified in the H&T space given the level of required research and alpha potential. As a result, we recommend that these strategies are accessed through actively managed strategies typically presented in mutual funds and private partnerships.