# When High Alpha Met Low Beta

A closer look at performance across hedge fund styles.

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When investing in hedge funds, it's all about the first two Greeks. Alpha and beta, that is.

More specifically, investors have historically tended to seek low beta strategies to diversify traditional asset classes and high alpha approaches in seeking to generate significant excess returns after controlling for traditional market exposures. Although many may assume a trade-off between alpha and diversification potential, that hasn't been the case: Over the past 15 years, *lower-beta* hedge fund styles have realized *higher* alpha.

There are many potential explanations for this counter-intuitive result and each strategy has its own story (see our *Featured Solution* from March, "Modern Macro," for a deeper dive). However, one pattern that emerges is that strategies with stronger "crisis alpha" during equity market drawdowns – precisely the scenario investors fear today if recession strikes – have also generated the highest long-term alpha.

Hedge fund strategy performance in 2022 provides the latest striking example. In 2022, while broad hedge fund indices declined 4.1% and $55 billion of capital fled the industry,[1] lower-beta strategies such as multi-strategy, macro, and trend-following delivered positive performance and much-needed diversification.

Widening the aperture, hedge fund industry assets have doubled from $1.9 trillion in 2007 to $3.8 trillion today, despite cumulative net flows of only $42 billion. In other words, hedge fund assets have seemingly grown steadily thanks primarily to long-term performance, but investors need to look under the hood to evaluate which strategies are driving the growth and where capital is flowing. For example, long/short equity has shrunk from 37% to 28% of hedge fund assets since 2007, whereas relative value, macro, and event-driven categories have all grown.

Looking forward, many investors are asking which hedge fund styles are more likely to prosper in an environment of heightened volatility and prolonged higher interest rates to combat inflation (see our *Cyclical Outlook* from April, "Fractured Markets, Strong Bonds.").

Our framework for evaluating the historical performance of underlying strategies helps explain these trends. As in 2022, periods of high volatility have often coincided with stock market weakness – punishing hedge fund strategies with higher equity beta relative to lower-beta strategies including trend-following and macro.

1 Performance proxied by the HFRI Fund Weighted Composite Index and flows proxied by total industry data from HFR.

## WINNING ON BOTH FRONTS: POSITIVE ALPHA AND INCREASED DIVERSIFICATION

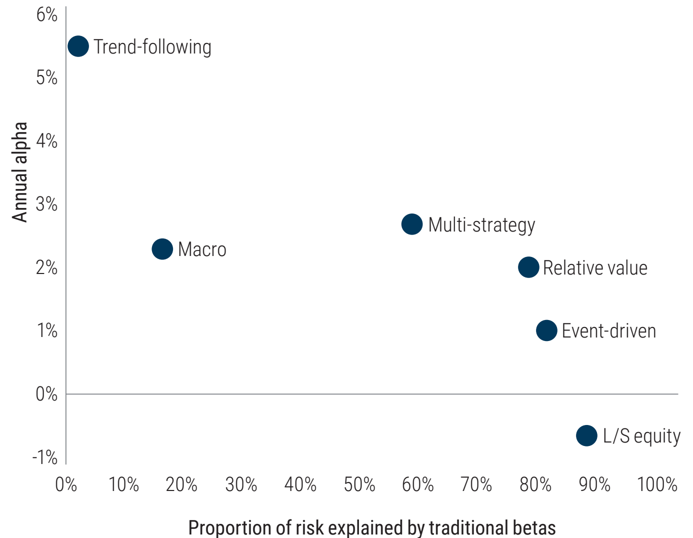
The appeal of hedge funds has generally relied upon alpha generation and diversification from traditional asset classes. These are easily quantified with a simple model that regresses hedge fund returns against four major asset classes (equity, interest rates, credit, and commodities). The results show what proportion of a hedge fund's historical returns is explained by traditional betas versus alpha.

It turns out that over the 15 years ending December 2022, strategies with lower beta to traditional markets – such as multi-strategy, macro, and trend-following – have also generated higher alpha (see Figure 1). This is a compelling "double-whammy" for allocators. Moreover, these results highlight the potential danger of evaluating hedge funds based on *total* returns alone. For example, a higher-beta strategy may have a greater *total* return than a lower-beta strategy during a bull market, but the *composition* of the lower-beta strategy's return may have significantly more alpha. In a total portfolio context, investors are understandably unwilling to pay hedge fund fees for returns that can be replicated in traditional liquid markets.

## CYCLICAL OUTLOOK FAVORS LOWER-BETA DIVERSIFIERS

For investors reconsidering their hedge fund allocations, we believe it is critical to assess how the risk of elevated volatility and interest rates could affect various hedge fund strategies. As Figure 2 shows, lower-equity-beta strategies such as trend-following and macro (which had betas of -0.10 and 0.07 since December 1999, respectively[2]) have done better in periods of high volatility when stocks tend to struggle. In addition, trend-following and macro have outperformed during higher cash-rate regimes – likely, in part, because those strategies have more unencumbered cash available to invest at higher market rates.

**Figure 1: Lower-beta diversifying strategies have realized higher long-term alpha**

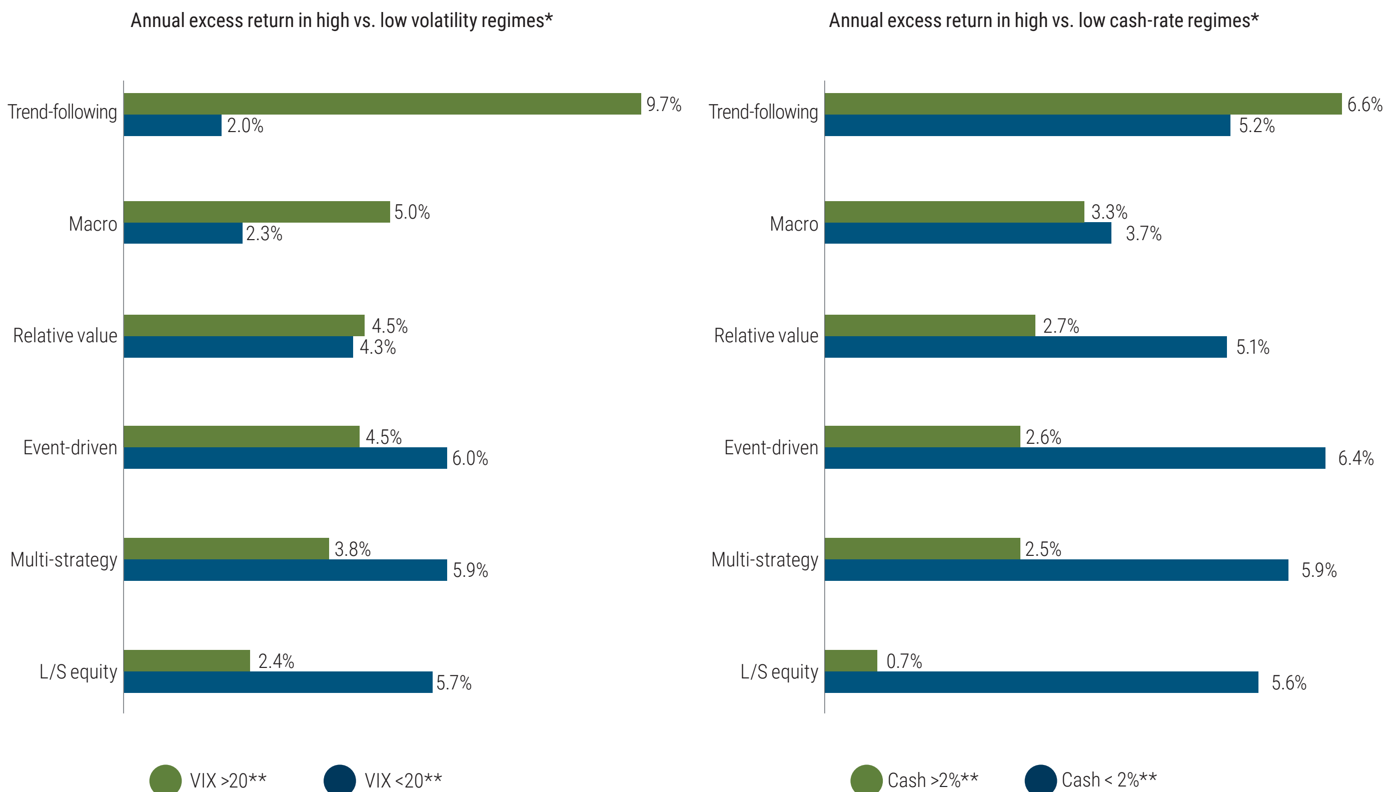



Source: PIMCO and Bloomberg as of 31 December 2022. **Past performance is not a guarantee or a reliable indicator of future results.**

Based on monthly returns from 31 December 2007 – 31 December 2022. Proxies: L/S equity = HFRI Equity Hedge Index; event-driven = HFRI Event-Driven Index; macro = HFRI Macro Index; relative value = HFRI Relative Value Index; multi-strategy = Credit Suisse Multi-Strategy Index; trend-following = SG Trend Index. Statistics are based on regression analysis of hedge fund index returns against four major asset classes (equity, interest rates, credit, and commodities). Proxies for asset classes being regressed: equity = S&P 500 Index; interest rates = Bloomberg Bellwether 10-year Swap Total Return Index; credit = Bloomberg US Credit Index (Duration Hedged); commodities = Bloomberg Commodity Index.

2 Proxies: Trend-following = SG Trend Index; macro = HFRI Macro Index

**Figure 2: Lower-beta strategies have outperformed in high volatility and high interest rate regimes**




Source: PIMCO and Bloomberg as of 31 December 2022. **For illustrative purposes only. Past performance is not a guarantee or a reliable indicator of future results.**
* Average rolling 12-month excess returns over cash in periods of high vs. low cash rates or volatility. Based on monthly returns from 31 Dec. 1999 – 31 Dec. 2022.
** Cash return is the trailing 12-month return of the FTSE 3-Month T-Bill Index. VIX is based on the trailing 12-month average level of the VIX Index. Other proxies: L/S equity = HFRI Equity Hedge Index; event-driven = HFRI Event-Driven Index; macro = HFRI Macro Index; relative value = HFRI Relative Value Index; multi-strategy = Credit Suisse Multi-Strategy Index; trend-following = SG Trend Index.

## FOLLOW THE TREND

The data indicate that the composition of investor hedge fund portfolios is changing – and for good reason. Investors are discerning about where they will pay hedge fund fees, and are gravitating toward styles that are hitting on both alpha and diversification objectives. Elevated volatility and interest rates may prolong this long-term trend, increasing the demand for strategies with superior defensiveness and alpha potential.

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**Beta** is a measure of price sensitivity to market movements. Market beta is 1.

The **correlation** of various indexes or securities against one another or against inflation is based upon data over a certain time period. These correlations may vary substantially in the future or over different time periods that can result in greater volatility.

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The **HFRI Equity Hedge Index** is an unmanaged index that consists of a core holding of long equities hedged at all times with short sales of stocks and/or stock index options. Some managers maintain a substantial portion of assets within a hedged structure and commonly employ leverage. Where short sales are used, hedged assets may be comprised of an equal dollar value of long and short stock positions. Other variations use short sales unrelated to long holdings and/or puts on the S&P 500 index and put spreads. Conservative funds mitigate market risk by maintaining market exposure from zero to 100 percent. Aggressive funds may magnify market risk by exceeding 100 percent exposure and, in some instances, maintain a short exposure. In addition to equities, some funds may have limited assets invested in other types of securities.The **HRFI Macro Index** is an unmanaged index that involves investing by making leveraged bets on anticipated price movements of stock markets, interest rates, foreign exchange and physical commodities. Macro managers employ a "top-down" global approach, and may invest in any markets using any instruments to participate in expected market movements. These movements may result from forecasted shifts in world economies, political fortunes or global supply and demand for resources, both physical and financial. Exchange-traded and over-the-counter derivatives are often used to magnify these price movements. The **HRFI Relative Value Arbitrage Index** is an unmanaged index that attempts to take advantage of relative pricing discrepancies between instruments including equities, debt, options and futures. Managers may use mathematical, fundamental, or technical analysis to determine misvaluations. Securities may be mispriced relative to the underlying security, related securities, groups of securities, or the overall market. Many funds use leverage and seek opportunities globally. Arbitrage strategies include dividend arbitrage, pairs trading, options arbitrage and yield curve trading. The **Credit Suisse Liquid Alternative Beta - Multi-Strategy Index** reflects the combined returns of the individual LAB strategy indices – Long/Short, Event Driven, Global Strategies, Merger Arbitrage and Managed Futures – weighted according to their respective strategy weights in the Credit Suisse Hedge Fund Index. The **SG Trend Index** calculates the net daily rate of return for a group of 10 trend following CTAs selected from the largest managers open to new investment. The SG Trend Index is equal-weighted and reconstituted annually and has become recognized as the key managed futures trend following performance benchmark.

It is not possible to invest directly in an unmanaged index.

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