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COVID-19 Hedge Fund Review: Perspective During a Pandemic

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Snapshot

- Hedge fund strategies outperformed broad equity benchmarks during the recent market selloff.
- Overall, our strategies limited losses in a difficult market.
- We believe the current crisis should generate opportunities for hedge fund managers to put capital to work.

While the start of 2020 has been a challenging period for just about every asset class, our hedge fund offerings—the SEI Opportunity Fund and the SEI Special Situations Fund—suffered only a fraction of the equity market's downside.

Both Funds were also well ahead of the HFRI Composite Fund of Hedge Funds Index over one, three and five years; over the last three years, the risk-adjusted return (or Sharpe ratio) of each Fund also exceeds that of the HFRI Composite Fund of Hedge Funds Index.

Annualised Performance as at 31 March 2020

	1Q 2020	YTD	1 year to 31 Mar 2020	1 year to 31 Mar 2019	1 year to 31 Mar 2018	1 year to 31 Mar 2017	1 year to 31 Mar 2016	Since Inception[4]	Volatility[2]	Sharpe Ratio[3]
SEI Funds[1]										
Special Situations Fund, Ltd.	**-9.3%**	**-9.3%**	**-3.1%**	**3.1%**	**6.6%**	**10.2%**	**-10.0%**	**3.5%**	**6.7%**	**0.3**
Offshore Opportunity Fund II Ltd.	**-5.3%**	**-5.3%**	**-2.6%**	**2.4%**	**3.1%**	**7.3%**	**-7.9%**	**2.2%**	**3.9%**	**-0.2**
Market Indexes										
S&P 500 TR	-19.6%	-19.6%	-7.0%	9.5%	14.0%	17.2%	1.8%	11.2%	15.2%	0.2
MSCI World TR	-21.1%	-21.1%	-10.4%	4.0%	13.6%	14.8%	-3.5%	7.0%	14.8%	0.0
MSCI Emerging Markets TR	-23.6%	-23.6%	-17.7%	-7.4%	24.9%	17.2%	-12.0%	-0.7%	17.3%	-0.3
Dollar Index	2.8%	2.8%	1.8%	8.1%	-10.3%	6.1%	-3.8%	2.5%	5.1%	-0.4
Bloomberg Barclays Global Agg	-0.3%	-0.3%	4.2%	-0.4%	7.0%	-1.9%	4.6%	2.2%	3.9%	0.4
Bloomberg Barclays US Agg	3.2%	3.2%	8.9%	4.5%	1.2%	0.5%	1.9%	3.9%	3.2%	0.9
Bloomberg Commodity	-23.3%	-23.3%	-22.3%	-5.3%	3.7%	8.4%	-28.7%	-6.1%	12.2%	-0.9
Hedge Fund Indexes										
HFRI Composite Fund of HF	-6.6%	-6.6%	-3.4%	-0.6%	5.7%	4.5%	-5.5%	1.5%	4.9%	-0.3
HFRI Div. Fund of HF	-5.9%	-5.9%	-2.5%	1.0%	5.5%	5.0%	-4.5%	2.3%	4.8%	-0.2
HFRI Global HF Indeex	-6.9%	-6.9%	-1.4%	-3.3%	3.2%	6.2%	-7.4%	0.6%	5.2%	-0.5

[1]Returns for SEI Special Situations Fund and Offshore Opportunity Fund II include March estimates. Performance is gross of investment management fees and net of administrative expenses and underlying fund expenses. Client implemented via collective investment trusts incur product-level fees, including trustee and administrative fees, while will affect performance. Past Performance is not a reliable indicator of future results.

[2]Volatility is annualised 3-year standard deviation through 31/3/2020.

[3]Assumes risk-free rate of 1.2% for 1/1/2017-31/3/2020.

[4]Inception date for Special Situations Fund is 1/10/2009. Since inception performance for Offshore Opportunity Fund II is attributed to performance from 1/10/2003-31/12/2007 for the SEI Opportunity Master Fund, LP and from 1/1/2008-31/3/2020 for the SEI Offshore Opportunity Fund II, Ltd.

Sources: Bloomberg, SEI.

While we took our lumps during the first quarter, our losses were generally in line with expectations. Many higher-profile hedge fund managers stumbled during this time. These managers typically had a few things in common—exposures that we try to avoid in our own investment process:

- **Excessive leverage**: Leverage can be good on the way up, because it magnifies returns. But it also magnifies losses on the way down; counterparties can force holders to liquidate at inopportune times. This is why we tend to avoid highly-levered strategies.
- **Liquidity mismatches:** Anything our managers own must be liquid over a period of a few months. Many strategies, such as private equity and parts of the asset-backed markets, have found their ways into hedge fund portfolios and created liquidity mismatches, which hurt investors in the first quarter.
- **"Bubbly" markets:** Parts of the market that have become popular in recent periods can grow riskier at inflated prices as investors pile on capital. Examples of this include direct lending (over the last few years) and various strategies looking to sell volatility.
- **Excessive complexity:** If we can't explain it to our clients, we don't invest in it. In times of stress, excessive complexity tends to hurt.

Looking Ahead

We believe the current crisis has increased the attractiveness of valuations in several areas:

- **Mergers & acquisitions:** In mid-March 2020, merger spreads exceeded the levels they reached in 2008[5]. Most of these strategic deals are likely to be consummated before the end of the year, so they do not require an investor to take a long-term view.
- **Relative value:** Market volatility has created distortions within the capital structure of companies, such as between common equity and debt, or between share classes of the same company. These types of anomalies don't really exist in "normal" times, but are plentiful in the current environment, creating opportunities in the short term.
- **Corporate credit:** The coming default and restructuring cycle is likely to exceed anything in past crises. The enormous amount of low-quality, investment-grade (BBB) issuance that we believe could be downgraded will put pressure on the high-yield universe. The severity and pervasiveness of the downturn will likely force many issuers into restructuring, which could create attractive opportunities for investors.

SEI's View

At its core, the current crisis is a tragic event. But from an investment perspective, we believe it will generate opportunities for hedge fund managers to put capital to work.

Broadly speaking, our strategies have done their job over this time. They have limited losses in a difficult market. As a result, we believe our underlying managers are in a good position to take advantage of some of these opportunities and generate returns.

We recognize that the hedge fund industry has become more crowded and competitive in recent years, and it has become more difficult to remain differentiated and generate alpha. SEI's approach has adapted and evolved in an effort to continue finding managers and strategies that can deliver attractive returns for our clients.

[5]Source: Wall Street Journal

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