Ten-year US Treasuries lost value last week as yields rose 18 basis points, while the S&P 500 declined 4.8% for its worst week since June. (ddp)

Tough times for markets highlight the appeal of hedge funds

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Government bonds have been failing to perform their traditional role of cushioning falling stocks as both fixed income and equities have declined in tandem.

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This pattern has been evident for much of the past year. Earlier this month, the Bloomberg Global Aggregate Total Return Index fell into bear market territory, down more than 20% since its 2021 peak.

History suggests that fixed income will resume its traditional role as a diversifier. Periods when 12-month rolling total returns fall simultaneously for both stocks and bonds have been followed by periods of strong performance. Since 1930, the 12-month bond performance following such periods has been positive 100% of the time, with an average return of 11%.

But in our view investors should also be seeking further sources of diversification for portfolios, and we see hedge funds as well-placed to navigate current market volatility.

Hedge funds continue to prove their worth in stabilizing portfolios. Hedge funds gained 0.4% month-over-month in August, based on the latest HFRI Fund Weighted Index released on 15 September, compared to a 4.2% decline in the MSCI World index and a 4% fall in the Bloomberg Global Aggregate Total Return index.

All strategies, apart from equity hedge, registered positive returns in volatile markets as the outlook for inflation and economic growth became the prime concern for markets going into the Jackson Hole Economic Symposium. Year-to-date, hedge funds overall have also outperformed. The HFRI Fund Weighted Index was down 4% from the start of the year to the end of August, versus an 17.8% negative return to the MSCI World Index and a 15.6% decline in the Bloomberg Global Aggregate Total Return Index.

Certain hedge fund strategies can perform well in volatile and sideways-moving markets, an environment we expect to last into next year. In our view, a durable improvement in market sentiment is unlikely until political risks and macro and monetary policy uncertainty recede. Inflation has been slower to decline than expected, based on the higher than-expected outcome from the US August consumer price index. Following this disappointment, we expect the Federal Reserve's policy meeting this week to deliver a third consecutive 75-basis-point rate hike, along with renewed signals that it will continue to tighten until inflation is reined in.

Political risks also remain elevated. Despite recent progress by Ukraine in regaining territory, our base case is that the war is likely to continue without a cease-fire in sight at least until the winter. Meanwhile, China's decision to persist with its zero-COVID policy is adding to risks to global growth. Certain hedge fund strategies, especially global macro funds, have the potential to do well in such challenging conditions.

A growing divergence between sectors and markets adds to the opportunity set for hedge funds. We have been stressing the need for investors to add selectively to exposure, and we see scope for further outperformance by value stocks, along with more defensive parts of the equity market, including consumer staples and healthcare. Non directional hedge fund strategies can be particularly well-placed to take advantage of opportunities on both the long and the short side of the market, which is outside the domain of traditional managers or strategies.

So, for the remainder of the year, we see the role of hedge funds increasing as markets remain volatile, central bank rates continue to rise, and divergence between sectors or regions increases.

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