HEDGE FUNDS ARE BACK!

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Pundits love to beat up on hedge funds these days. The glory days are long gone, they argue, and investors should stick to low cost, passive investments like the S&P 500. For nearly every fund that proved its mettle during March, another two imploded. Hedge fund fees mean investors are in a heads-you-win-tails-I-lose trap (disclosure: a point the author himself has made). A rational investor, they say, should skip the space altogether. And yet, recent surveys show institutional investors planning to increase allocations.

These blanket critiques miss the larger picture. During the 2000s, while the S&P 500 lost 1% per annum – the "lost decade" – hedge funds returned 6% a year. The shining periods were 2000-02, when hedge funds made money during the dotcom bear market by investing in cheap, small cap stocks and shorting high-flying technology shares. Within a few years, many of those same hedge funds had pivoted into emerging markets stocks and capitalized on the BRIC and commodity wave. 2007 was a banner year, as bets against subprime mortgages paid off. By contrast, 2008 was a bit of a disappointment: hedge funds declined more than expected, some suspended redemptions and the industry overall was tainted by Madoff. But by the end of the decade, hedge funds had recovered. For these reasons, the 2000s are often called the Golden Years.

The 2010s, by contrast, were dominated by passive investing. In a world of constant monetary easing, a simple portfolio of stocks and bonds returned nearly 7% per annum. Global investors flocked to US large capitalization stocks, exemplified by the S&P 500 and later technology monopolists; prices rose accordingly. This was a brutal decade for active management overall: under-loved value stocks suffered historic underperformance and many strategies were hammered by a market seemingly divorced from fundamentals. During this decade, hedge funds returned only 4% (also, interestingly, about 3.5% above the risk-free rate). While some hedge funds called the shift into US equities as far back as 2012 and later embraced future trillion-dollar stocks like Apple and Alphabet, it was nearly impossible to keep up. Alpha, a measure of value added, was modestly negative. On a relative, if not absolute, basis, these may be deemed the Lost Years.

The lesson from both decades is that hedge funds do one thing very well: shift into the right markets at the right time. In addition to ample talent, the true competitive advantage of hedge funds may be their flexibility. Most investors, by contrast, have stringent "constraints": a US large cap equity manager must still buy those stocks even at sky high prices; pension funds might tilt their portfolios by a few percent, but no more. Research on hedge funds shows that they will change, and change in a big way, as market conditions evolve.

A small cap value investor in 2000 might have pivoted into emerging markets by 2005 and later to US large cap quality stocks. In some circles, "strategy drift" is a derogatory term; with hedge funds, it is a plus.

Which brings us to the 2020s. The S&P currently trades at 33x earning and a high percentage of US equity value rests in a handful of stocks with nosebleed valuations; history tells us that the easy money has been made. On the fixed income front, Treasury yields are alarmingly close to zero and corporate credit appears to be in a bubble. The 2020s may well be a "lost decade" for simple, passive portfolios.

We see evidence that hedge funds recognize that 2020 looks more like 2000 than 2010. Several investing legends now call tech stocks a "bubble." On a relative basis, overlooked or forsaken areas like small cap stocks, value investments, non-US equities, and emerging markets are historically cheap. In fact, our risk models show that, over the past year, hedge funds have been shifting into many of those areas. We appear to be amid an inflection point, although it will take some time to confirm this.

What could go wrong? The biggest headwind is that hedge fund fees remain too high: many investors pay away $6 out of every $10 in returns, which simply makes it harder to make money in a lower return environment. Another issue is that most capital today resides with the largest managers, who may not be as nimble nor able to capitalize on more esoteric opportunities as their much smaller forebears. A related concern is that institutionalization may limit strategy drift since pension funds place managers in narrower buckets than the family office investors of twenty years ago. Finally, and significantly, the rapid and broad dissemination of information means markets have become far more efficient over time – a headwind not just for hedge funds, but all active investors.

Taken together, hedge funds may have a more compelling opportunity set today and the hurdle to demonstrate value will likely be low over the coming years. The 2020s, then, might well be a Second Golden Age.

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