

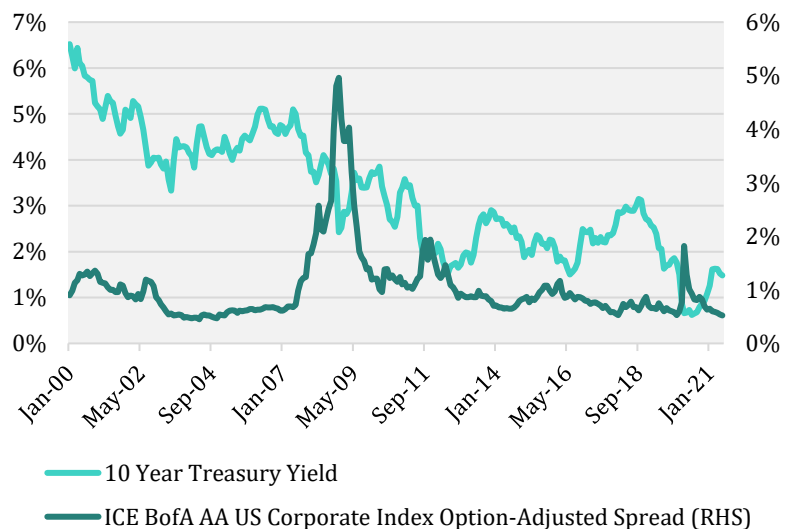


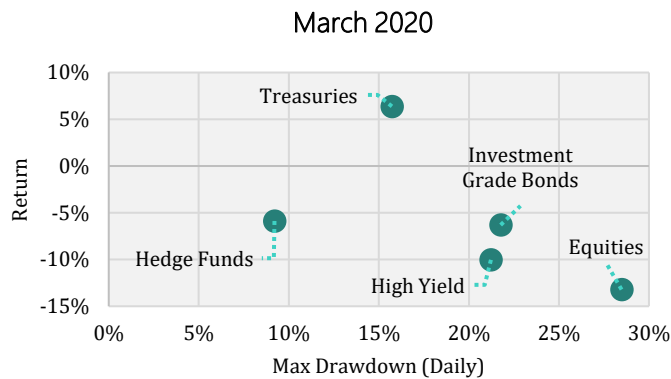
## HOW HEDGE FUNDS BECAME THE NEW FIXED INCOME SUBSTITUTE

Almost overnight, allocators started to swap out fixed income exposure for hedge funds. What's driving this? Two trends: after large and sudden drawdowns in both 2020 and 2021, many allocators simply want out of traditional fixed income; meanwhile, with alpha back, hedge funds appear to have much better return potential with comparable or lower risk.

Let's start with the first trend. The difficult reality today is that fixed income investors face paltry expected returns with potentially big downside risk. Take AGG, an ETF that tracks the Barclays Agg, a diversified representation of Treasuries, investment grade bonds and more complicated things like mortgage securities. Per Blackrock, the current average yield to maturity is around 1.4%. Let's call this the base case: very simplistically, you put \$100 in AGG today and six plus years later you have around \$109. Less than you used to earn in a savings account, but that notoriously low volatility (3%) can feel nearly as safe, predictable. One allocator coined a phrase to describe this thinking: "fixed income is the new cash."

But volatility is misleading: the real concern these days is downside risk. Investors need to walk a tightrope to earn that 1.4% per annum: risk-free rates stay historically low, credit spreads remain razor thin, defaults are non-existent. As the chart<sup>1</sup> on the right shows, both rates and credit spreads are at or near historical lows. As a practical matter, as both approach the "lower bound" of zero, return expectations drop and risk rises.





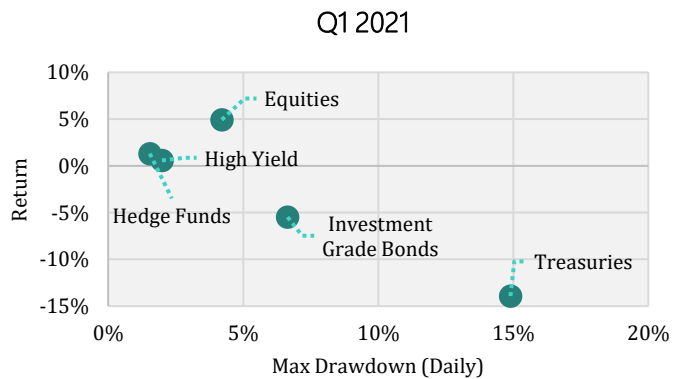
Investment Grade Bonds refers to the iShares Investment Grade ETF (LQD); Treasuries refers to the iShares 20+ Year Treasury Bond ETF (TLT); High Yield Bonds refers to the iShares High Yield ETF (HYG); Equities refers to the MSCI World Index; Hedge Funds refers to the HFRX Global HF Index

Two recent canaries in the proverbial coal mine underscored this “fat tail” risk. In the first three weeks of March 2020, as the pandemic took hold, Treasury yields plummeted to well below 1% while credit spreads quintupled. By month end, fortunately, the Fed had launched an unprecedented QE program and markets recovered much lost ground.

But the intramonth drawdowns were too extreme to gloss over. The chart<sup>ii</sup> to the left shows the March 2020 return

and intramonth drawdowns of Treasuries, investment grade bonds and high yield.<sup>iii</sup> Both investment grade and high yield bonds suffered intramonth drawdowns of greater than 20% and posted losses that wiped out years of returns. Even long dated Treasuries, which rose during the month, had a 15% drawdown. This was a flock of angry black swans.

Then during the first quarter of this year, the “too hot” recovery caused an inflation scare and a spike in Treasury yields. As shown on the right, longer dated Treasuries lost nearly 15%. Investment grade bonds also lost money – again, the equivalent of 2-3 years of returns – and had a drawdown of around 7%. High yield bonds fared much better due to higher sensitivity to equities, which rose. For many segments of the bond markets, a normalization of rates by 300 bps – not a huge stretch considering the past twenty years – could mean losses of 10-20% and wipe out a decade of returns. Put another way, more black swans lurk around dark corners of the fixed income world.



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Enter hedge funds. A few years ago, hedge funds were a tough sell. Allocators were primarily concerned that a deflationary spiral might cut the legs out from under sky-high equity valuations. On the fixed income front, yields were abysmal, but the taper tantrum of 2013 was ancient history and monetary tightening an unlikely prospect. Yet the deflationary spiral did not kick in, and as low rates went even lower, both equity and bond prices marched upward. Rather than act as shock absorbers, both sleeves of the proverbial 60/40 portfolio were hitting on all cylinders. Hedge funds, in the midst of a rough period for alpha



generation, had the dubious honor of delivering bond-like performance with equal or higher risk, or less than half the return of equities with half the risk. Many investors concluded, perhaps rightly, why bother?

Today, the hedge fund renaissance is in full swing. Take the March 2020 period described above: like most investors, hedge funds were largely caught off guard by Covid-19 and the hedge funds lost 9% intramonth (see chart above) – not perfect, but very good in the context of both equities and bonds. Yet hedge funds adapted quickly and, as we’ve written elsewhere, anticipated both the economic recovery and value rotation. They ended the year up high single digits with enough alpha generation to make up for years of struggles. Then many hedge funds, like managed futures, called the inflation scare early and made money as rates jumped. The latter performance increased the appeal of some strategies as “dynamic inflation hedges” – and hence a direct way to mitigate some of the fat tail risks described above.

Which brings us full circle to expected returns. What will hedge funds return over the coming decade? Obviously, no one knows for certain. But 1-2% per annum in fixed income is a very, very low bar. Even during the “lost” years of the 2010s, hedge funds earned 4% a year – after a ton of fees. Throw in some decent market conditions with alpha generation, and you can easily see 6% a year. Intelligently cut out fees and expenses and even more alpha generation might make its way back to client portfolios. For allocators, this could mean 3-4x the return with the same or lower risk. Framed this way, the substitution argument may be a no brainer.

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<sup>i</sup> Data for the 10-Year Treasury yield and ICE BofA AA US Corporate Index Option-Adjusted Spread are sourced from Fred - the Federal Reserve’s economic research website.

<sup>ii</sup> ETF and index data are sourced from Bloomberg.

<sup>iii</sup> We use ETFs to measure intramonth daily moves because of the issue of thin trading in many pockets of the fixed income world. A counterargument is that ETFs exaggerate moves when prices diverge from NAV; we think it more likely that NAV failed to decline fast enough to reflect economic reality. Whether corporate bonds declined 15% or 22% is largely irrelevant when thinking through the broader risk-return question.

