TIFF
INVESTMENT MANAGEMENT

HERE COMES THE SUN

The Rise of Hedge Fund Performance

Recognizing Hedge Funds as a Key Part of a Diversified Portfolio

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Executive Summary

We believe it's time for investors to warm up to hedge funds again, especially given their four-plus–year run of outperformance:

- From 2008 to 2019, we experienced a period of declining or very low interest rates
  - Hedge funds struggled to keep pace with rising stock prices and strong fixed income markets
- We believe those headwinds have become tailwinds
  - The Fed's policy tightening in 2022 restored volatility to stocks and bonds – and dispersion in both markets
- Dispersion provides the fuel for good hedge funds to generate superior returns
  - Hedge funds have outperformed bonds from 2020 through 2024 year to date

Against this backdrop, in this paper we will:

- review hedge fund performance since the pandemic
- place it in historical context
- review the process of building a hedge fund portfolio of hedge funds
- and share how we think about selecting the right managers

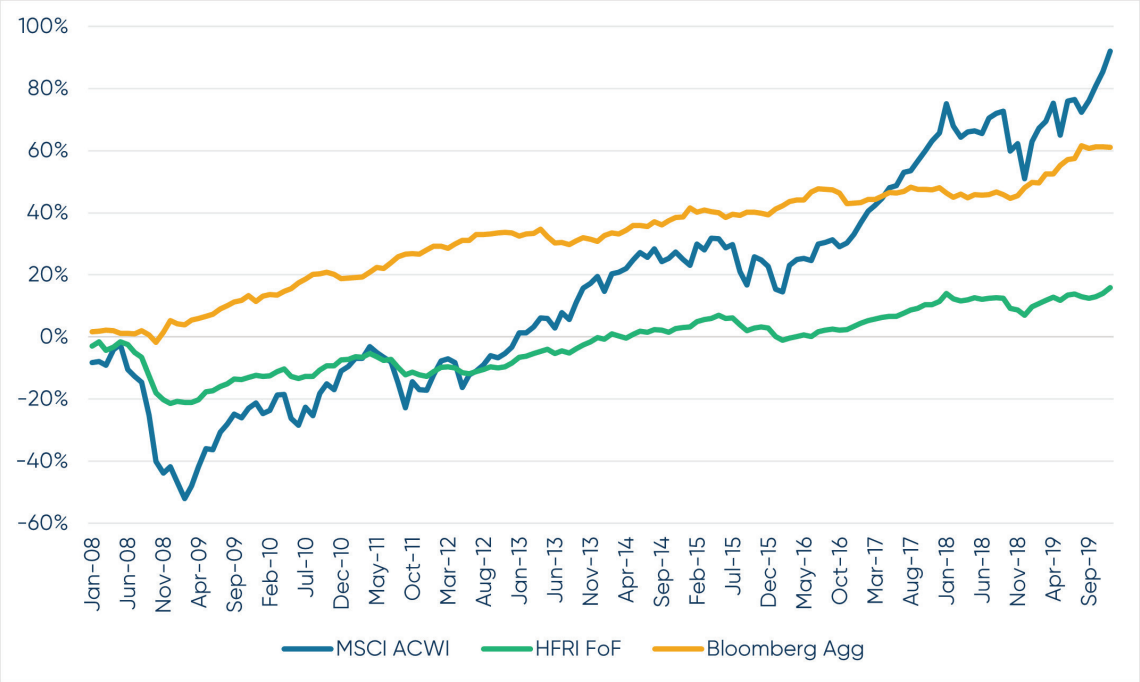
Introduction

In a recent white paper, Wind of Change: A Favorable Environment for Hedge Funds, we highlighted how the long-running headwinds faced by hedge funds could be turning to tailwinds amid a shifting market environment. We believe it's still a good time for investors to warm up to this asset class, especially given hedge funds' recent, four-plus–year run of outperformance. It's time to bring hedge funds out of the shadows – and into your portfolio.

For nearly 15 years, from 2008 to 2019, we experienced a period of declining or very low interest rates, and hedge funds struggled to keep pace with the seemingly endless rise of stock prices and the strength of fixed income markets. From 2008 to 2019, the MSCI All Country World Index (ACWI), a measure of global stocks, returned an average of 5.6% per year. The Bloomberg US Aggregate Bond Index (Agg), which

replicates the broad US bond market, posted an annualized return of 4.1%. The HFRI Fund of Funds Composite Index (HFRI FoF), a measure of the hedge fund universe, lagged stocks and bonds, with a yearly gain of 1.2%.[1] The disappointing drawdown in 2008 and subsequent underperformance caused many investors to lose faith in the asset class.

A Disappointing Period: Cumulative Return of Stocks, Bonds, and Hedge Funds
(January 1, 2008 to September 30, 2019)[2]



We believe the winds have turned. The inflation that hit in mid-2021 and caused the US Federal Reserve (Fed) to hike rates aggressively and tighten policy in 2022 helped restore volatility to stocks and bonds, breaking the negative correlation between the two. Hedge funds have been mounting a comeback, outperforming bonds in 2020, 2021, 2022, 2023 and so far in 2024. Because of this changed environment and hedge funds' ability to help build strong, long-term investment outcomes in both up and down markets, we believe the asset class is poised to remain an important holding in investors' portfolios.

In this piece, we'll take a look at how well hedge funds have performed since the pandemic, reminisce about historical periods that come to mind as we study today's

[1] Source: Bloomberg and Hedge Fund Research.
[2] Source: Bloomberg and Hedge Fund Research.

markets, discuss the process of building a portfolio of hedge funds, and delve into what TIFF believes is important when selecting the right hedge fund managers for your portfolio.

To Everything, There Is a Season

After the Great Financial Crisis (GFC) of 2007 to 2009, hedge funds entered a long period of relative underperformance. As global governments flooded the system with cheap money, interest rates declined faster than my GPA after I met my wife in college — although, in my defense, my grades never flirted with zero. Meanwhile, both equity and bond markets launched into party mode, broadly marching higher for more than a decade.

The steady rise of global markets from 2009 to 2019 under the cover of lower interest rates and Quantitative Easing (QE) created an insidious environment devoid of dispersion, robbing hedge funds of opportunities for alpha generation. The asset class struggled in this alpha-scarce environment, posting relatively low returns. That changed beginning in 2021, as inflation caused one of the sharpest interest rate–hiking cycles in history. Starting in March 2022, the Fed raised its key rate 11 times, from essentially zero to a 22-year high of 5.25% to 5.5% by the end of July 2023.

From January 2020 through March 2024, ACWI returned 10.3% on an annualized basis, and the Agg posted an annualized decline of 0.9%. Meanwhile, the HFRI FoF returned 5.0% per year – handily beating the Agg. It also provided nearly half of ACWI's returns but did so with approximately one-third of the market exposure, or beta (a measure of how an instrument moves relative to the broad market). In short, the HFRI FoF was more efficient than both the Agg and ACWI.

TIFF Insights

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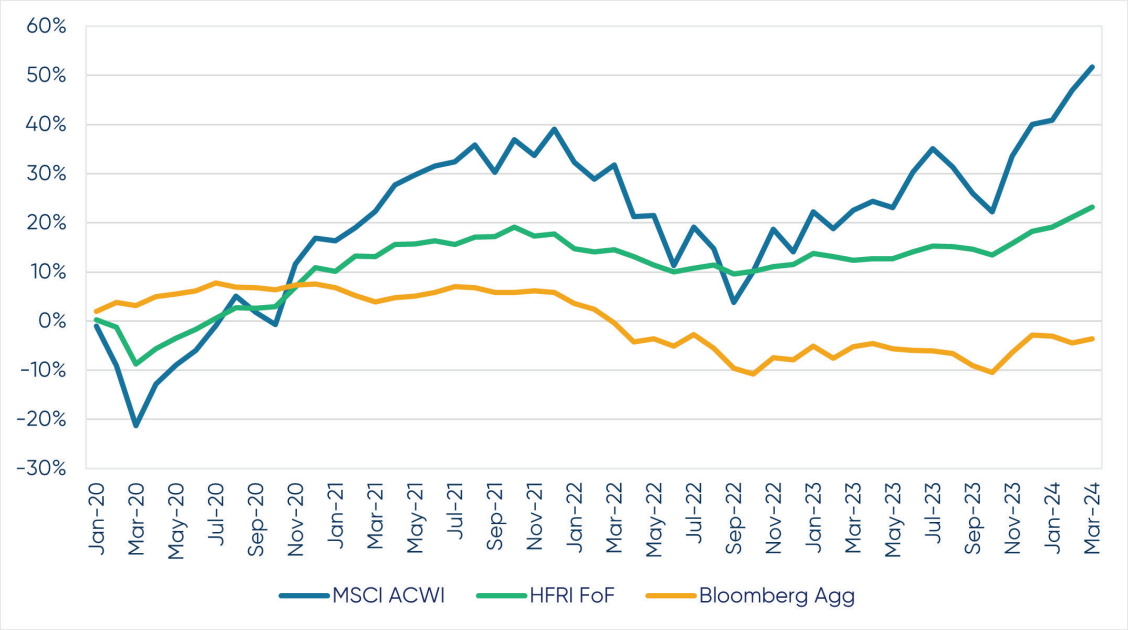
Wind of Change: A Favorable Environment for Hedge Funds

Stayin' Alive: The Importance of Risk Management in a Risky Market

A New Era: Cumulative Return of Stocks, Bonds, and Hedge Funds
(January 1, 2020 to March 31, 2024)[3]



Absolute performance, or what investors actually received in terms of capital growth, is the primary driver of portfolio growth and is obviously paramount. In addition, the path and risks taken to achieve these returns is also important. At TIFF we consider performance not just in absolute terms but also on the basis of efficiency — that is, in terms of the level of risk involved.

The Best of Both Worlds

Absolute Returns in an Efficient Manner

We explored the concept of volatility in the recent white paper Stayin' Alive: The Importance of Risk Management in a Risky Market. Volatility is a measure of the magnitude of potential risk inherent in an investment. Efficiency combines both risk and return, by asking (and answering) the key question: How much risk are you tolerating in order to achieve an expected level of return? Absolute gains are what every investor aims for, but taking on too much risk in order to generate those gains can often end poorly.

[3] Source: Bloomberg and Hedge Fund Research.

Efficiency of Select Asset Classes
(January 1, 2020 to March 31, 2024)[4]

	MSCI ACWI	Bbg US Agg	HFRI FoF	65/35	65/20/15
Annualized Return	10.3%	-0.9%	5.0%	6.6%	7.8%
Volatility	19%	6%	6%	14%	14%
Efficiency	0.6	-0.1	0.8	0.5	0.6

Hedge funds can increase the efficiency of a portfolio because they tend to shine in risk-adjusted terms. In 2020 and 2022, hedge funds offered downside protection. In 2023 and early 2024, they generated alpha. As we can see above, a simple, traditional portfolio of 65% equities and 35% bonds yielded an annualized absolute return of 6.6% between January 2020 and March 2024. However, if we reduce the fixed income to 15% and add in 20% exposure to hedge funds, returns rise by 1.2% annually. During this period, volatility was somewhat elevated for both equities (16%) and bonds (6%). Including hedge funds, with their 6% volatility, does not change portfolio's risk level materially – but it improves returns. Hedge funds can be fun in the sun *and* protect the portfolio during times of rain.

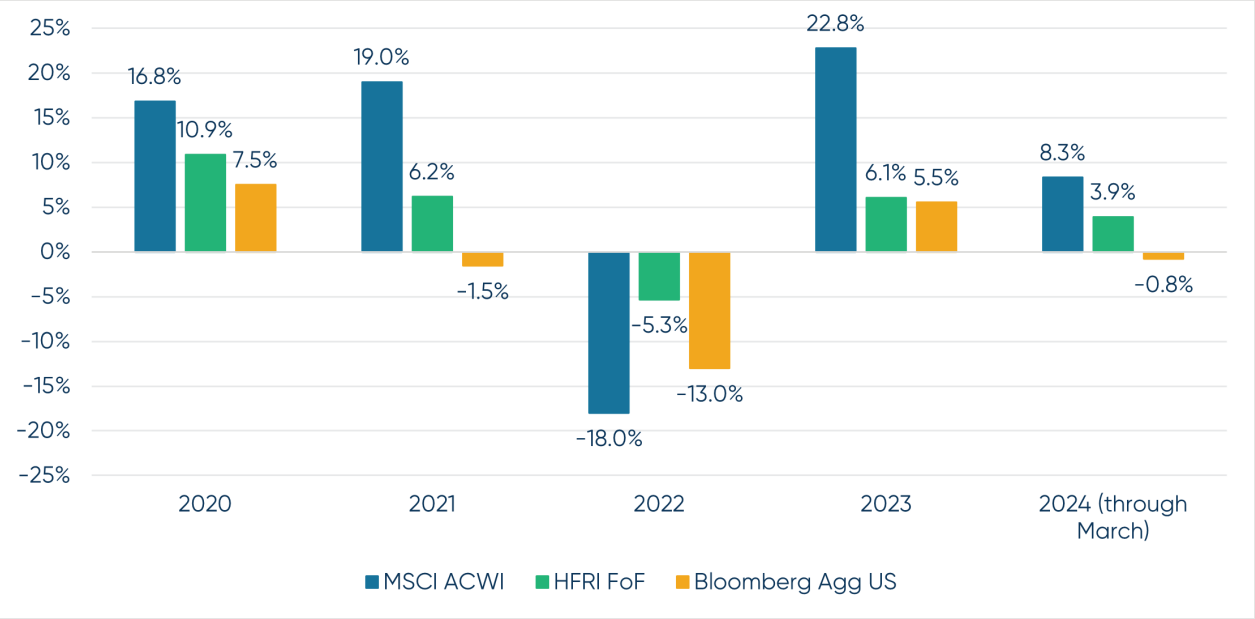
Downside Protection and Upside Alpha

Hedge funds also tend to outperform during high interest rate periods for two reasons: 1) a high level of earnings on cash balances; and 2) increased value-creation opportunities as market dispersion increases and fundamentals come to the forefront. With so much recent talk of rate cuts, it can be easy to forget that we're coming off a very long period of ultra-low borrowing costs that are unlikely to repeat, even when inflation and rates do begin to behave better. In the meantime, rates are likely to remain higher for longer, especially compared to the post-GFC period.

The correlation between bond and equities markets often changes when rates rise. We saw that very clearly in 2022, when ACWI posted its worst year since 2008, and the Agg suffered the worst year ever for bonds, as characterized by Edward McQuarrie, a Santa Clara University professor and financial historian who has compiled bond returns from 1794. Hedge funds did lose money in 2022, but far less than stocks or bonds did, when these asset classes were at their darkest moments.

[4] Source: Bloomberg and Hedge Fund Research.

Annual Performance of Hedge Funds Versus Bonds
(2020 to March 2024 YTD)[5]



In 2023, hedge funds still outperformed bonds, delivering strong and efficient gains even as equities roared to big gains and bonds found their footing. (The Agg was down 1.2% through September, before cooling inflation, expectations for interest rate cuts, and tightening spreads helped it reach a 5.5% calendar-year advance.) Whatever happens next, we believe portfolios can continue to benefit from incorporating hedge funds — which limit losses and generate gains, potentially improving your portfolio's absolute performance and efficiency.

Anchoring Remains a Concern – But Should It?

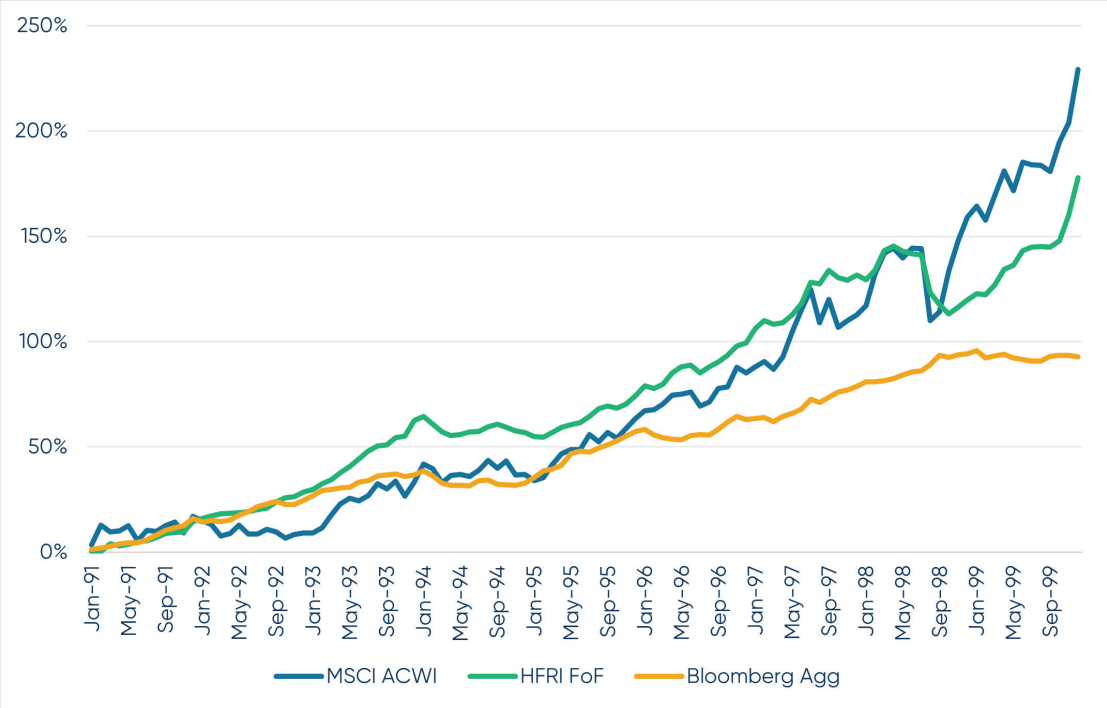
The hedge fund era from the GFC through 2020 remains fresh on the minds of a lot of investors and may help explain their hesitation to embrace the asset class. Anchoring is a key bias within the field of behavioral finance. We all have a built-in tendency to rely too much on one piece of information, which can cause us to ignore or minimize contrary data or trends. For example, imagine you sold a share of stock for $50, and the stock rises to $100. You may be tempted to avoid the stock, irrationally expecting

[5] Source: Bloomberg and Hedge Fund Research.

it to fall back to your arbitrary $50, even though the fundamentals of the company could have changed significantly.

The same forces may be at work when it comes to hedge funds, despite what we've seen since the pandemic. However, when the market environment shifts to the extent that it did as interest rates rose, we believe it is important to think carefully about potential forward returns and put them into context. To do this, let's travel back to the 1990s, when boy bands roamed the earth and a new application called "Microsoft Excel" was replacing Lotus spreadsheets.

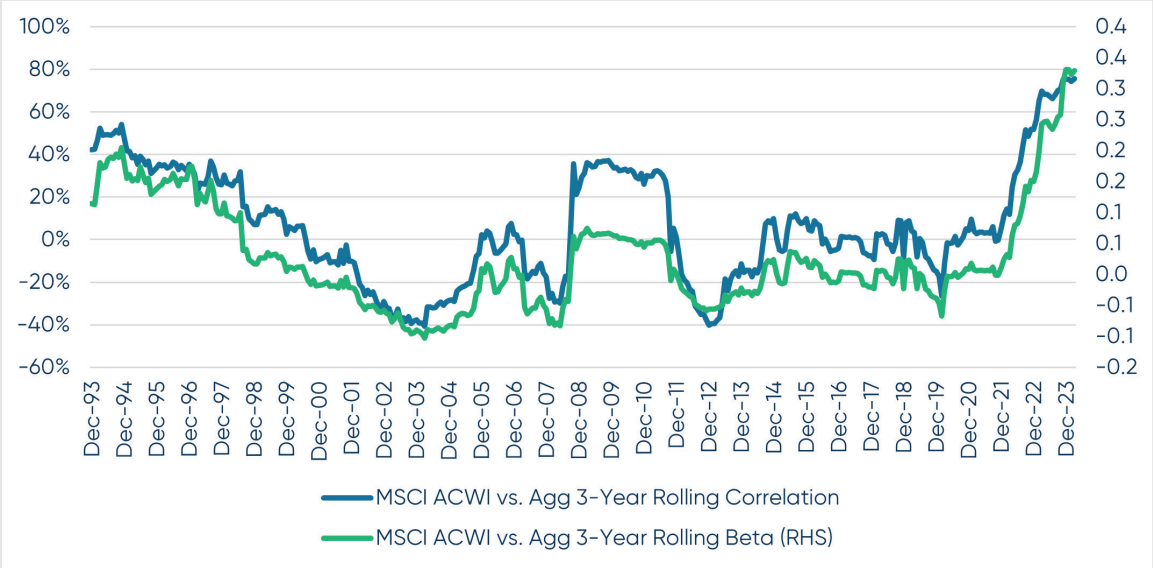
Hedge Funds Shine: Cumulative Return of Stocks, Bonds, and Hedge Funds
(January 1991 to December 31, 1999)[6]



That era provides a much more optimistic outlook for hedge funds, because 1991 to 1999 was a magical time. Hedge funds earned 12%-plus annualized returns, almost matching ACWI's 14% and far outpacing the Agg (7.6%). What's more, hedge fund volatility was 6.2%, less than half that of ACWI. The period of outperformance actually ran much longer, taking savvy investors on a great ride that lasted until the GFC. The reasons are many, but it should be noted that the 1990s was the last time interest rates breached today's levels.

[6] Source: Bloomberg and Hedge Fund Research.

Rising Correlation and Beta of Equities and Bonds
(December 31, 1993 to December 31, 2023)[7]



Another risk of anchoring is the reliance on certain relationships between asset classes, though those relationships can change over time. Equities and bonds enjoyed almost two decades of negative correlation and negative beta – minus a brief period during the GFC – from 2000 to 2019. However, this relationship changed in 2021 as interest rate pressure pushed down the present value of both bonds and equities. When bond and stock prices move together, their diversification benefit goes away, further reducing the value of bonds within a portfolio. Although we don't expect that the positive correlation of stocks and bonds will necessarily remain at these elevated levels, we do expect that a well-diversified hedge fund portfolio will provide diversification and better returns than bonds.

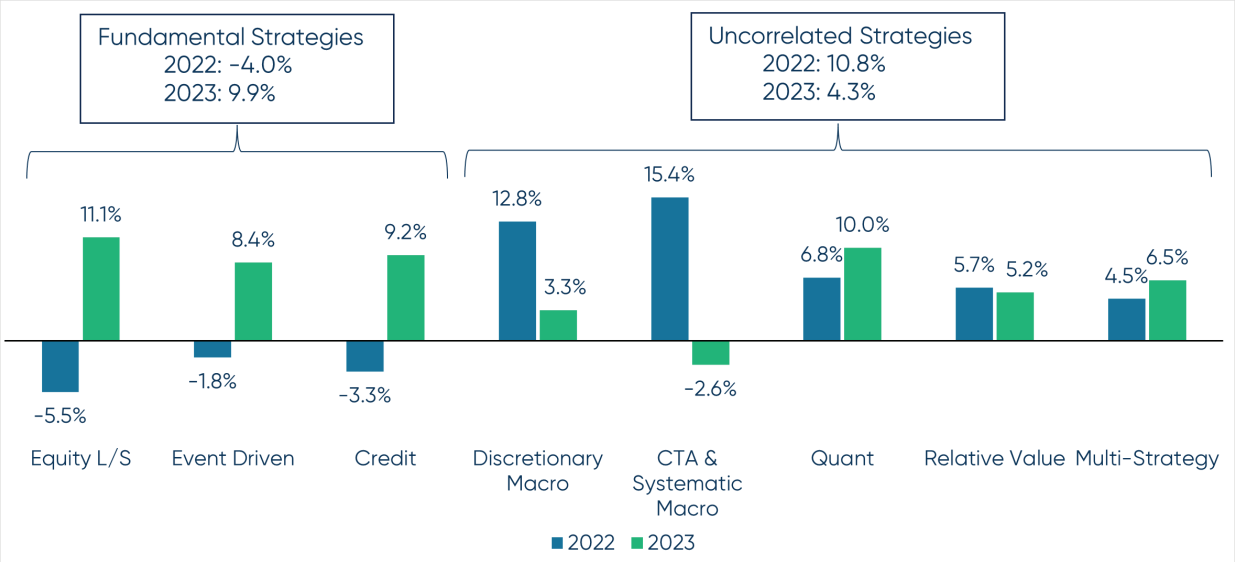
Balance and Choice

Hedge funds employ a wide array of strategies, making it difficult to point to a "typical" hedge fund. The attractiveness of the asset class lies in its wide range of strategies. The process of constructing a hedge fund portfolio feels like mixing the perfect cocktail: It's all about balance. We believes that it is important to have a mix of strategies within a hedge fund portfolio. In 2022, strong performance from

[7] Source: Bloomberg and Hedge Fund Research.

such uncorrelated strategies as diversified macro and CTA funds offset weakness in fundamental long-biased strategies. In 2023, the reverse happened. Owning a healthy mix of hedge funds can help provide balance.

Hedge Fund Performance by Strategy
(2022 and 2023)[8]



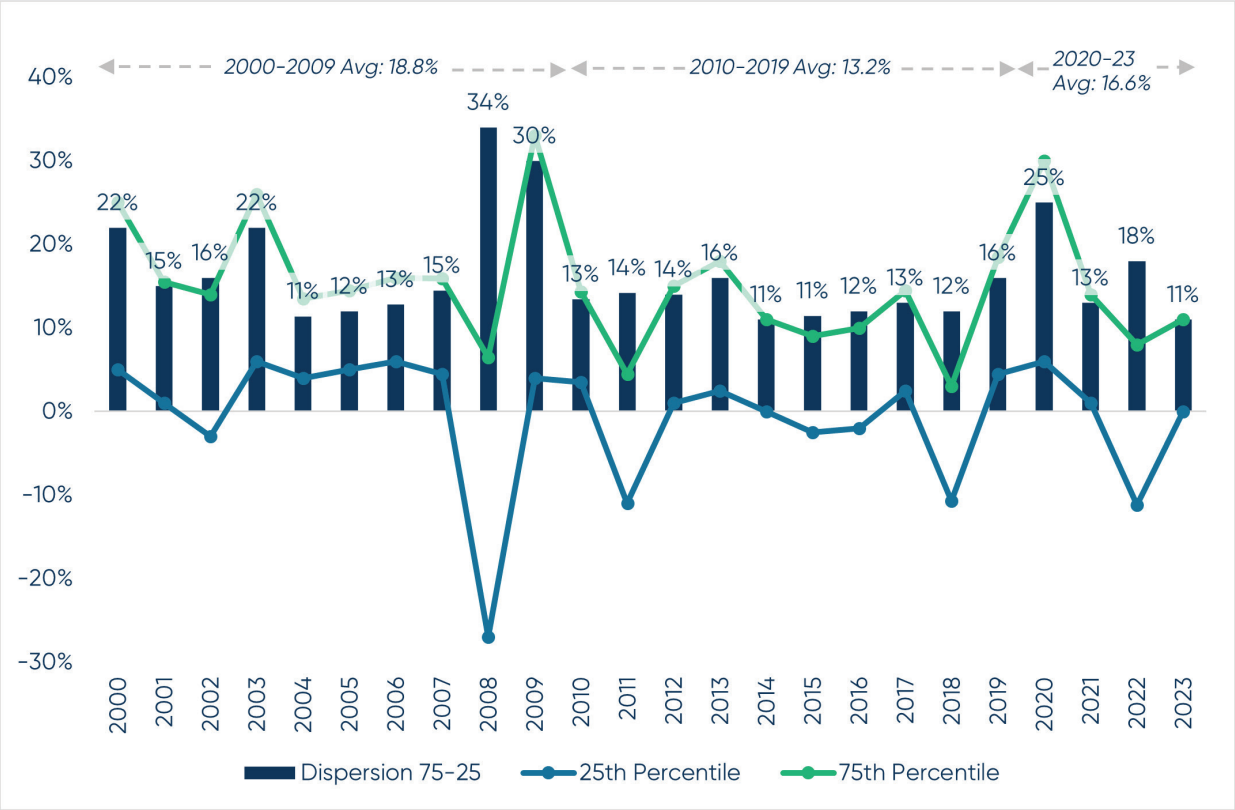
In addition, the return dispersion between the top and bottom quartiles of the hedge fund universe can be significant at times. From 2020 to 2023, the difference in absolute performance between the two groups was 16.6 percentage points per year. That's why, in addition to putting together the right portfolio allocation, selecting the right managers to generate alpha is also critical to meeting long-term performance goals.

For many, manager selection is a vexing challenge because of the sheer size of the hedge fund universe and the apparent similarity of many funds. At TIFF, we've developed a systematic philosophy around screening and identifying funds we believe can be outstanding. To eliminate candidates early on in our diligence process, we use various forms of quantitative analysis and checklists, honed through experience, to help identify red flags that may drive persistent underperformance. Warning signs can be funds that are understaffed, feature erratic investing strategies, or lack the right incentive alignment. Meanwhile, the stars of yesterday may suffer from their success and turn into tomorrow's bottom performers due to turnover, loss of

[8] Source: Goldman Sachs Prime Insights – The Waiting Game – 2024 HF Industry Outlook.

focus, too much growth in AUM, or product proliferation. (Having lavish office spaces, spending more time on one's yacht, or purchasing a sports team are but a few signs that an investment manager may be distracted.) The goal here is to avoid the bottom 25%.

Hedge Fund Performance Dispersion: Returns for 25th and 75th Percentiles and Inter-Quartile Spread (2000-2023)[9]



On the flip side, we aim to identify key indicators of likely success to help us capture the top quartile funds of tomorrow. Key characteristics include strong industry experience and investment team pedigree, a tangible investing competitive edge, streamlined business operations, and a drive to remain humble but hustle hard. Consistent outperformers are hard to find because everyone has a cold streak now and then. We hold firmly that smart managers don't become dumb overnight. Our research process allows us to build conviction in our partners so we may add to good managers when they do hit a rough patch, while trimming managers who have fundamentally over-earned during an unusually strong period. Keeping balance

[8] Goldman Sachs Prime Insights – The Waiting Game – 2024 HF Industry Outlook.

within the portfolio with high conviction managers allows the portfolio to participate in all market environments and remain flexible enough to adapt to changing market conditions.

Conclusion

Indeed, the years since the GFC were a long, cold, lonely winter for hedge funds. It may feel like it's been years since the sun has shone upon the asset class, but that's not really true. The ice has melted, and the sky is clearing as the macroeconomic winds push aside the clouds. Here comes the sun, and I say, it's alright. We believe hedge funds can continue to bring smiles to the faces of investors, by protecting downside while generating upside performance in an efficient manner.

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