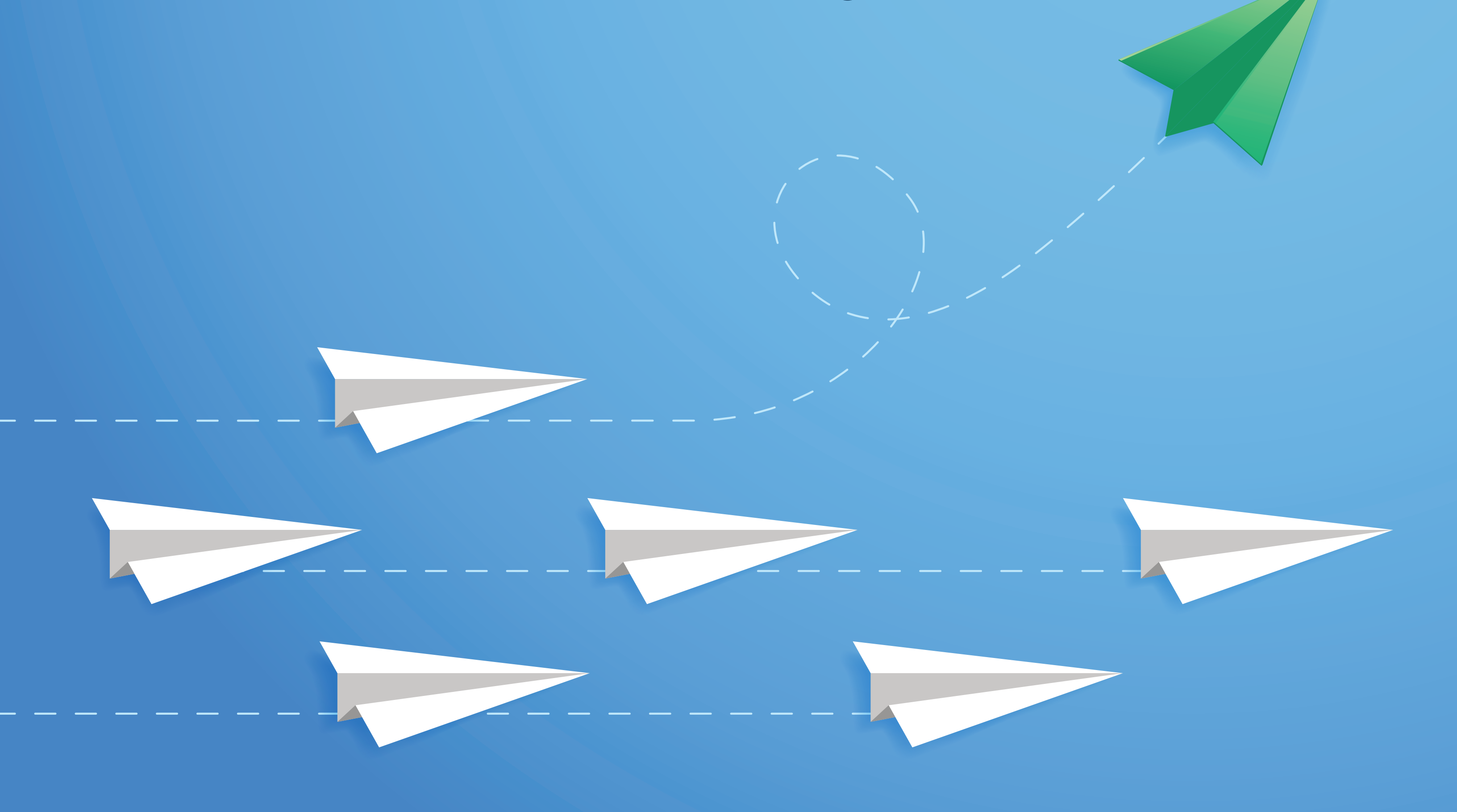
Wind of Change

A Favorable Environment for **Hedge Funds**



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TIFF
INVESTMENT MANAGEMENT

Executive Summary

Our most recent white paper on Diversifying Strategies, Stayin' Alive: The Importance of Risk Management in a Risky Market, focused on the role of Diversifiers in offering downside protection. In this follow up, we look at how hedge funds contribute to returns – a view that is timely, since we feel that current market conditions position hedge funds to succeed in capturing greater upside than in the recent past.

At TIFF, we use hedge funds alongside fixed income to reduce portfolio risk and enhance returns, primarily through exposure to investment strategies with reduced correlation to the equities markets. We still believe that this is the highest and best use for Diversifying Strategies, even as bond yields have improved.

Here, we expound on how we feel that the current higher interest rate environment fuels market dynamics where hedge funds tend to do well:

Higher rates tend to create more dispersion in markets, creating a broader hunting ground for hedge funds and increasing the number of short opportunities

High dispersion benefits Macro strategies in particular, given their focus on exploiting short-term pricing inefficiencies

Higher rates translate to higher short rebates for hedge funds, and the steady predicable interest income stream from these rebates adds to net returns

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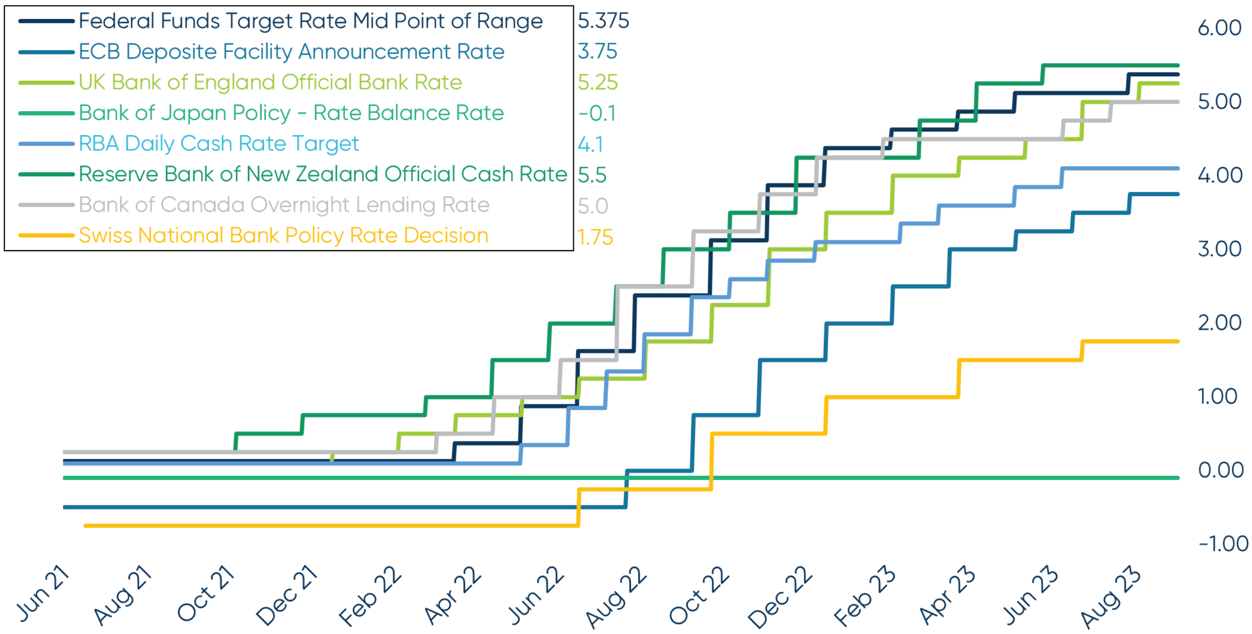
Scan the QR code to download TIFF's earlier white paper on Diversifying Strategies, Stayin' Alive: The Importance of Risk Management in a Risky Market.

Through any environment, including this one, manager selection remains a key determinant of success. Investors should continue to cede discretion – and dollars – thoughtfully.

Background

2022 saw one of larger pivots in recent market history: We emerged from our COVID bunkers to a record level of stimulus – both fiscal and monetary, which caused inflation to rear its ugly head. The Fed was initially slow to react, but later played catch up by unleashing one of the most aggressive series of rate hikes in history as other central banks globally reacted similarly.

Central Bank Cash Rates
(%, June 1, 2021 to August 31, 2023)[1]



These hikes led to uncertainty around a potential recession, credit tightening, and the upheaval of business models designed for a zero-rate environment. We believe hedge funds, by their adaptive nature and ability to use non-traditional investment approaches, have an edge in navigating these uncertain markets. Of course, investing in hedge funds also involves risks, including possible loss of principal, and performance cannot be guaranteed.

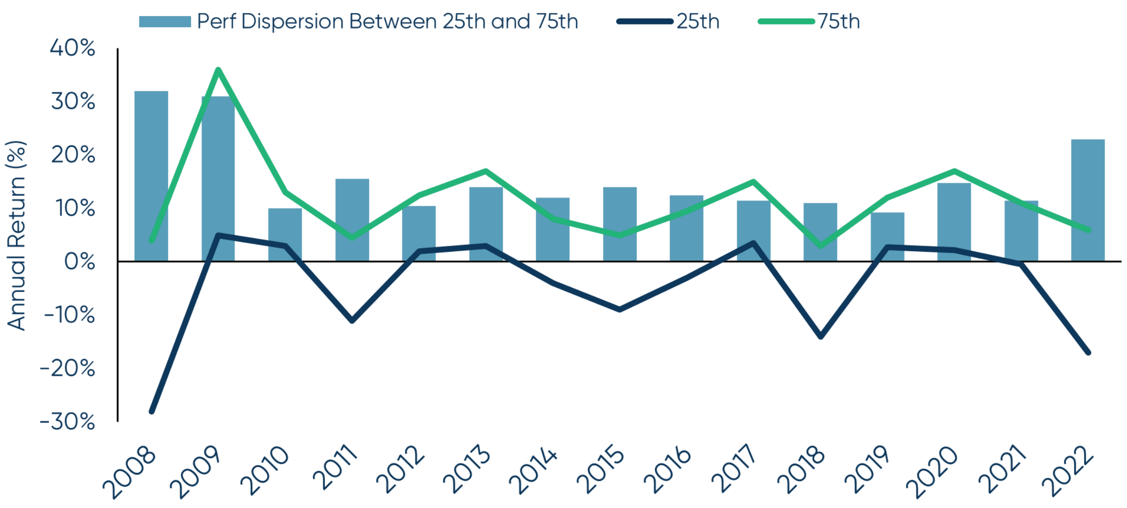
[1] Source: Bloomberg. Fed Funds rates represented by midpoint of target range.

Enhanced Ability to Leverage Market Dispersion

To quote Howard Marks: "I think we may be in the midst of a third [sea change] today."[2] Rising rates generally lead to higher market volatility and thus to more dispersion within markets. Geopolitics, AI adoption, and clean energy transition are just a few of the macro themes underpinning dispersion and seeing clear winners and losers.

There is also greater dispersion across hedge fund returns during these volatile times as those who can navigate difficult markets float to above the rest.

Hedge Fund Dispersion is Vast and Widens During Volatile Periods
(percentile; January 1, 2008 to December 31, 2022)[3]

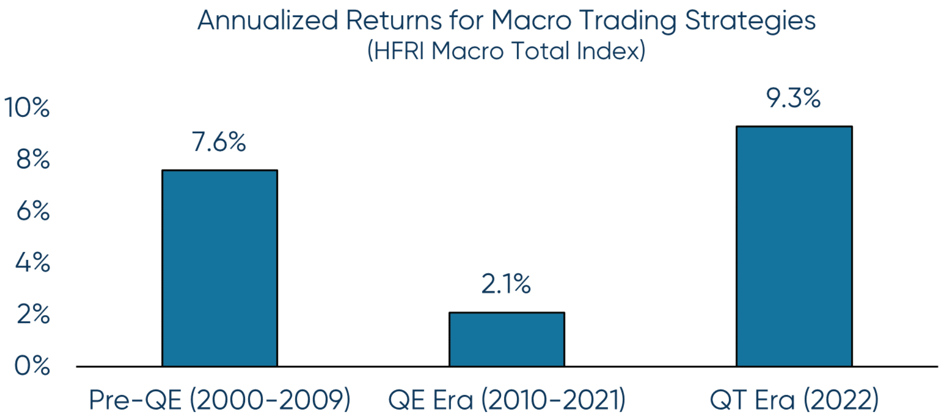


Hedge fund strategies are designed to capture the richer opportunities – and excess returns – found in the broader hunting grounds created by dispersion.

In particular, we are watching to see if Macro strategies will benefit from greater market dispersion. Macro hedge funds seek to profit from broad market swings caused by geopolitical or economic events. When central banks across the world lowered rates to historic lows in the post-2008 Quantitative Easing era, Macro funds experienced the equivalent of a polar bear trying to hunt on a melting ice cap:

[2] Howard Marks, Sea Change, December 13, 2022, Oaktree Capital.
[3] Goldman Sachs Asset Management XIG Hedge Fund Database.

Macro Hedge Fund Strategy Returns under Different Monetary Policies
(%; January 1, 2000 to December 31, 2022)[4]



Major macro events in 2022 coupled with Quantitative Tightening central policies could herald a potential new era where Macro funds may have much more space to roam.

Fundamental hedge funds are also seeing opportunities to capture alpha on the short side for the first time in many years. Low interest rates coupled with Quantitative Easing has allowed many companies with poor business models to stay on life support provided by cheap financing. Couple this with dangers of shorting companies that may turn into "meme stocks" and many hedge fund managers all but threw in the towel on trying to generate returns from the short side, instead resorting to blunt tools like ETFs or customized baskets to help hedge their portfolios.

As you may have read in TIFF's 2nd Quarter 2023 CIO Commentary, this dynamic has taken a 180-degree turn. We are now experiencing one of the narrowest markets in the past 50 years, with only 24% of stocks in the S&P 500 outperforming the index. This means that *three quarters of the stocks within the S&P 500 are underperforming the index* – a ripe ground for picking short positions.

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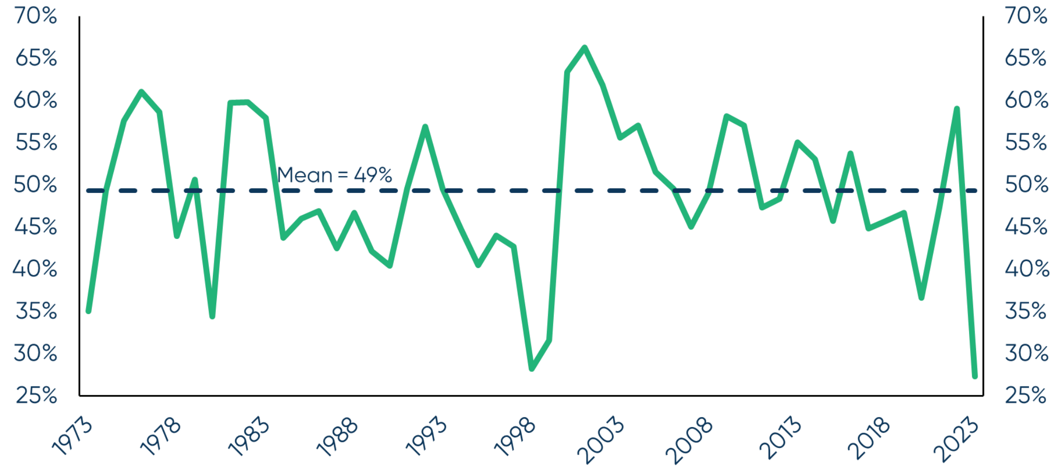
[4] Source: Bloomberg and HFRI Macro Total Index; monthly returns.

Percentage of S&P 500 Stocks that Outperformed the S&P 500 Over the Calendar Year
(%; December 31, 1973 to August 18, 2023)[5]



Correctly identifying winners and losers is easier said than done. Managers need to deal with an ever-growing list of crosscurrents that include factor risk, fund-flow risk, geopolitical risk, and rate risk. Understanding the fundamentals of idiosyncratic investments while positioning the portfolio to avoid market crosscurrents is a skill few managers possess. A greater ability to capture this dispersion usually translates directly to increased performance.

We believe there are approaches to increase the odds of capturing dispersion, including investing in specialist managers operating in underfollowed parts of the market. These managers have adapted their investment approach to a particular market.

By their very nature, inefficient markets are less understood by the average investor – think of the intricacies of investing in such complex and fragmented sectors as Healthcare or Metals & Mining. Often, investors resort to broader tools like ETFs to gain exposure. This creates opportunities for specialist managers to capture alpha by taking a more dynamic and targeted view.

Another benefit of partnering with specialist managers is their ability to identify and dig into new markets ahead of the general populace. We have found this helpful in our global Carbon Credit allocations, where our managers can sometimes capture attractive arbitrage opportunities otherwise absent in efficient markets.

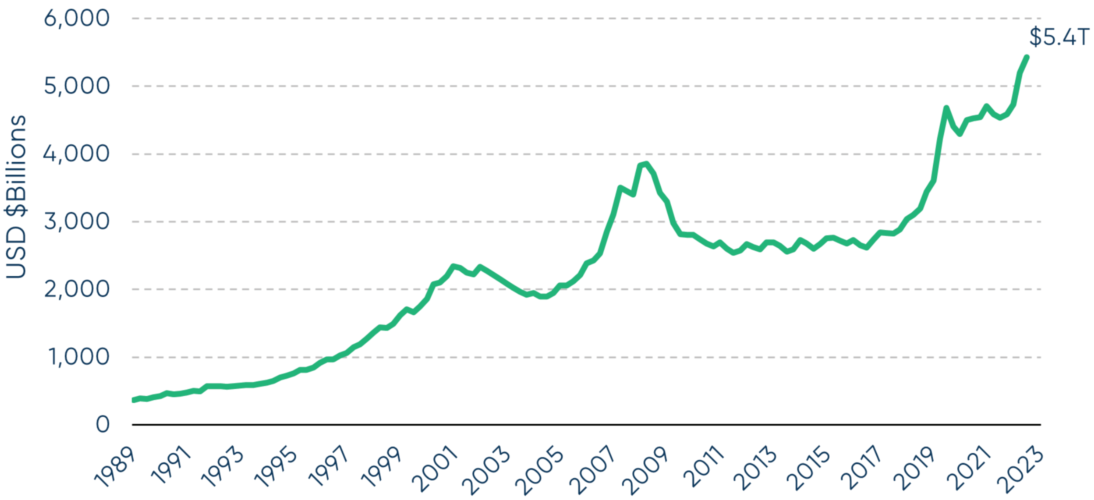
[5] Ned Davis Research, August 18, 2023. Source: S&P Dow Jones Indices.

At TIFF, market inefficiency and manager specialization come in various forms: sector, geography, asset class, market cap, etc. We work hard to identify alpha-generating funds who help us to find the best niche areas to fish for excess return, creating differentiated and less-correlated return streams.

Short Rebates Dampen Effect of Fees

Aggressive Fed hiking has led to higher risk-free rates. Many money market accounts are now yielding 4% to 5% from investments in US Treasuries.[6] As a result, we have seen eager investors flocking to these vehicles, causing asset levels to balloon to historic highs:

ICI Money Market Fund AUM
($bn; January 1, 1990 to June 30, 2023)[7]

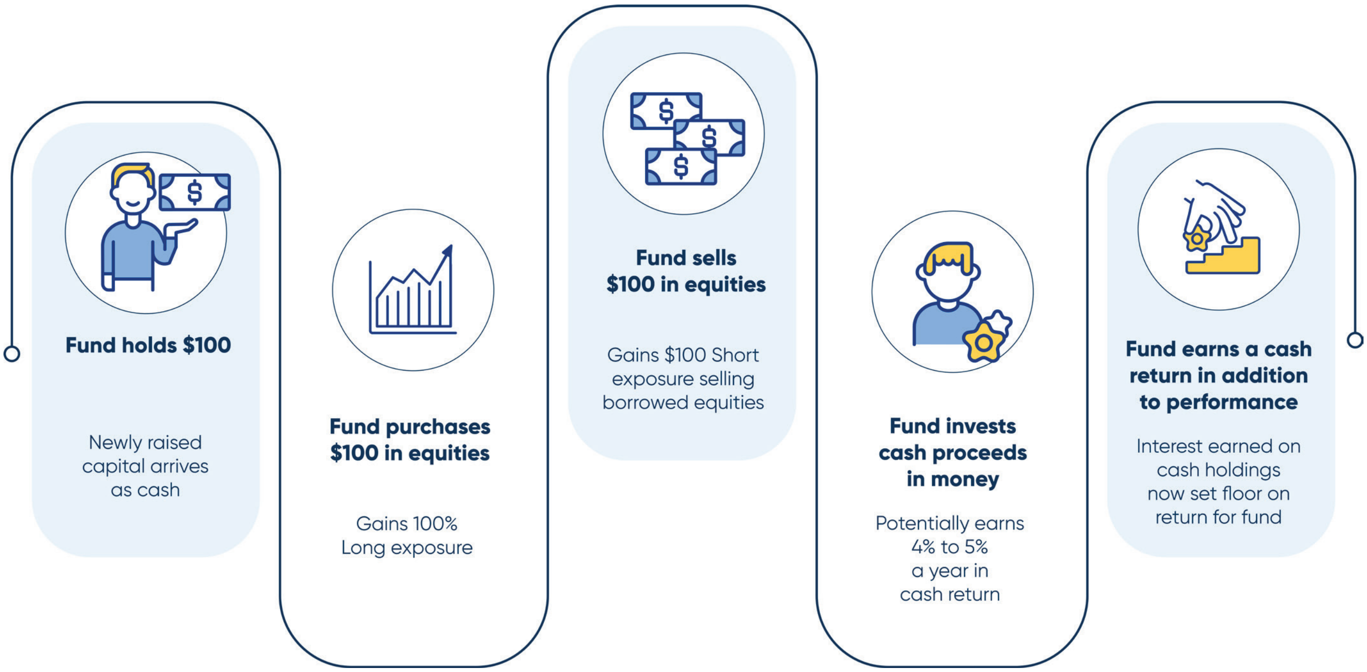


US equity hedge funds in particular stand to gain from higher rates. Recently, Long / Short Equity funds have taken on higher gross (Long + Short) and lower net (Long – Short) exposures. This reflects a relatively bearish view on the US equities, as low net exposure means hedge funds have little directional exposure to the markets. It also reflects the abundance of opportunities that hedge funds are seeing in both owning some stocks and being short others.

[6] Source: Bloomberg.
[7] Source: Bloomberg.

Hedge funds with larger short positions can benefit from earning more on their cash than they earn from selling positions short. Given today's 4% to 5% yield on money market accounts, hedge funds should see a direct and uncorrelated boost to their bottom lines.

Illustrative Impact of Higher Rates on a Hypothetical Market Neutral Long / Short Equity Fund with 200% Gross Exposure and 0% Net Exposure[8]



Although this is by no means a competitive edge, it is still a meaningful benefit to hedge funds who hold cash as part of their strategy. Not too long ago this cash was yielding nothing, producing a drag on returns. This former headwind is now a return tailwind for many funds, and one that is independent from the outcome of the short thesis.

One effect of having a 5% tailwind to performance for hedge funds is the ability to dampen the impact from fees on hedge fund performance. A 1.5% annual management fee when hedge funds are generating 8% in annual returns means fees eat up 19% of the total performance. However, fees do not scale with interest rates, meaning that investors pay the same 1.5% when the fund is now yielding 13% (8% returns + 5% risk free cash rate) which is a much more manageable 11% of total performance.

[8] Example is illustrative and for discussion purposes only and cannot be viewed as an indicator or guarantee of future performance. There is no guarantee that any particular asset allocation or mix of strategies will meet your investment objectives.

Shrewd investors might already be jumping out of their seats in protest at paying hedge fund fees to these funds for doing nothing more than capital sweeping. We wholeheartedly agree and don't reward funds for this free lunch. Not only do we make sure we're looking at returns net of all fees and expenses, but we also tie a portion of our expected returns to the amount of cash a fund carries. A fund formerly yielding high single digits should now be able to push to a low-teen return profile. Should funds fail to meet the increasing expectations, we are likely to search for new partners.

Expectation of Better Returns

What does this mean for hedge fund performance? We believe hedge funds are poised to generate better absolute returns in a higher interest rate environment.

Historical analysis illustrates the performance of hedge funds during different interest rate environments. As interest rates increase from a range of 2% to 4% to a range of 4% to 6% – where we are now – hedge funds have historically generated annual absolute returns of almost 14%.

Hedge Fund Performance and Excess Return Across Different Interest Rate Environments (January 1, 1990 to December 31, 2022)[9]

Prevailing Rate	Hedge Fund Returns	Equity L/S Returns	Equity L/S Alpha	Equity Market Returns	Equity Dispersion	Equity Correlation
<2%	8.5%	9.5%	4.1%	11.6%	0.22	0.30
2% – 4%	6.3%	3.7%	3.9%	-3.6%	0.23	0.22
4% -6%	13.9%	17.2%	5.3%	13.5%	0.24	0.22
>6%	19.1%	28.3%	19.3%	7.6%	0.33	0.16

Should hedge funds be able to generate similar results to those historically, which cannot be guaranteed, we believe hedge funds are an attractive addition to the traditional portfolio.

[9] "A New Hope", January 2023, Goldman Sachs Prime Services. Source: Goldman Sachs Prime Services; annualized returns.

Conclusion

As we have highlighted in this piece, market shifts have brought about winds of change. We believe hedge funds will go from battling headwinds to enjoying tailwinds going forward which should directly benefit absolute performance. At TIFF, we aim to partner with the right managers to help us capture these shifting dynamics and rise above the flock with the wind beneath our wings.

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Past performance is no guarantee of future results and the opinions presented cannot be viewed as an indicator of future performance.

There is no guarantee that any particular asset allocation or mix of strategies will meet your investment objectives.

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