Perspectives

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# Is Now a Good Time for Equity Long/Short Strategies?

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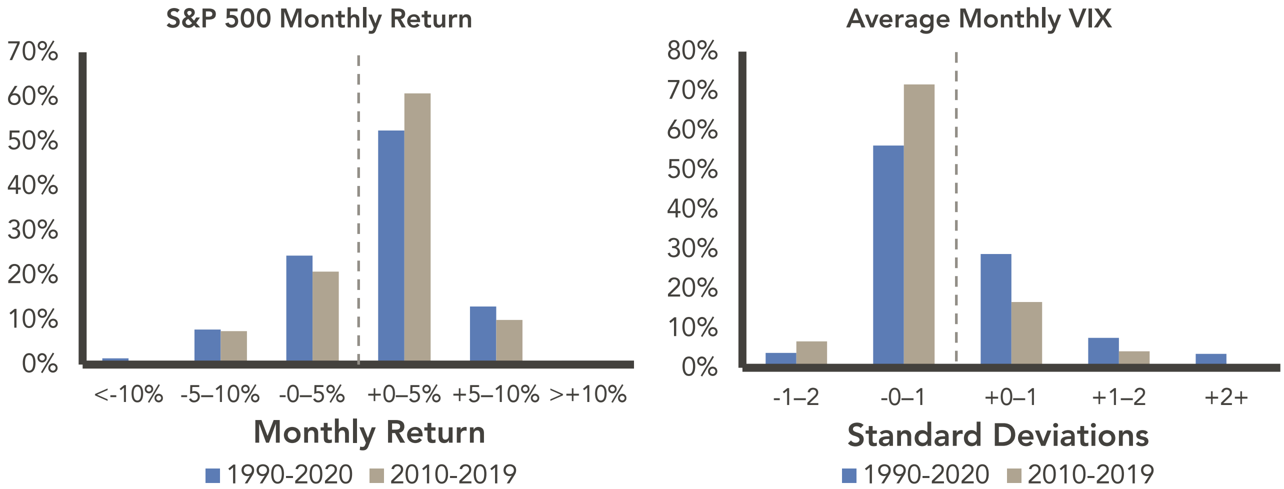
**The investment landscape looks different post-COVID. Real interest rates have fallen into negative territory. The outlook for investment portfolios built on a fixed income allocation has meaningfully changed. The stock market is just off of new highs, increasingly disconnected from the underlying economy. Are equities unstoppable, or set up for a massive correction on any negative vaccine news or a pullback in stimulus? And how will the November election impact portfolios?**

Clearly, there are many moving pieces for asset allocators trying to balance risk and return. Given the current environment, part of the solution may be an allocation to equity long/short hedge funds. Equity long/short strategies can improve portfolio diversification, help protect capital in periods of market weakness or heightened volatility, and increase overall risk-adjusted returns. In August, Hedge Fund Research noted that institutional investors were actively looking to increase exposure to hedge funds in the second half of the year as a direct result of the volatility of the first half. Here, we outline a few reasons why.

First, to level set, the S&P 500 from March 2009 to February 2020 is not the right benchmark for hedge funds. This was the longest and nearly the strongest bull market in history. Over that time, the index returned an average of 18% per year, 70% higher than its long-term average of 10.6%. Equity long/short strategies were not designed to outperform extreme bull markets. These strategies excel in periods of market weakness, market volatility, and market dispersion. In the context of history, these intervals are more common than the last decade would suggest. Going forward, there are a number of reasons (a contentious U.S. presidential election, a virus this country has so far been unable to control, a global recession complicated by trade tensions, among other dynamics) to expect a return to a more typical cadence.

Exhibit 1 on the following page quantifies this notion, categorizing monthly S&P 500 returns and average volatility levels. The 2010s stand out as a period of below average volatility and more consistently positive returns, in hindsight an ideal environment for passive equity investment. While no one has a crystal ball, to the extent that we return to a more normalized environment, investors may see lower overall returns and more volatility month to month.

**Exhibit 1:** The Last Decade Was the Anomaly



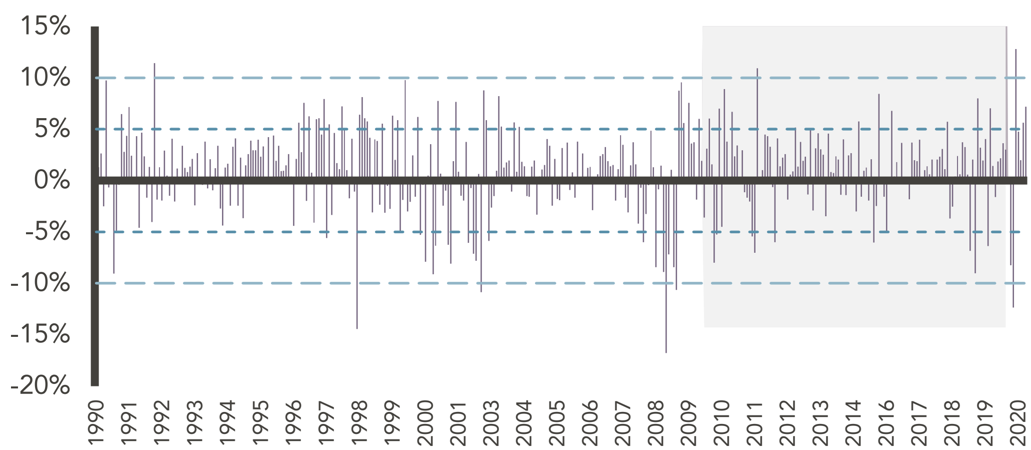

Source: Bloomberg

## DOWN MARKETS

As 2020 has harshly reminded us, equity markets can go down: a lot, quickly, and unpredictably. Equity long/short hedge funds, typically with net exposure below 100% (which would be considered fully invested for a long-only strategy) and opportunities to generate alpha on both the long and short sides, are positioned to better protect capital and outperform through those down markets.

Exhibit 2 shows monthly S&P 500 returns, bucketed into 5% increments, and the average relative performance of hedged equity funds, as measured by the HFRI Equity Hedge (Total) Index. When the market is down, these strategies outperform. In a modest down month when the market is down less than 5%, hedged equity outperforms by an average 1.6%, and in an extreme down month, down more than 10%, hedged equity funds outperform by an average 6.6%. As would be expected these strategies do lag in up markets, but note the asymmetry: **these funds outperform by more when the market is down than they underperform when the market is up.**

**Exhibit 2:** S&P 500 Monthly Returns and Hedged Equity Outperformance




| | |
|---|---|
| > +10% | -6.1% |
| +5–10% | -3.4% |
| +0–5% | -0.6% |
| -0–5% | 1.6% |
| -5–10% | 4.1% |
| < -10% | 6.6% |

Sources: HFRI, Bloomberg

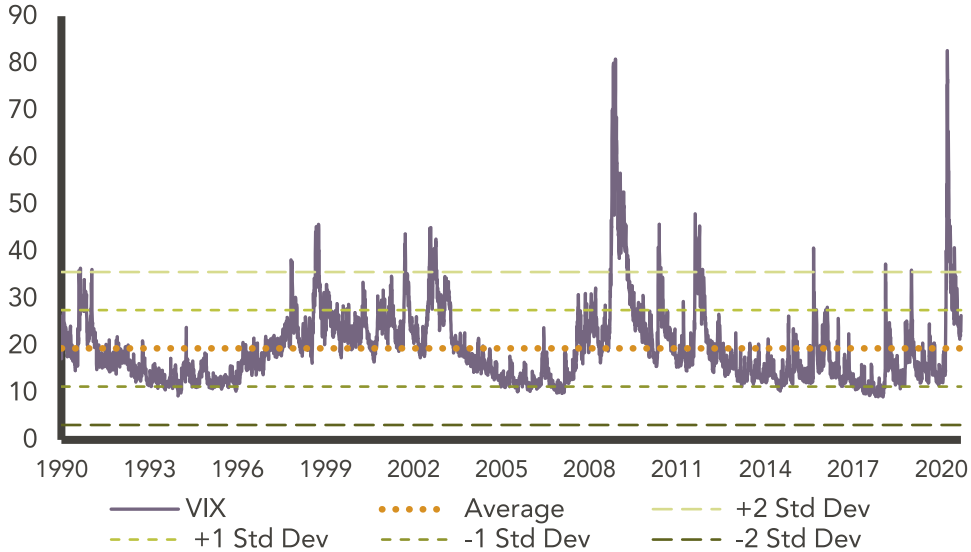
## VOLATILE MARKETS

In addition to outperforming during periods of market weakness, equity long/short hedge funds also tend to do better than the market when volatility is higher. This is not entirely uncorrelated, as volatility tends to spike during market sell-offs, but does represent a different perspective that should also be considered as we look forward.

Exhibit 3 below, similarly to Exhibit 2 previously, shows relative hedged equity performance during periods of above- and below-average volatility. The same asymmetric pattern holds: **these strategies outperform by more during periods of heightened volatility than they underperform during periods of low volatility**. And again, although the last decade proved to be especially mild, it is imprudent to underwrite to that expectation going forward. There will be surprises, and with volatility those surprises are always to the upside.

Fundamentally this outperformance makes sense. Volatility as measured by the VIX Index is also correlated with market dispersion and consequently, the effectiveness of active management. Equity long/short funds, with the ability to generate alpha on both the long and short sides, are then especially well positioned. Even as overall market volatility normalizes, new post-COVID dynamics are creating more real winners and real losers in the market than active managers have seen in some time. This is a stock picker's market.

**Exhibit 3:** VIX and Hedged Equity Outperformance




| | |
|---|---|
| +2+ Std Dev | 1.0% |
| +1–2 Std Dev | 0.6% |
| +0–1 Std Dev | 0.3% |
| -0–1 Std Dev | -0.3% |
| -1–2 Std Dev | -0.3% |

Sources: HFRI, Bloomberg

### BUT WHAT ABOUT…

- **Fees**: Fees are a common pushback to hedge fund investments but must be taken in context. The incentive fee structure aligns manager and investor interests and attracts some of the best talent in the investment management industry. Marquette always focuses on net returns, which are returns after all management and incentive fees, to normalize for fee differences across managers and asset classes.
- **Liquidity**: Liquidity may be another concern for investors. Whereas mutual funds generally offer daily liquidity, hedge funds may limit redemptions to a monthly or quarterly schedule, typically require 30–60 days' notice, and may include an initial lock-up period or investor gate. This allows managers to invest in less-liquid securities, similarly to private equity. While this is not suitable for

all clients — particularly those with large cash needs — for longer-term investors it is generally sufficient. Marquette follows its managers closely and in most cases recommendations and decisions are made and changed over a longer period of time. Key man provisions may also help bridge any gap in the extreme case when a key decision maker is incapacitated.

- **Transparency**: Another common opposition that may be misunderstood is lack of transparency. Hedge funds, especially those that Marquette recommends, are a long way from the notion of black box investing. For long positions, hedge funds are not much different than mutual funds — often reporting exposures, attribution, and top positions monthly, with full holdings disclosed quarterly in regulatory filings. There is less visibility on the short side; naming short positions could be detrimental to the manager's process — potentially restricting access to management teams or driving crowding. We focus on transparency to ensure managers are sticking to their stated and proven investment process. This can largely be accomplished without perfect transparency into short holdings.
- **Business Risk**: Beyond investment risks, hedge funds may also have above average business risk. Hedge fund management companies tend to skew smaller, perhaps with fewer products and a more concentrated investor base, which could lead to liquidation — though not necessarily capital loss — in times of stress. The group also has a history of being less regulated by government agencies. While cases of outright fraud are rare, they do make for great headlines and so can overly influence public opinion. Marquette takes operational due diligence very seriously and seeks to avoid any avoidable risks.

With hedge funds there are a number of important risk factors that investors should consider beyond the traditional risk and return metrics; we only argue that they should be considered thoughtfully.

## CONCLUSION

Amid today's uncertainty with asset allocations at risk due to current interest rate levels and the risk/return outlook for equities increasingly nuanced, equity long/short funds — with a greater focus on alpha than beta — should be part of the conversation. These strategies can help diversify a portfolio, protect capital in periods of market weakness and heighted volatility, and improve total risk-adjusted returns. While the data in this piece was based on the equity long/short universe as measured by the HFRI Equity Hedge (Total) Index, hedge funds are an actively managed asset class where manager due diligence is especially important. Through Marquette's investment and operational due diligence, we have identified a number of select managers and strategies that we believe can outperform this broad universe. As always, please contact one of our consultants or hedge fund analysts for more information.

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