Hedge Funds in Rising Rate Environments

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EXECUTIVE SUMMARY

In recent months, we have seen central banks in Western countries respond to persistent and higher levels of inflation by tapering bond purchases as a precursor to a cycle of interest rate increases. In the US, inflation concerns have accelerated, with headline CPI surpassing 7% (and core CPI hitting 6%), This has prompted economists to significantly revise their expectations for the December 2022 Fed Funds rate from the 0.75% forecasted earlier to a range of 2-2.50% currently.

In equity markets, higher rates expectations likely drove capital rotation out of growth (especially non-profitable technology companies) into value in the first quarter.[1] Meanwhile in fixed income markets, real rates remain negative and the US yield curve has flattened. Investors face evolving risks to elements of fixed income return: risk free rates, yield curve, inflation expectations, and credit spreads.

Institutional investors have often considered well-constructed low beta hedge fund portfolios as an alternative to traditional fixed income. Both are liquidity-providing strategies, both target returns expressed as a spread over the risk-free rate and both exhibit low volatility compared to equities. Unlike fixed income securities, however, hedge fund strategies are generally uncorrelated to changes in interest rates, as many of the securities they trade have little sensitivity to interest rate changes and hedges can further limit exposures. (In addition, strategies that are unlevered or implemented via margin actually benefit from rising short-term interest rates on unencumbered cash). Furthermore, the very conditions that make fixed income investing challenging often present compelling alpha generating opportunities for hedge funds.

Investors allocating to hedge funds have generally been attracted by the combination of potential positive returns, dampened volatility, limited duration risk and low betas to traditional asset classes. In the current environment of rising interest rates, investors are considering hedge funds as a possible alternative to a traditional fixed income allocation.

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.

Over the last 20 years, there have been six distinct periods since Aetos' inception where the 10-year Treasury yield has increased by at least 1% (*Chart 1*).

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

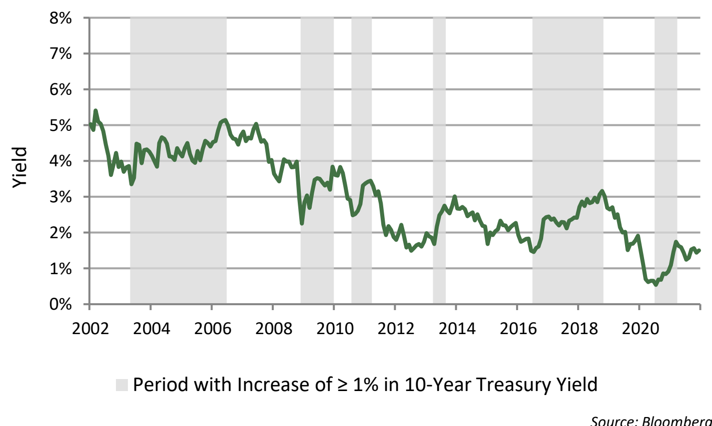
Leadership
Anne Casscells
Co-President & Chief Investment Officer

Michael Klein
Co-President & Chief Risk Officer

Locations
New York, New York
Menlo Park, California

[1] For the first quarter 2022, the Russell 3000 Growth Total Return Index returned -9.3%, while the Russell 3000 Value Total Return Index returned -0.8%.

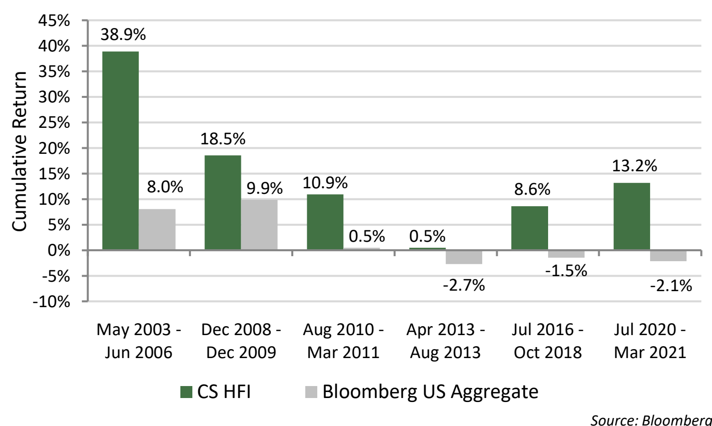
Chart 1: 10-Year Treasury Yield – Periods of Rising Rates



Source: Bloomberg

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

Chart 2: CS HFI vs. Bloomberg US Aggregate Bond Index



Source: Bloomberg

Across the entire 20-year period from January 2002 through December 2021, hedge funds tended to outperform in the individual months that experienced negative fixed income market performance *(Table 1)*.

Table 1: Negative Fixed Income Months (Jan 2002 – Dec 2021)[2]

	Average Return
Bloomberg US Aggregate Bond Index	-0.64%
CS HFI	+0.17%
10-Year Treasury	-1.31%
CS HFI	+0.66%

Source: Bloomberg

Hedge funds also outperformed in fixed income markets' worst month in all periods *(Table 2).*

Table 2: CS HFI Return in Worst Fixed Income Month in Each Period of Rising Rates

Rising Rate Period	CS HFI Return	Bloomberg US Aggregate Worst Month Return
May 2003 – Jun 2006	0.08%	-3.36%
Dec 2008 – Dec 2009	0.88%	-1.56%
Aug 2010 – Mar 2011	2.90%	-1.08%
Apr 2013 – Aug 2013	0.42%	-1.78%
Jul 2016 – Oct 2018	0.36%	-2.37%
Jul 2020 – Mar 2021	2.33%	-1.44%

Source: Bloomberg

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 (Bloomberg US Aggregate Bond Index) has been near zero (0.1) over this period.
- Over the same period, the three-year rolling monthly correlation of the CS HFI to the Bloomberg US Aggregate Bond index and the 10-Year Treasury averaged 0.0 and -0.2, 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-stage economic cycles when the demand/supply environment in the economy prompts concerns about inflation. Although this creates headwinds for traditional, long-only fixed income allocations, we believe that it has created interesting investment opportunities across a variety of fixed income alternatives, and specifically hedge fund strategies, as highlighted below.

Fixed Income Arbitrage

These strategies seek to exploit anomalies arising from temporary developments or structural issues in interest rate markets. Central bank bond-buying programs and rates near the theoretical "zero"

[2] Negative fixed income months indicate months where the performance of the Bloomberg US Aggregate Bond Index and 10-Year Treasury were negative; during this period, 35% and 46% of months were negative, respectively.

bound, have combined to suppress fixed income volatility in recent years, leading to less dispersion and fewer opportunities for relative value/arbitrage managers. In the near-term, rate hikes and quantitative tightening could create pockets of illiquidity that detract from hedge fund performance; however, increased fixed income volatility should produce a greater number of anomalies for hedge fund managers to capture. This dynamic rewards managers who are disciplined and properly positioned for emerging opportunities. Divergent central bank activity should also benefit managers who take positions in multiple markets.

Macro (Discretionary & Systematic)

Macro managers seek to benefit from trading economic and market insights, including into monetary and fiscal policy. Many discretionary macro managers are currently short fixed income securities anticipating higher interest rates, but that is reflective of current portfolio positioning rather than the group's inherent exposure to changes in interest rates. Portfolios are generally implemented via futures, so managers should benefit from higher yields on excess cash in a rising interest rate environment; however, the more important factor for macro opportunities is diverging central bank activity, with non-uniform levels of inflation concerns across countries leading to more trading opportunities.

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. Potential regulatory, tax, and tariff issues also can create 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. Even in sectors or styles (e.g., growth, value) that may be interest rate sensitive, portfolios can be constructed long and short to isolate individual companies' advantages/disadvantages and hedged to lower net exposures to insulate the positions from macro interest rate risk. Furthermore, higher interest rates may also bring into focus the debt service ability of financially levered firms. This could lead to additional dispersion between companies that are cash flow positive and those that are more reliant on financing markets, further producing the opportunity for gains for skilled long/short managers.

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 (in 2021, the default rate for high yield bonds was 0.26%). It is also potentially exposed to interest rate increases as rolling over debt becomes more difficult and expensive for levered companies. We believe a flexible long/short credit strategy is more appropriate from a credit standpoint in addressing the late cycle environment, and potential 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 over 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 potential pool of opportunity to profit from shorts within credit portfolios.

Event Driven

Corporate transactions, including mergers and acquisitions, spin-offs, and industry consolidation tend to proliferate in the late stages of economic cycles, as increasing interest rates can drive buyers to bid on companies while financing remains relatively cheap. 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, 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 equity or fixed income markets, though they are not immune. In recent periods, merger activity has slowed amid increased regulatory scrutiny and global geo-political tensions, especially relating to information security, and we believe these headwinds are unlikely to be directly impacted by interest rate expectations.

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.[3] In fact, late cycle periods generally see an increase in volatility and dispersion, offering more unique opportunities across a range of hedge fund strategies from which to construct a diversified portfolio. We believe that by including hedge funds in a thoughtfully constructed portfolio, institutions can better position themselves to navigate this changing market climate and deliver on the goals of their overall investment program.

[3] Note that past results are not necessarily indicative of future performance and that the relationships and relative returns that we have cited in this paper may not repeat in the current and prospective environment for any number of reasons.

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.

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- Bloomberg US Aggregate Bond Index: Index designed to broadly measure the performance of the investment grade, US dollar-denominated, fixed-rate taxable bond market. The Bloomberg US Aggregate Bond Index includes Treasury securities, government-related and corporate securities, MBS, ABS, and CMBS with maturities of no less than one year.
- Credit Suisse Hedge Fund Index: Index of individual hedge 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.