AETOS INSIGHTS

Hedge Funds in Rising Rate Environments

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EXECUTIVE SUMMARY

With quantitative easing having ended in the US and the cycle of interest rate increases well along, investors are faced with a period of continuing risks to their traditional fixed income portfolios. Depending on how a portfolio is constructed, it may be exposed to the risk of changes in some or all of the components of fixed income return: risk free rates, inflation expectations, yield curve shape and credit risk. Of these, changes to the risk-free rate and the shape of the yield curve—combined with the duration of holdings—generally have the greatest effect on the value of fixed income portfolios. Portfolios with high allocations to credit will also have more sensitivity to credit spreads and liquidity.

Hedge fund strategies are not highly correlated to changes in interest rates as many of the securities they trade have little sensitivity to interest rate changes and managers often actively hedge such exposure. In addition, short positions generally benefit from rising short-term interest rates as the proceeds from short sales are usually invested in short-term government securities. As such, many investors consider hedge fund strategies as an alternative to traditional fixed income in their portfolios during a period of rising interest rates.

Generally speaking, the combination of potential positive returns, dampened volatility and low betas to traditional asset classes, along with lesser magnitudes of drawdowns, is the justification for the inclusion of an allocation to hedge funds in an institutional portfolio. Historical performance indicates that this justification holds for periods of rising interest rates.

HISTORICAL PERSPECTIVE

To examine hedge fund behavior specifically during periods of rising interest rates, we can look at the Credit Suisse Hedge Fund Index ("CS HFI") as a proxy for hedge funds. The CS HFI has a long track record based on a consistent discipline in index construction, and its statistics are similar to what well-diversified institutional portfolios of hedge fund strategies and managers have exhibited over time on a net-of-fees basis.

In the last 16 years, there have been five distinct periods since Aetos' inception where the 10-year Treasury yield has increased by at least 1% *(Chart 1)*.

Chart 1: 10-Year Treasury Yield – Periods of Rising Rates

Source: Bloomberg

AETOS AT-A-GLANCE

Firm Overview
Aetos Alternatives Management, LP ("Aetos") is an independent firm that, since its inception, has been a leader in providing investment advisory services and constructing fully customized hedge fund solutions for a broad range of institutional clients.

Founded
2001

Firm AUM[1]
$11.1 billion

Leadership
Anne Casscells
Co-President & Chief Investment Officer

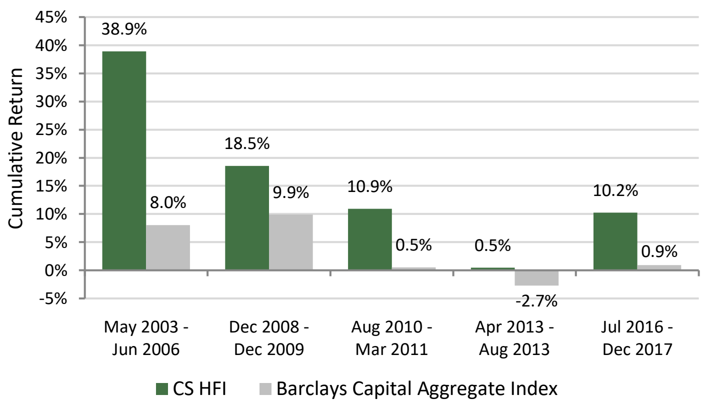
Michael Klein
Co-President & Chief Risk Officer

Locations
New York, New York
Menlo Park, California

[1] As of June 30, 2018

Hedge funds outperformed fixed income markets in each of these periods *(Chart 2)*.

Chart 2: CS HFI vs. Barclays Capital Aggregate Index



Source: Bloomberg

Hedge funds also outperformed fixed income markets during their worst performance month for each period *(Table 1)*.

Table 1: Worst CS HFI Month in Each Period of Rising Rates

	Return in Worst CS HFI Month	
Rising Rate Period	**CS HFI**	**Barclays Capital Aggregate Index**
May 2003 – June 2006	-1.46%	-3.36%
Dec 2008 – Dec 2009	-0.88%	-1.56%
Aug 2010 – Mar 2011	-0.18%	-1.08%
Apr 2013 – Aug 2013	-1.66%	-1.78%
Jul 2016 – Dec 2017	-0.49%	-2.37%

Source: Bloomberg

Even across the entire 16-year period from January 2002 through December 2017, hedge funds tended to outperform in the individual months that experienced negative fixed income market performance *(Table 2)*.

Table 2: Negative Fixed Income Months (Jan 2002 – Dec 2017)[2]

	Average Return
Barclays Capital Aggregate Index	-0.66%
CS HFI	+0.21%
10-Year Treasury	-1.39%
CS HFI	+0.64%

Source: Bloomberg

[2] Negative fixed income months indicate months where the performance of the Barclays Capital Aggregate Index and 10-Year Treasury were negative; during this period, 33% and 44% of months were negative, respectively.

Historical data over this period also indicates that a rising rate environment has not generally served as an impediment to positive hedge fund returns.

- The historical beta of hedge fund returns (CS HFI) to domestic fixed income securities (Barclays Capital Aggregate Index) has been near zero (0.09) over this period.
- Over the same period, the three-year rolling monthly correlation of the CS HFI to the Barclays Capital Aggregate index and the 10-Year Treasury averaged +0.03 and -0.23, respectively.

The relatively low beta and correlation to traditional fixed income securities is driven by the greater flexibility of hedge funds to manage risk by controlling net exposure through both long and short positions compared to their long-only counterparts who are typically more constrained.

CURRENT ENVIRONMENT

Rising interest rates are characteristic of late economic cycle periods, like the current environment. This stage in the cycle creates opportunities for several hedge fund strategies highlighted below.

Fixed Income Arbitrage

These strategies seek to exploit anomalies arising from temporary developments or structural issues in interest rate markets. Rising rates tend to be accompanied by increased volatility in fixed income markets, which typically produces a greater number of anomalies in valuations that hedge fund managers can exploit. Divergent central bank activity presents less correlated/more idiosyncratic opportunities from which to construct a portfolio. Proper arbitrage portfolios tend to be constructed with limited duration and interest rate risk, which tends to insulate them from market risk.

Distressed / Credit

At this stage of the cycle, a traditional long-biased distressed strategy is constrained by a lack of supply due to recent low rates of default. It is also potentially exposed to interest rate increases as they make rolling over debt more difficult and expensive for levered companies. A flexible long/short credit strategy is more appropriate from a credit standpoint in addressing the late cycle environment, regulatory, tax, and trade policy changes, and can profit from both winners and losers. In particular, a number of factors point to the opportunity on the short side of credit portfolios: current spread pricing, the leverage of issuers, and the large supply of BBB rated debt, which has grown to represent approximately half of the investment grade corporate market while trading at historically tight spreads. Rising interest rates will tend to have the most negative effect on the financially weaker issuers, a particular pool of opportunity to profit from shorts within credit portfolios.

Long / Short Equity

In the current environment, less correlation within and across markets increases the universe of exploitable mispricings, which increases the diversifying effect of individual long and short positions, and results in returns that are less correlated to markets in general. Recent regulatory, tax, and tariff issues have also created the possibility of winners and losers within and across industries, creating opportunity for those who can do the complex analytic work to understand these issues and how they impact individual companies. As noted earlier, rising short-term interest rates also increase returns on short positions' reinvestment of cash collateral, also known as "the short rebate." Even in sectors that may be interest rate sensitive, portfolios can be constructed long and short to isolate individual companies' advantages/disadvantages and insulate the positions from macro interest rate risk.

Event Driven

Corporate transactions, including mergers and acquisitions, spin-offs, and industry consolidation tend to proliferate in the late stages of economic cycles, in the current case aided by changes in regulatory approaches and in corporate tax policies in the U.S. Event driven strategies seek to take advantage of valuation differences resulting from other market participants' constraints in holding securities over short-term to intermediate-term that are subject to uncertainty surrounding potential or announced events. Providing liquidity to the market offers a premium to managers who can analyze and underwrite and hedge these opportunities – a premium that tends to be larger with greater uncertainty and/or complexity connected with the situation. The prices of these types of investments tend to be more sensitive to the idiosyncratic developments of directly related events, rather than to the general movement of markets, though they are not immune.

CONCLUDING THOUGHTS

In summary, interest rates tend to rise at later stages of cycles, but history has indicated that this is not generally an impediment to positive hedge fund returns, with late cycle periods offering unique opportunities across a range of hedge fund strategies from which to construct a diversified portfolio.

DISCLOSURES

Hedge fund investing involves substantial risks, including the risk of loss of invested capital. Hedge fund investments are typically made through investments in illiquid, unregulated investment funds that employ sophisticated investment techniques, often involving derivatives and leverage, in a wide range of financial instruments and markets. These investments entail a wide variety of risks, which remain substantial notwithstanding the risk management practices we employ in selecting and monitoring the funds in which we invest. Past performance is not indicative of future returns.

Certain information contained in this document constitutes "forward-looking statements," which can be identified by the use of forward-looking terminology such as "may", "will", "should", "expect", "anticipate", "target", "project", "estimate", "intend", "continue" or "believe" or the negatives thereof or other variations thereon or comparable terminology. Due to various risks and uncertainties, actual events or results or the actual performance of any particular investment or investment portfolio may differ materially from those reflected or contemplated in such forward-looking statements and no undue reliance should be placed on these forward-looking statements, nor should the inclusion of these statements be regarded as Aetos' representation that any particular strategy or objective will be achieved. The mention of any particular security or company should not be viewed as a recommendation nor should it be construed as implying that any Aetos account has exposure to such security or company.

Not every client account has participated in each investment or investment theme discussed herein as each account is subject to individually-negotiated investment objectives and guidelines.

Index returns are obtained through Bloomberg. Indices are not actively managed, do not reflect any deduction for fees, expenses or taxes, and investors cannot invest directly in an unmanaged index. The volatility, investment holdings and other characteristics of the indices presented may be materially different from those of investments made by Aetos referenced herein. The indices shown have not been selected as appropriate benchmarks to compare to the performance of those of investments made by Aetos; rather they are provided to allow for comparisons to the performance of well-known and widely recognized indices.

- Barclays Capital Aggregate Index: Market capitalization weighted index that covers the USD-denominated, investment-grade (must be Baa3/BBB- or higher using the middle rating of Moody's Investor Service, Inc., Standard & Poor's, and Fitch Inc.), fixed-rate, and taxable areas of the bond market. This is the broadest measure of the taxable U.S. bond market, including most Treasury, agency, corporate, mortgage-backed, asset-backed, and international dollar-denominated issues, all with maturities of 1 year or more.

- Credit Suisse Hedge Fund Index: Asset-weighted hedge fund index of funds that report to the Credit Suisse Hedge Fund Database. Constituent funds have a minimum of $50 million under management, a minimum one-year track record and current audited financial statements. The index is calculated and rebalanced on a monthly basis.