The End of the Benign Economy and the New Era for Managed Funds

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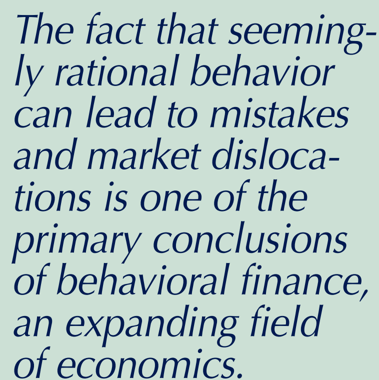
With today's penchant for dating change, many pundits have declared the events of September 11 as the beginning of a new era. However, a new period for investment uncertainty actually began earlier, with the stock market sell-off and economic slowdown. The terrorism and political events since September reinforce an already changing environment that does not bode well for traditional investment approaches. The benign economic environment of stable growth and high productivity led to only localized dislocations. For many investment professionals, this is the first recession they have seen. It also is their first extended bear market and world conflict that may last longer than a few weeks. We look for periods of comparison, but this is not the 90s, 80s, 70s, 60s or 50s. Cultural and investment trends that have lasted for the last decade have ended. We may move from a calm global economy that has seen only limited recessions or major market dislocations to one of greater turbulence.



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In this new era, investors will further benefit from the wider diversity of investment styles offered through alternative investments that have already been seen during the benign 1990s. This does not mean that all hedge funds or styles will do well. Some successful strategies of the past few years may show declines. Nevertheless, the days of the buy-and-hold strategy, employed under the belief of an ever-increasing stock market and long declines in bond yields, may be over. What is the challenge for the New Year? Determining how to bundle these alternatives in a diversified portfolio that allows for return performance under periods of stress.

Why Investors May Not Be Ready for Turbulence

Strategies that were effective for years in a benign economy may be ineffective in the newly volatile environment. Investors may generate past return and risk statistics to design asset allocations or make decisions that may not be applicable in a changing environment. There may be too much reliance on the recent past and not enough on how intuition may guide us. Investors are often not adept at assessing the meaning of specific events or changes that shift the status quo. Economic complexities often force market participants to use heuristics or rules of thumb to make decisions that are inadequate in market transitions and turbulence. Old models and linkages employed to extrapolate into the future also are often ineffective when the environment changes.

Additionally, investors are often overconfident in their own abilities and skill—a Lake Wobegon effect—and place too little weight on the randomness of economic events. This overemphasis on what investors think they know and have experienced leads to investment mistakes when confronted by

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new or random events. These mistakes may take the form of overreaction or under reaction to news. The fact that seemingly rational behavior can lead to mistakes and market dislocations is one of the primary conclusions of behavioral finance, an expanding field of economics.

More specifically, the economies of the world may now be synchronized in ways not seen during the Asian crisis of 1997-1998, global integration and trade may decline, government surpluses may disappear and resources will be reallocated as firms come to grips with oversupply. Both voluntary and involuntary shutdowns and bankruptcies are a growing norm. In an attempt to stem economic decline, monetary policy has driven interest rates to levels not seen since the 1960s without a clear immediate result. The transition away from the benign economic environment of the 1990s may be upon us, and market forces may not be gentle as adjustments to a new order accelerate. The current economic pessimism may lead to a better economic order tomorrow, but requires prudence and sensitivity to any asset allocation decision made today.

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Managed Funds in All Forms Will Provide Opportunities

Traditional managers are often hamstrung by benchmarks and indices that limit their available set of opportunities, so a strategy of long-term investing based on a stable growth environment may not be applicable in a turbulent world. Hugging benchmarks requires passivity and a sense of fatalism, which is not present in the skill-based, competitive environment of alternative investments. An investment style that focuses on long-only growth or value substantially limits the opportunities for return when the set of assets can widen globally. Fixed income investing, which in the long run is primarily driven by the power of compounding, will be hampered in a low interest rate environment, especially with increases in credit risk. For investors, style diversification will embrace change, and a wide array of style choices offers an advantage because firms within the Managed Funds Association may find increased profit opportunities.

These style differences can be based on the stability of the economic environment. Broadly defined, there are: 1) convergent styles that will perform better in a stable environment when there is movement back to the mean of long-term relationships; and 2) divergent styles which perform better when the market is unstable or in periods of dislocation. Because it is difficult to define which type of environment will exist, a combination of both broad styles may best serve investors.

For managed futures funds, markets with significant divergences or trends will play to their strength of profiting from dislocations and movement away from the mean or status quo. This style may underperform in a stable world environment and may outperform when there are extremes from trend dislocations and high volatility. Investors who held managed futures funds, which offer perhaps the strongest divergent style of investing, have recently been compensated with higher returns.

For other directional hedge fund managers, their overall lower exposure to the market portfolio may be a positive. More importantly, the greater dispersion in stock returns now allows stock pickers who trade from both the long and short side greater opportunities to show their skills in ways that were not possible in a one directional upward market.

For non-directional hedge funds, there is also the potential for value from higher volatility that provides an increase in arbitrage opportunities. However, these arbitrage strategies which attempt to provide enhanced cash returns may not produce the same high returns as the last five years given the overall decline in interest rates. Event-driven strategies may also profit from change, albeit at the firm-specific level. Merger activity may decline, but divestiture and spin-offs may increase in response to corporate restructuring. Market dislocations that force firms to restructure offer profit opportunities; such dislocations are less prevalent in a benign economy.

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Hedge Funds Have Diversified Risk and Return Even in the Era of Indexing

Hedge funds have a meaningful impact on the efficient frontier, the optimal trade-off of risk and return, for investors who usually hold only traditional assets. The unique correlation and return profiles for hedge funds create return and risk opportunities for a wide range of investors who have both high and low levels of risk tolerance. This impact is accentuated when markets move to extremes or face changing environments. Nevertheless, the risk/return effects of alternative asset classes on a portfolio are not all alike. For example, minimum variance portfolios may not hold all alternative asset classes, and those asset classes included may have significantly more stand-alone volatility, albeit with lower correlation to many of the alternatives. The value of any asset allocation will be markedly affected by the unforeseen changes of the coming years, and the relative differences in style will drive performance.

A Comparison of Traditional and Alternative Asset Benchmarks

Classic equity portfolio diversification states that a better mix of risk and return can be obtained through changing the mix between equity and bond holdings. With alternative investments, the set of opportunities can be further enhanced. To find the efficient frontier with all alternatives, the risk-adjusted returns for different levels of risk tolerance can be maximized and compared against traditional diversification. This provides the potential benefits of hedge funds for a wide range of investor types.

Hedge funds classes can be divided into three broad categories: 1) directional funds – market-timers, global macro, and managed futures; 2) non-directional funds – classified by arbitrage management styles; and 3) event-driven funds, which trade distressed securities and merger candidates. We analyzed five combinations of these investment styles:

- Domestic and international (equity and bonds)
- Domestic and directional hedge funds
- Domestic and non-directional hedge funds
- Domestic and event-driven hedge funds
- Domestic, international and all hedge funds

Using the last five years as a dataset, we found that as style diversification is increased, there are significant increases in the opportunities available to investors. There are limited benefits from the addition of international stocks and bonds to a domestic portfolio relative to hedge funds.

The combination of all alternative assets provides an envelope for the various subset combinations, and shows that adding these alternatives may enhance return at any given level of risk. Style differences enhance opportunities for reducing risk or enhancing returns, with the relative impact based on the risk tolerance of the investor.

When directional hedge funds are added, there is a marked increase in opportunities both for lowering risk and raising returns. Their benefit is especially evident for investors who have a higher risk tolerance. Directional hedge funds with broad mandates may provide the most value-added, as measured by the increase in the opportunity set of alternatives. The impact of event-driven hedge funds and non-directional hedge funds is also significant, especially for those investors who have a lower risk tolerance. The greatest marginal effect for more risk-averse investors is from the addition of non-directional hedge funds. These styles increase the set of low risk opportunities, which is consistent with these strategies having lower correlation with the overall market and high Sharpe ratios.

The Prudence of Adding Alternative Assets in a Changing Environment

Though highly stylized, efficient frontier analysis provides a good foundation for measuring the benefit of hedge funds to a traditional asset portfolio. All major hedge fund styles–directional, non-directional, and event-driven–provide enhancements to the opportunity sets for both risk-averse and risk-tolerant investors. There is room for different combinations of hedge funds to sculpt the risk/return profile desired by an investor in ways that international diversification has historically been unable to do.

The benign economy is over. However, investors who use alternative strategies, which take advantage of change, and investment managers with the skill to differentiate the value of change, should be eager to embrace the new order. ■

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