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Research Paper

Considerations for Alternative Asset Investors

The Role of Hedge Funds and Private Capital Today

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Uncertainty surrounding the magnitude of the COVID-19 outbreak coupled with a strong selloff in crude oil prices and energy-related companies have pushed global stocks into bear market territory. It, followed by a historic spike in the unemployment rate, raises the likelihood of a global recession. This has resulted in substantive volatility in financial markets and it is no surprise that the alternative investment fund industry has been impacted as well.

Investors look beyond traditional asset classes in order to preserve capital and generate uncorrelated positive real returns. Those with exposure to alternative assets, including hedge funds and private markets, can improve the resiliency of their portfolios through diversification as well as potentially generate returns in times of turmoil. Below we examine how alternative assets are faring during this global pandemic and which strategies we believe are poised for success.

Hedge Funds – Positioned to Protect Capital and Profit from Public Market Dislocations

Structurally, hedge funds have more flexible investment mandates than their benchmark-driven counterparts. They are designed to pivot quickly in order to generate strong risk-adjusted and uncorrelated returns over a market cycle. Most hedge funds focus on protecting the downside first, as minimizing losses allows them to reinvest and compound capital at a higher rate.

There have been limited periods of prolonged market stress since the Global Financial Crisis, along with extended periods of historically low volatility as measured by the VIX. The opportunities for hedge funds to prove their worth

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have been few and far between over the last decade, until now, as fears stemming from the potential snowball effects of the COVID-19 outbreak have contributed to a global repricing of risk in both February and March.

In February, the MSCI ACWI Index fell 8.1 percent and the S&P 500 lost 8.23 percent. Even more noteworthy was the rapid pace of losses that came shortly after the S&P 500 reached an all-time high on February 19, 2020. That same month, the VIX Index surged from 13 to 40 before going as high as 82.7 in March.

Most hedge funds, however, more successfully navigated the tumultuous environment. In February, the HFRI Fund Weighted Composite Index and HFRI Fund of Funds Composite Index both lost less than 2 percent, and meaningfully outperformed global equities. In March, the MSCI ACWI and S&P 500 lost 13.2 percent and 12.4 percent respectively, while the HFRI Fund Weighted Composite and HFRI Fund of Funds Composite lost 5.9 percent and 4.9 percent respectively, protecting capital and generating alpha over public equities.

Although hedge fund performance, year-to-date, has varied widely across strategies, themes have emerged in our conversations with managers.

- In March, there was a significant dispersion in Equity Long Short managers, with outperformers taking defensive positions going into the month, often reducing leverage, covering short positions, adding broad index hedges and rotating into companies with stronger balance sheets.

- Discretionary Macro managers traded tactically with the increased market volatility. Not surprising, tail risk strategies and macro managers with long volatility positions performed well after years of negative to flat performance.

- Event Driven managers with large M&A books saw mark-to-market losses as deal spreads widened. It hurt performance for the quarter but allowed managers to take advantage of attractive asymmetric risk-reward opportunities. Event Driven managers also rotated away from soft-catalyst events and hedged the portfolio with single-name credit shorts in companies sensitive to even greater economic pressure and reduced demand.

- Fixed Income Relative Value managers saw extreme dislocations across rates and credit markets that caused many to stumble. This space, typically more levered than others, was under the most stress after funding markets seized in March. Cognizant the dislocations present trading opportunities, top-tier managers remain disciplined from a risk management perspective.

We include hedge funds in an investment portfolio as we believe there is potential to generate attractive returns while offering a measure of capital preservation during challenging economic and market conditions. The result has been uncorrelated returns with downside protection in periods of market stress. Given the dislocation and selloff across risk assets, significant alpha opportunities for hedge funds across strategies are expected as volatility remains elevated and the situation evolves.

Private Markets – Equipped to Support Portfolio Companies and Deploy Record Amounts of Dry Powder

While private market metrics lag public markets, it remains a GDP-linked asset class. Both business investment and consumer spending will weaken as a result of the pandemic, along with a corresponding slowdown in private market deal flow. Although private markets managers are armed with capital to help alleviate pressures from an economic contraction, it will still be challenging.

The pace of activity has already declined, as economic uncertainty places pressure on fundraising, transaction volume, and the M&A market. The pandemic has forced limited partners to reevaluate their liquidity needs, which has led to extensions in fundraising periods for managers. A volatile public market also increases difficulty completing transactions. Fund managers need to be more prudent when underwriting portfolio companies. And, for some, that includes re-underwriting deals that were near completion. Even though we do not expect activity to grind to a halt, plan on both buyers and sellers being increasingly cautious.

Seasoned private market investors will try to take advantage of lower entry multiples as competition subsides and some investors are forced to sell due to liquidity needs. However, in the near-term, many private markets managers will need to allocate their time, operational expertise and resources on their current portfolio companies.

Longer term, private market investors have plenty of dry powder to tap. With the decline in public market valuations and corresponding lower entry multiples, private market investors are in a position to pick up great companies at discounted prices; and even hunt for bargains. Pitchbook estimates approximately $2.4 trillion of dry powder stored in private vehicles. When the panic subsides, be it in months or quarters, we expect this deep pool of capital to be invested.

In fact, managers flush with cash will not need debt financing to complete transactions and can be more flexible with opportunities presented as sellers push to close deals. In addition, special situations and distressed funds that found it difficult to secure opportunities over the past few years, compared with traditional buyout, are well capitalized to take advantage of dislocations and acquire assets at depressed prices as they have been waiting for the cycle to turn.

Historically, investing during a market bottom or in the early stages of a recovery results in meaningfully positive returns for investors; while funds trying to sell portfolio companies during a downturn tend to underperform on a relative basis. Vintages that invest during turbulent times are likely to earn higher rates of return than those that are trying to harvest gains.

Cambridge Associates found the median internal rate of return for private equity during 2006, 2007 and 2008 was 11.1 percent, 11.2 percent and 12.4 percent, respectively. The vintage years that underperformed were 2004 and 2005 which returned 9.1 percent and 8.2 percent, respectively. This resulted from either managers accepting lower multiples, as deals were realized at depressed prices during 2008 and 2009, or managers extended the holding period of companies, that reduced the internal rate of return. Coming out of a downturn produced strong returns; 2009 vintages earned an average of 17.7 percent.

A benefit of private capital is that it is long-term in nature and can withstand short-term volatility. In addition, the drawdown structure is conducive to fund managers exploiting attractively priced opportunities during tough times.

Our approach to private markets, specifically, emphasizes managers who have expertise navigating inefficient markets combined with a preference for conservative capital structures. We favor value creation through earnings growth rather than financial engineering so that experienced buyout managers can build better and stronger businesses. These managers should be well suited to weather the storm and take advantage of the current environment.

For investors who are not sensitive to liquidity, a strategic allocation to private markets may improve the absolute performance and risk-adjusted returns of their investment portfolio.

Continue to Persevere

The global macroeconomic and geopolitical outlook remains in a state of flux. While it is impossible to predict what will happen in the future, the alternative asset firms that have successfully prepared themselves to navigate trying periods will emerge stronger and better positioned to add value in the future.

We recognize the impact and ongoing concerns of COVID-19 for all of us. It is our hope that you, your loved ones and colleagues are safe during these unprecedented times.

For more information, please contact any of the professionals at Fiducient Advisors.

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Angelique is a Senior Research Analyst in the firm's Global Private Markets group. Within this group, Angelique is responsible for sourcing and performing due diligence on investment opportunities across private equity, private credit and private real assets. Angelique is a voting member of the firm's Global Private Markets Team and Hedge Fund Research Team. Prior to joining the firm in 2018, Angelique was a Senior Investment Analyst at Granite Associates and an Investment Research Associate at Utah Retirement Systems. Angelique graduated summa cum laude with a BA in Finance from Westminster College in Salt Lake City. She is a CFA® charterholder and a member of the CFA Society of Chicago, the CFA Institute and 100 Women in Finance. Angelique is also pursuing her MBA from the Kellogg School of Management at Northwestern University. She enjoys world-travel, cooking, reading and being active in her free time.