Asset Management

Hedge funds in a non-zero interest rate environment

April 2023

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Zero interest rate regime 2008-2021

- When ZIRP (zero interest rate policy) was introduced in the US in December 2008 it was characterised at the time as "extraordinary monetary policy". It was however a full 7 years before rates started to move away from zero in December 2015. In tandem with this we also witnessed 6 years of quantitative easing (QE).
- Fast forward to March 2020 US interest rates, which had previously reached a high of just 2.5%, had again been reduced down to near zero. In addition we embarked on another round of QE 20x in quantum to that witnessed during the Global Financial Crisis.
- Unsurprisingly asset classes which benefit from lower costs of borrowing (the vast majority) performed well. Equities, as proxied by the S&P 500 Index amassed a cumulative return of 427.7% from Dec 2008 to Dec 2021, representing an annualised return of 13.7%. Bonds as measured by Barclays Aggregate Total Return Index advanced a more measured 63.2%, annualising 3.8%.
- Hedge fund performance in contrast benefits from both normalised levels of dispersion and volatility across markets. Both these market dynamics were artificially compressed during this period of unconventional monetary policy.

Normal interest rate regime 2022 onwards

- The reverse of course was true during 2022 with both equity and bond indices falling sharply as interest rates were rapidly hiked away from zero and Quantitative Tightening (QT) has been initiated.
- Why was this? In fixed income markets interest rates and bond values have an inverse relationship. Equities are valued based on the expectation of future dividends being received by the holder which are then discounted back to present using a discount (interest) rate. These dividends therefore become less valuable as interest rates rise.
- In contrast the re-emergence of volatility and dispersion in abundance as interest rates have risen resulted in a marked outperformance by hedge funds of traditional asset classes during 2022.
- Further to this, hedge funds, which are hedged in construct as their name implies, are often also characterised as employing flexible investment strategies, in some cases using margin to build positions, and are regularly described as a "cash +" investment solutions.
- There are a number of reasons for this. In fact certain hedge fund strategies, which we will describe below, will directly benefit from higher cash rates.
- Further to this other hedge fund strategies will find the non zero volatility environment, (associated with rates moving upwards) fertile hunting ground for returns.
- Higher interest rates also tend to be associated with declining asset values. A number of hedge fund strategies generate performance by being short assets such as equities and credit instruments. Thus the performance bandwidth for these strategies widens as interest rates rise.

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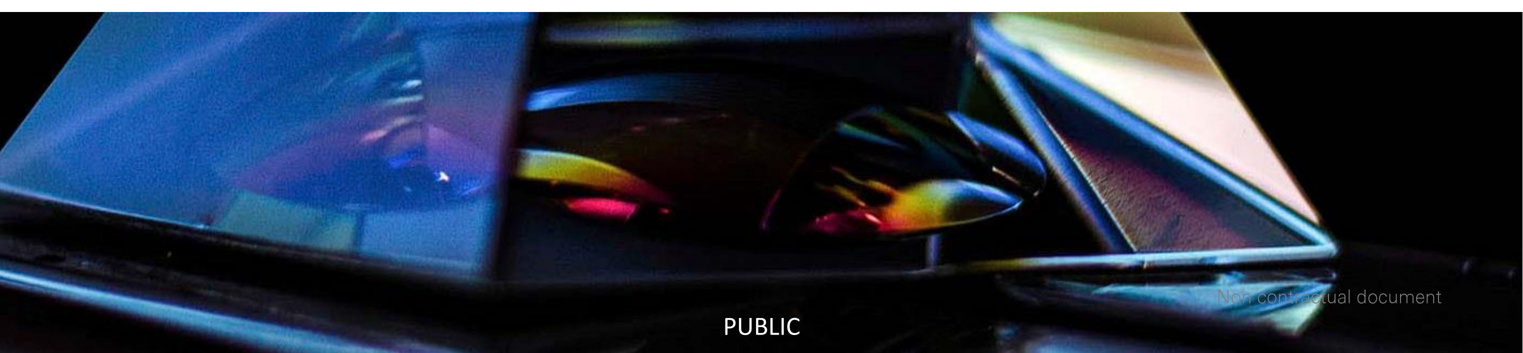

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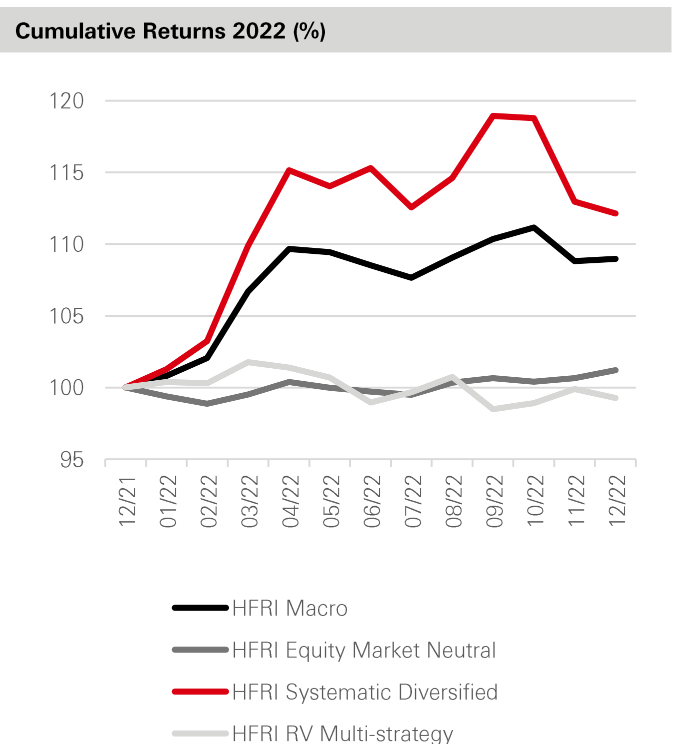
Strategy Example 1

- **Managed Futures** or CTAs benefit from trends prevailing across financial assets. They do so primarily by entering futures contracts either long or short in equities, commodities, currencies and interest rates. Futures contracts are inherently leveraged financial instruments. This means the Fund has to merely deploy 10% to 20% of its capital to enter positions. The remaining 80% to 90% sits in short term cash related instruments. Thus with interest rates at 5% for example there is a 4-4.5% performance tailwind for the strategy every year. This represents their direct performance uplift from higher interest rates.
- Their indirect performance uplift and one of the main drivers of their strong performance during 2022 is their ability to make money from declining asset values. Financial markets fall, more often than not, when interest rates are rising as we have witnessed so far this year. This widens the opportunity set for CTA's as evidenced by the strong YTD returns from the HFRI Systematic Diversified Index in the chart (RHS).



Strategy Example 2

- Discretionary Macro managers traditionally benefit from elevated asset class volatility, and recent sharp moves across interest rate markets have represented significant sources of alpha for this strategy. The end of "Forward Guidance" by Central Banks has also resulted in a greater opportunity set. Related falls in equities as interest rates have risen have been a further boon for performance in 2022.
- In tandem with the above we have maintained a constructive outlook for the strategy's performance potential during 2022. The managers across our portfolios have rewarded us with strong positive performance year to date. We further expect these managers to continue to identify opportunities under the new market regime of heightened uncertainty associated with higher interest rates.

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Strategy Example 3

- **Equity Market Neutral Strategies** seek to generate returns both from buying stocks that the manager believes will rise in value and selling stocks that are expected to perform poorly resulting in a "market neutral" portfolio of equities. For example, If the fund takes in 100 million USD in capital from clients, a typical investment approach would be to spend the 100 million USD buying equities and "short sell" 100 million USD worth of equities – receiving cash proceeds for the short sold positions. Typically there is a haircut or a cost paid by the manager in order to borrow/short the stock and this cost will rise with interest rates. However the prevailing dynamic is that the short book is financing the long book resulting in the fund holding substantial sums of cash which will earn interest acting as a tailwind to performance in a similar manner to CTA's.

Strategy Example 4

- **Relative Value Multistrategy (RV)** More generally a number of hedge fund strategies can benefit from higher interest rates. RV managers will enter positions long and short based on their valuation of one asset vs another asset or derivative. Those that provide liquidity to fixed income markets are an example. Rising rates increases volatility in fixed income markets and this increase in volatility can lead to higher returns for strategies such as these that are more trading orientated.

Index	2017	2018	2019	2020	2021	2022
HFRI Macro Index	2.20%	-4.08%	6.50%	5.37%	7.71%	8.98%
HFRI Equity Market Neutral Index	4.89%	-0.98%	2.33%	-0.11%	7.05%	1.21%
HFRI Systematic Diversified Index	2.12%	-6.62%	7.08%	2.61%	6.44%	12.13%
HFRI RV Multi-strategy Index	4.09%	0.22%	5.29%	6.69%	7.03%	-0.73%

Source: Hedge Fund Research as of April 2023.

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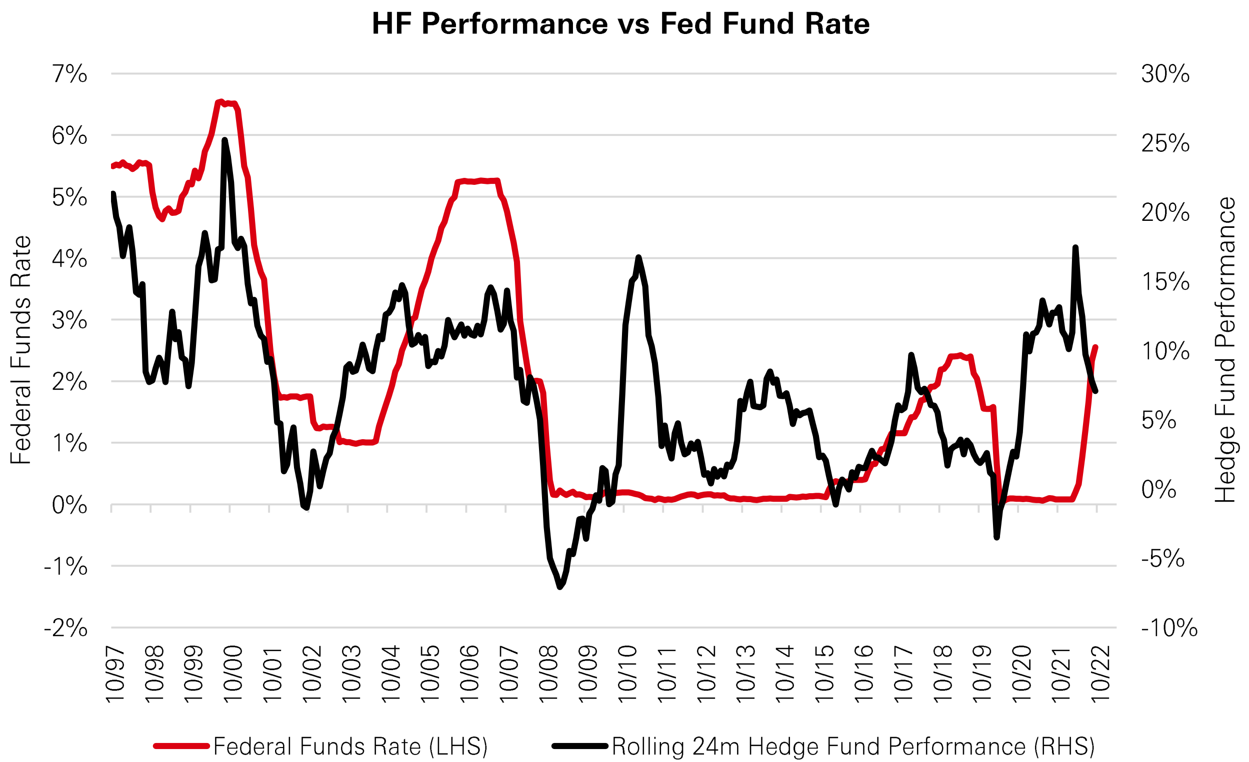

Source: BBG and Hedge Fund Research as of April 2023. Hedge Fund Performance relates to the HFRI Asset Weighted Composite.

Conclusion

Higher interest rates represent a performance tailwind for a number of hedge fund strategies for reference see chart above. To summarise we can characterise the benefits as being either direct and indirect.

Direct Benefits

- Any hedge fund strategy that has market neutral characteristics where the short book is largely financing the long book will benefit from its substantial cash pile earning interest.
- A strategy entering positions using margin such as CTA's via futures will again benefit from its high allocation to cash earning interest.

Indirect Benefits

- Strategies such as CTA's and Discretionary Macro benefit from a broadened opportunity set when there are falls in asset values associated with higher interest rates.
- In addition the short books of both equity and credit long/short strategies are more likely to be performance accretive under a normalised interest rates environment.

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Key Investment Risks

Investors in hedge funds should bear in mind that these products can be highly speculative and may not be suitable for all clients.

The value of investments and any income from them can go down as well as up and investors may not get back the amount originally invested. Past performance does not predict future returns. The return may increase or decrease as a result of currency fluctuations.

There are several key issues that one should consider before making an investment into hedge funds. The risks specific to this type of investment may include, but are not limited to:

Regulation

The hedge fund industry is lightly regulated, with the majority of funds domiciled in offshore jurisdictions. Hedge funds are generally classified as "unregulated" and are not typically subject to the same levels of scrutiny and protection as a traditional investment fund. A thorough due diligence process can mitigate these concerns.

Gating

In event that redemptions requests on a particular dealing date are much higher than the normal level and full satisfaction would jeopardise the longer term portfolio balance, a gate or partial execution of redemption requests may be implemented generally on a pro-rata basis.

Side pocket

There may be instances when certain assets in a fund portfolio could become less liquid and the fund manager may segregate these illiquid positions from the main portfolio into a side pocket (or a separate vehicle).

Suspension of redemption

Suspension of redemption is a temporary halt in exiting the fund during a given redemption window. This is a stronger measure than gating because there is no dealing for the fund. This is generally used under special circumstances such as when liquidity conditions have markedly deteriorated in a short period of time or when there are heavy asset outflow such as the loss of a core investor.

Access

Hedge funds operate larger investment minima than traditional investment funds. Investors are often unable to access a hedge fund unless they were willing to invest US$500,000 to US$2million.

Liquidity

Hedge funds typically have much longer dealing cycles than traditional investment funds. Depending on the strategy being utilised, a hedge fund may only allow subscriptions and redemptions on a monthly or quarterly basis. Furthermore, some hedge funds have long lock-up periods, where an investor is not permitted to redeem from the hedge fund unless a period of 6 months, a year or even 2 years has passed. Some may allow a redemption before the lock-up period is over, but the investor would have to pay a hefty penalty to be able to do this.

Transparency

Many hedge fund managers are wary of regularly publishing their positions in the belief that this will remove any advantage that they have over their peers. This can pose a problem to the investor, as he or she cannot be certain to which stocks, geographies, markets or even strategies he or she will be exposed to when investing in the hedge fund. However, trusted investors who have built strong relationships with the hedge funds can access this information for the majority of funds, enabling thorough monitoring of the investment.

Manager failure

Over time, a number of hedge funds will close or fail, due to weak performance or operational difficulties. An investor must take this into consideration before making an investment, seeking professional advice to help minimise the risk of investing in a fund that is likely to fail.

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Postal address : 38 avenue Kléber 75116 PARIS
Head Office : Immeuble Coeur Défense - 110 esplanade du Général de Gaulle - La Défense 4 - 92400 Courbevoie - France
www.assetmanagement.hsbc.fr
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