



DUSTING OFF GRAHAM AND DODD?

HEDGE FUNDS SAY THE VALUE ROTATION IS REAL

Andrew D. Beer is the Founder and Managing Member of Dynamic Beta investments, LLC, a New York-based firm that specializes in liquid alternative investment strategies.

Have hedge funds bought into the much-discussed value factor rotation that began in the Fall? The short answer is yes, in a big way.

Strategies that replicate portfolios of hedge funds using factor models can determine how hedge funds are positioned today across major equity markets, and how those positions are changing. It follows, then, that these models can provide potentially valuable insight into how some leading hedge funds view the world. Right now, hedge fund positioning indicates that the value factor rotation is real.

The Hedge Fund Factor Rotation of 2020

It is important to note that hedge funds have a very good track record of calling market inflection points. In 2000, a pivot to small cap stocks with a short of large cap dotcoms preserved capital in a grueling bear market. By 2005, many of the same funds had migrated into emerging market stocks, which outperformed the S&P 500 for years on the back of the BRIC/commodity boom. Then in 2012, hedge funds surprised people by buying US quality stocks which, while perhaps not as cheap on a statistical basis, offered better risk-reward characteristics than, say, European stocks buffeted by a fragile common currency or emerging markets stocks subject to geopolitical risks. The last few years' endorsement of quasi-monopolistic tech stocks and subsequent profitable run, then, was not an isolated incident.

So, hedge funds had a long tech bias leading into 2020. As much as five years earlier, the game-changing business models of the FAANG stocks often ranked among the most popular hedge fund longs. By early 2020, an index of widely held hedge fund stocks had a correlation of greater than 95% to the Nasdaq. Consequently, when the coronavirus hit, hedge fund longs, on average, went down less than the overall market and rebounded much faster.

By the summer, two important trends emerged. First, after holding tight during the short, sharp bear market, equity exposure began to increase. Hedge funds, broadly speaking, were early adopters of a global version of "don't fight the Fed" and endorsed the view that there was a floor under equity prices. Second, and as importantly, risk started to shift to areas of the equity markets that had been de-emphasized for years:

emerging markets, especially, but also small cap stocks and international developed equities. Consequently, by the time those markets began to materially outperform in the Fall, hedge funds were well positioned. Much hedge fund alpha last year is explained by those two trends.

How does this relate to the value factor? EM, small cap, and international developed equities tend to have a much higher percentage of “value” stocks than, say, the S&P 500 or, obviously, Nasdaq – think: oil and gas companies, banks, commodity producers, homebuilders, etc. Plus, as we know, those markets have underperformed their large cap and tech-y brethren for years and trade at much lower multiples. Hence, it makes sense that, as the relative valuation rubber band was stretched further and further, stock pickers at some point would pivot into them. So, the 2020 factor rotation among hedge funds strongly supports the broader claim of a long overdue rotation into value.

Defining “Value” and “Rotation”

There is of course no universal agreement on how to define the value factor. In fact, there are dozens of definitions. It would seem anachronistic to use Fama’s price-to-book ratio; and yet it would seem arbitrary to pick a different factor. This imprecision makes it impossible to draw a straight line from the factor rotations above to a clear endorsement of a “value factor” in the coming years. That said, the shift into “cheaper” seems real.

Rotations are also more nuanced than how they are often described in the media. We see no evidence that hedge funds have abandoned stocks like Apple, and certainly no evidence that they are now short, as was true during 2000-02. They obviously did not wake up one day and dust off Graham and Dodd. But, if they had bought stocks like Apple or Alphabet several years ago, by summer 2020, those stocks might have doubled or tripled. With a flood of retail money chasing performance and “this time is different” themes, each soared spectacularly in a few months and valuations were lifted to extremes. A prudent, valuation-sensitive hedge fund manager likely would trim positions and take profits. The question, then, is where to deploy that cash. The evidence suggests that talented managers determined that the risk-reward dynamic had shifted to favor stocks outside a narrow market leadership and acted accordingly.

Conclusion

There is a great deal of noise, and often little signal, in the value vs. growth debate. As soon as the Pfizer vaccine was announced, long-time value proponents began to declare victory. Like political forecasting, voting along a party line is predictable and uninteresting; swing voters, however, can tell us a lot. In this way, hedge funds are like swing voters: broadly speaking, they are dogma-agnostic and have the flexibility to shift what they do over time. Plus, they have their own money on the line, which fosters a certain intellectual honesty. Lastly, they tend to make bigger, more pronounced bets: while an institutional allocator with a bullish view might increase emerging markets from 4% to 6%, hedge funds have added, by our estimate, 15% this year alone. Taken together, it is worth paying attention to what hedge funds are doing.

Lastly, these rotations do not happen in isolation. The broader macro consensus among hedge funds is that the economic recovery is on track, vaccines will be effective and eventually end the pandemic, fiscal and monetary support will remain robust, growth will be stronger in countries (e.g., Asia) where containment efforts were more successful, and resurgent inflation in the US might cause a rapid decline in the US dollar. Those macro themes should be supportive of equity markets that have underperformed for years, and certainly of “value” stocks. On the other hand, if those macro underpinnings break down, we could see a

sharp reversal. This is, in a sense, what happened in early 2018 when a global synchronized growth thesis was quickly replaced by synchronized global slowdown. So, while die hard value factor proponents might see an inflection point pointing toward a resumption of a decade or two of excess returns, we will cautiously watch how talented, flexible and self-interested hedge funds are shifting their portfolios in the years ahead.

IMPORTANT DISCLOSURES

THIS ARTICLE HAS BEEN PREPARED AND CIRCULATED FOR INFORMATIONAL PURPOSES ONLY AND SHALL NOT CONSTITUTE AN OFFER TO SELL OR THE SOLICITATION OF AN OFFER TO INVEST IN ANY PROGRAMS OFFERED BY DYNAMIC BETA INVESTMENTS ("DBI") IN ANY JURISDICTION.

PAST RESULTS ARE NOT INDICATIVE OF FUTURE RESULTS. INVESTMENT IN ANY DBI PRODUCTS IS SPECULATIVE AND INVOLVES A HIGH DEGREE OF RISK, INCLUDING THE RISK THAT THE ENTIRE AMOUNT INVESTED MAY BE LOST.