HEDGE FUNDS IN A TIME OF RISING AND HIGHER INTEREST RATES:

THE *ADVANTAGE* AND THE *OPPORTUNITY*

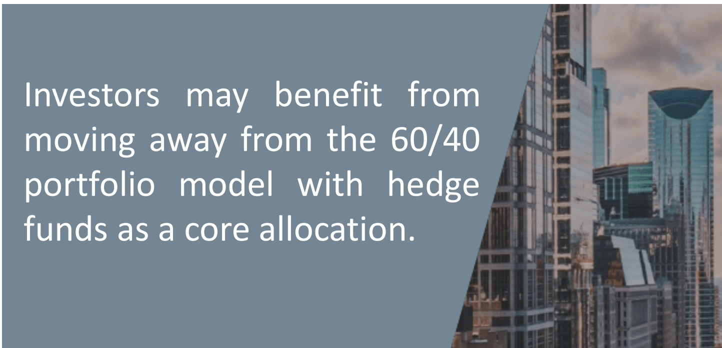
EXECUTIVE SUMMARY

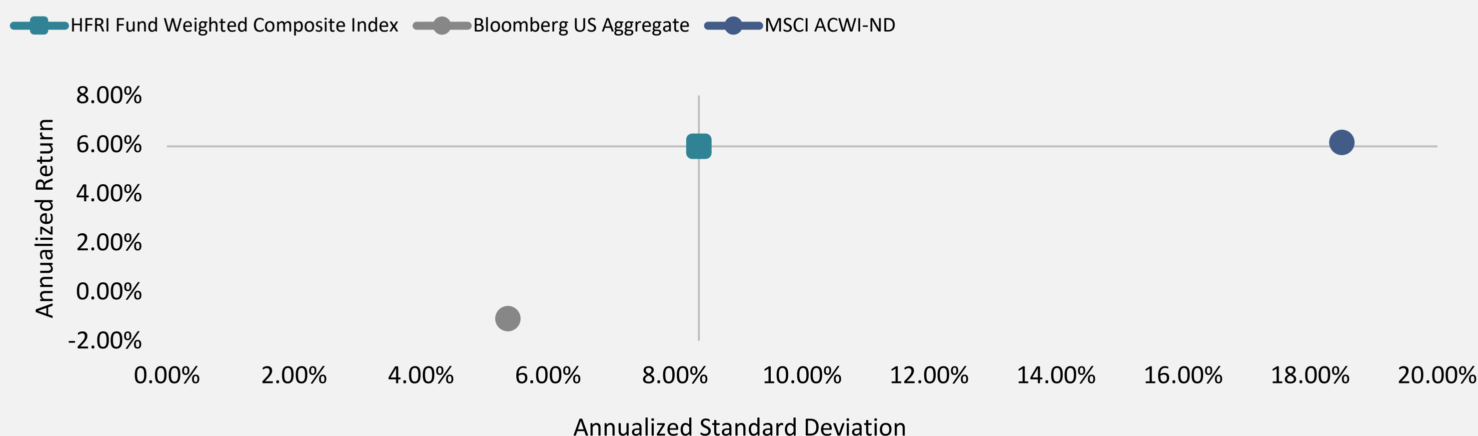
- We believe we are entering a normalization phase in financial markets as central banks withdraw their easy monetary policies and raise interest rates in their fight against inflation.
- At 50 South Capital we believe investors that have access to a broader range of investment options may benefit going forward from moving away from the 60/40 Portfolio model, and including an allocation to Alternative assets, with hedge funds as a core allocation.
- Hedge funds have structural advantages in a higher interest rate environment. Higher interest rates can be associated with higher market volatility, generally good for unconstrained active management, and present a better opportunity set for shorting. In this backdrop, we believe hedge funds have the opportunity to generate strong risk-adjusted returns, adding value to portfolios as an alternative to equity risk.
- There is a structural tailwind to short positions when interest rates are higher, as managers earn a higher return from investing the proceeds of a short sale.
- Higher interest rates will likely contribute to higher volatility in stock and bond prices. Higher volatility and greater dispersion in security prices creates a more attractive landscape for active money managers.
- History shows hedge fund earning higher returns in periods of higher equity market volatility, and the equity volatility may stay elevated for some time. The higher volatility started in 2020 and has continued to increase through 2022. With the most recent increase in volatility, hedge funds have again crossed over to outpacing equity returns.

THE ADVANTAGE AND THE OPPORTUNITY *FOR HEDGE FUNDS*

Prior to 2022, much was written about the death of the traditional "60/40 Portfolio". The 40% fixed income allocation in that model was yielding less than 1.5% nominal returns, as referenced by the average yield on the Bloomberg US Aggregate Bond Index ("the bond index") at just 1.4% during the pandemic years of 2020 and 2021, and negative real returns when inflation averaged 2%. This year, investors have experienced losses not seen in decades as the market has digested a sudden and sharp increase in interest rates. Today, the merit of that traditional 60/40 Portfolio is still being debated, and conversations focus on how to construct a portfolio in an investment landscape looking to be very different from the last decade. One approach investors may consider is to reduce equity allocations in favor of higher bond allocations, to capture a more attractive forward yield, while some investors are looking to other assets classes and allocations outside of long only equity and fixed income. At 50 South Capital we believe investors that have access to a broader range of investment options may benefit going forward from moving away from the 60/40 Portfolio model, and including an allocation to Alternative assets, with hedge funds as a core allocation.

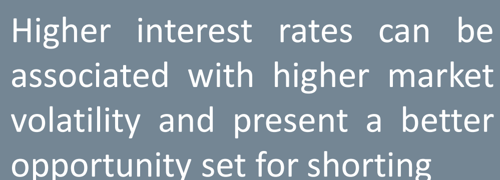
Those investors who shifted capital away from traditional bonds to hedge funds in recent years have been rewarded with strong relative and absolute risk-adjusted returns. The yield on the bond index first dipped below 3% in March 2019. Since then, the HFRI Fund Weighted Composite Index ("the hedge fund index"), a representative index for the hedge fund universe, has annualized at 5.9% vs the bond index return of -1.10%. Investors accepted modestly higher risk for these hedge fund returns with a standard deviation of 8.4% compared to 5.4% for the bond index. During this time, the hedge fund index achieved similar returns to global equities with less than half the volatility.





Source: eVestment. Risk / Return from March 1, 2019 through October 31, 2022.

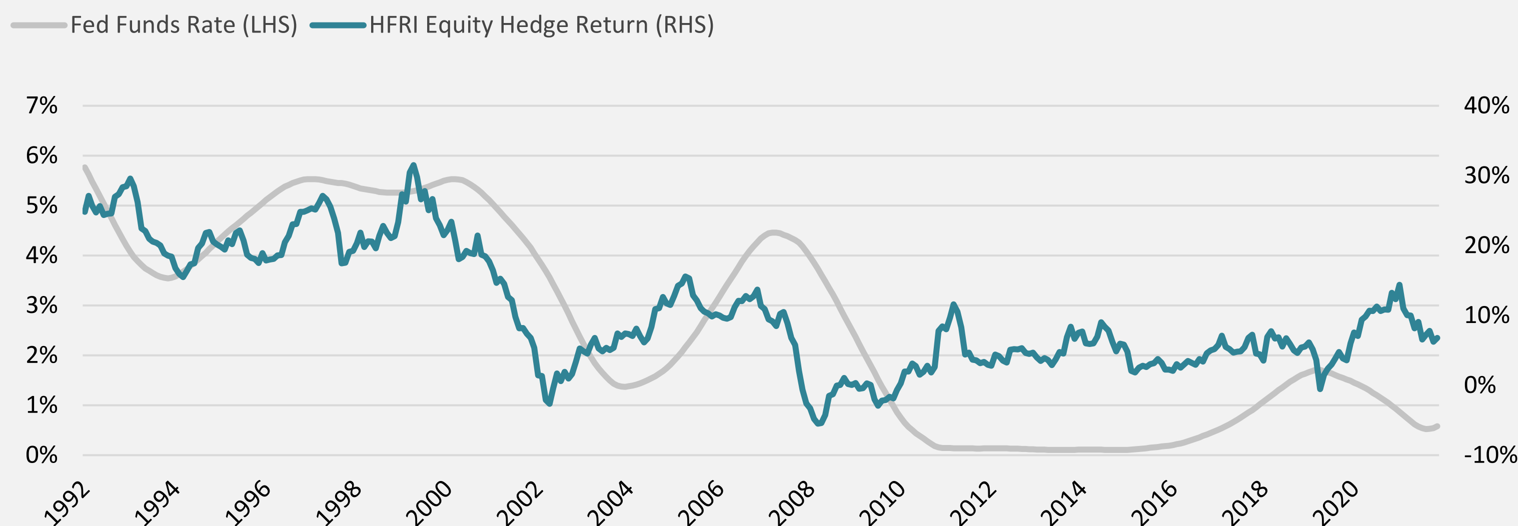
We expect investors have been happy with these relative results from a hedge fund allocation, but the question today is what to expect from hedge funds going forward, in an environment with higher interest rates. The period from 2008 through 2019 was a period of historically low rates, amidst a policy of liquidity and easy money. This served as a more challenging backdrop for hedge funds, which have traditionally benefitted from higher interest rates and higher volatility. The change in 2022 has felt drastic with a sharp increase in the Fed Funds Rate over a short period of time. While difficult for equity and bond markets, this year has so far been a relatively good period for hedge fund performance and there are a number of reasons to believe this will persist. While higher absolute levels of interest rates provide a tailwind to fixed income, hedge funds also have structural advantages in a higher interest rate environment. Higher interest rates can be associated with higher market volatility, generally good for unconstrained active management, and present a better opportunity set for shorting. In this emerging new environment, we believe hedge funds have the opportunity to generate strong risk-adjusted returns, adding value to portfolios as an alternative to equity risk. In the following, we will explore these structural advantages and fundamental backdrop that could lead to higher alpha generation for hedge funds.



One reason for our forward outlook is that higher interest rates may create a much better opportunity for shorting than we have seen in many years. A hedge fund that shorts a stock will borrow that stock for a fee and sell it. They manager will then invest the cash proceeds of the short sale into risk free assets. The interest earned on that risk free rate, net of borrowing costs, is additional return on top of the return made on the trade itself. If the risk-free rate, minus borrowing costs, is 5% annualized, that position has earned 5% in addition to any amounts made on the short stock position.

From January 2009 through May 2017, the Fed Funds Effective Rate was below 1%. Much of that time it was just a few basis points. The Fed tried to get the economy off ultra-cheap credit and the rate got to 2.4% in 2019, but then the pandemic hit and the rate went back to near zero. With inflation increasing in 2022, the rate now stands at 3% and the Fed has indicated it will move higher still. This is a direct input into the expected return for hedge funds. From January 2009 through May 2017 the Fed Funds rate averaged 0.19%. The HFRI Equity Hedge Index annualized at 6.7% during this period. Today, the Fed Fund's rate is 3%. That may not sound like a lot in absolute terms, however, if hedge funds could have added an extra 3-5% due to higher rates, total returns over that period could have been in the high single to low double digits.

3-Yr Average Fed Funds Rate vs. 3-Year Annualized Hedge Fund Index Returns



Let’s look to history as a guide. The above chart shows the relationship between the return of the HFRI Equity Hedge Index and the Fed Funds Rate since 1990. Hedge fund returns were high when interest rates were higher in the 1990s. Interest rates declined following the burst of the tech bubble in the early 2000s, but there was a clear increase in hedge fund returns from the beginning of 2000s through 2007 as interest rates went back up. Then we entered the period of free money and historically low interest rates. From January 2009 through December 2016 the Fed Funds Rate averaged 0.2%, and hedge fund returns annualized at a lower rate. The Fed Funds Rate increased from 2017 through February 2020 and you can see hedge fund return increasing from that peak. With higher interest rates, we see potential for higher hedge fund returns.

There are fundamental reasons for shorts to work better in a higher rate environment. The most basic is that with higher rates, companies may have a harder time borrowing and servicing debt. Companies that were struggling in a low interest rate environment could borrow at low costs to help them stay afloat. That crutch is no longer available when rates are higher. There may be more dispersion amongst stock prices as company fundamentals are on display, and we could experience downward pressure on the stock prices of those companies without solid financial footing. It is expected that stock prices could reflect long term cash flows of companies rather than hopes and dreams when credit is freely available, and good fundamental analysis may be rewarded.

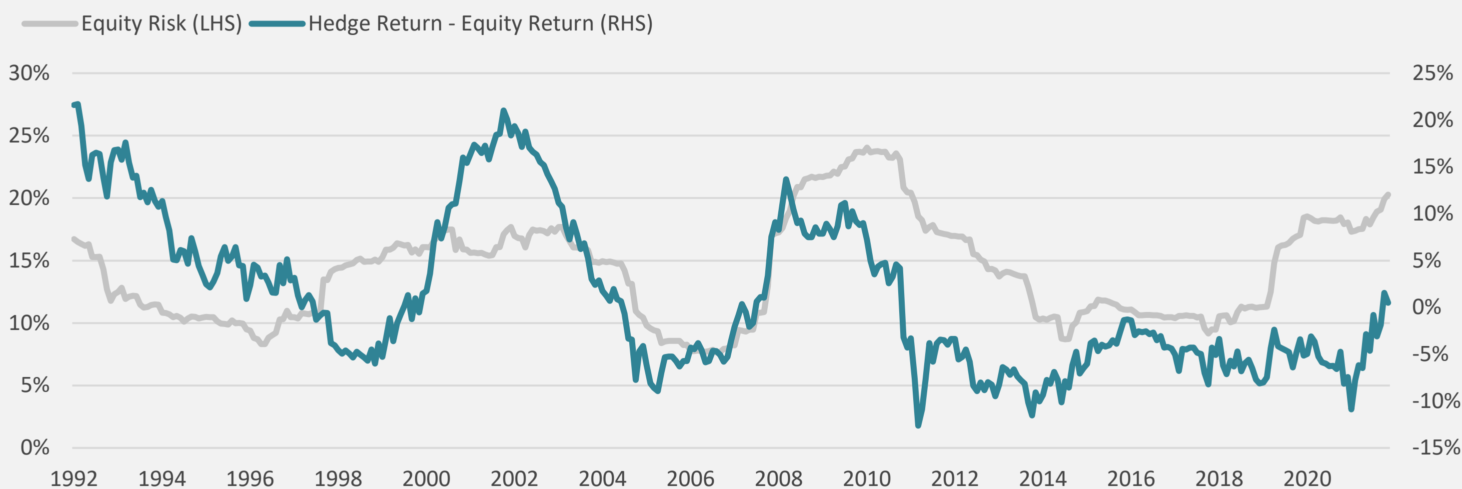
Short positions have structural tailwind when interest rates are higher - managers earn a higher return from investing short proceeds

Source: Federal Reserve Economic Data, Federal Reserve Bank of St. Louis. Hedge Fund Index Returns represented by the HFRI Hedge Equity (Total) Index. Performance from January 31, 1990 through October 31, 2022.

A second reason for our forecast is the historical relationship between higher equity market volatility and hedge fund returns, and the belief equity volatility may stay elevated. Looking back to the early 1990s, when hedge fund return indices began to be published, and looking at rolling three year data, we observe four periods where equity risk, as defined by standard deviation of the MSCI World (ND) equity index, was above 15%. The excess return in the chart below shows the return of the HFRI Fund Weighted Composite Index relative to the MSCI World (ND) Index.

The first period of elevated volatility was the first three years since inception of the hedge index where hedge funds outperformed equities by over 20%. Next was in the early 2000's as the tech bubble burst and equity volatility spiked. In 2002, the three-year return of hedge funds outpaced equities by over 20%. The third period where equity volatility was above 15% was during and after the global financial crisis of 2008. This time hedge fund returns outpaced equities by nearly 14%. The current period is the fourth time equity volatility has increased above 15%. The higher volatility started in 2020 and has continued to increase through 2022. With the most recent increase in volatility, hedge funds have again crossed over to outpacing equity returns. It appears to be still early in this cycle and full outperformance by hedge funds may yet to be realized.

As investors consider how to construct a portfolio to meet return and risk expectations in this new and evolving investment landscape, we believe hedge funds have the opportunity to add value and warrant an allocation in a portfolio. We welcome the opportunity to speak with you about how hedge funds can help you meet your investment goals.



Source: eVestment. Data from January 31, 1990 through October 31, 2022.

50southcapital.com | © 50 South Capital 2023

Interests in the Fund will be offered and sold by representatives of Northern Trust Securities, Inc., an affiliated broker-dealer and registered investment adviser, member FINRA, SIPC and a wholly owned subsidiary of Northern Trust Corporation.

The information contained herein is for informational and educational purposes only. It is neither an offer to sell, nor a solicitation of an offer to buy an interest in an investment fund managed by 50 South Capital Advisors, LLC. The information is obtained from sources believed to be reliable, and its accuracy and completeness are not guaranteed. Information does not constitute a recommendation of any investment strategy, is not intended as investment advice and does not take into account all the circumstances of each investor. Alternative investment funds may charge higher fees, are less liquid than mutual funds and are not subject to the same regulatory requirements.

All securities investing and trading activities risk the loss of capital. Hedge funds engage in trading that is speculative and involves a substantial risk of loss. Investment performance may be volatile and an investor could lose all or a substantial amount of their investment. Past performance is not indicative of or a guarantee of future results which will fluctuate as market conditions change. Hedge funds are illiquid and are not suitable for all investors. Transferability may be limited or even prohibited. Alternative investment funds may involve complex tax structures and delays in distributing tax information required for income tax filings. In many cases, the underlying investments may not be transparent. Hedge funds are not appropriate for all investors and is not intended to be a complete investment program. There is no guarantee that hedge funds will achieve their investment objective. Hedge fund managers may utilize highly speculative investment techniques, including extremely high leverage, maintaining highly concentrated portfolios, investing in workouts, startups and illiquid securities, taking control positions, engaging in short sales and derivative transactions and pursuing other speculative and risk strategies. The managers will, among other items, utilize specialized investment strategies, follow allocation methodologies, apply investment models and assumptions, and enter into other strategies intended, among other things, to affect the performance while targeting risk levels. An investor could lose all or a substantial amount of their investment.

Certain information contained herein represents or is based on forward-looking statements or information, including descriptions of anticipated market changes and expectations of future activity. Forward-looking statements and information are inherently uncertain and actual events or results may differ from those projected.

Comparative indices shown are provided as an indication of the performance of a particular segment of the capital markets and/or alternative strategies in general. Comparisons to indices are for illustrative purposes only as they are widely used performance benchmarks. It is not possible to invest directly in an index.

The opinions expressed are as of the date set forth herein, are subject to change at any time without notice and do not constitute investment, legal, tax, accounting or professional advice. The information cannot be relied upon for tax purposes and does not constitute investment advice or a recommendation to buy or sell any security and is subject to change without notice. Each investor should consult with their own advisor regarding the legal, tax and financial suitability of investing in alternative investments.

Northern Trust Asset Management is composed of Northern Trust Investments, Inc. Northern Trust Global Investments Limited, Northern Trust Fund Managers (Ireland) Limited, Northern Trust Global Investments Japan, K.K, NT Global Advisors Inc., 50 South Capital Advisors, LLC and investment personnel of The Northern Trust Company of Hong Kong Limited, Belvedere Advisors, LLC, Northern Trust Asset Management Australia Pty Ltd and The Northern Trust Company.

50 SOUTH CAPITAL ADVISORS, LLC

50 SOUTH LASALLE STREET
CHICAGO, ILLINOIS 60603