WHIPLASH 2022

Navigating Markets Both Familiar and Foreign

AUGUST 2022

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You can't compound capital you don't preserve.

Investors faced multiple headwinds in the first half of the year, creating new headaches and questions for portfolios:

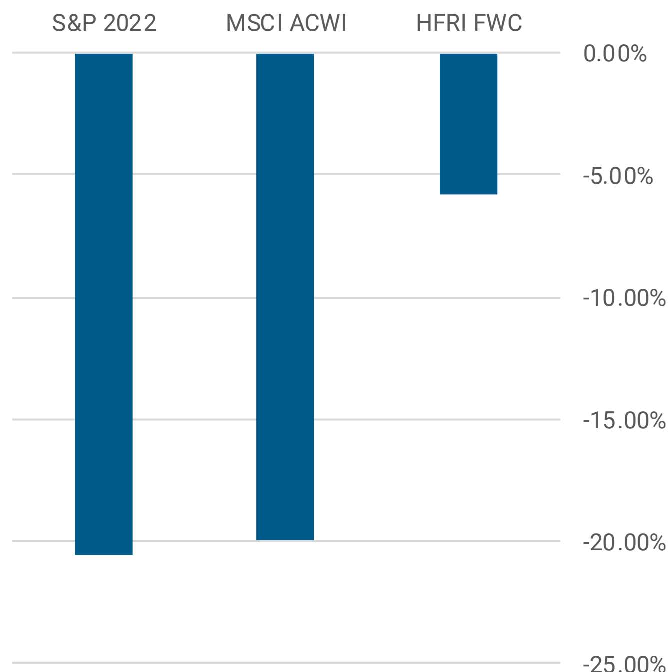
- **S&P**: Worst 1st half since 1970
  What do the last 50 years tell us about what may lie ahead?
- **BTC**: Biggest monthly drop in June since 2011
  How do new asset classes evolve and thrive?
- **ESG**: First retail outflows since 4Q2018
  Will assets continue to moderate?
- **GDP:** U.S. economy contracts for two consecutive quarters (1Q, 2Q '22)
  Is this 'just' a technical recession?
  Or a "pre-cession…"
- **USD:** Dollar strengthening creates headaches for emerging markets and some corporates
  How will other central banks respond?
- **CPI:** U.S. inflation surging to 40 year highs
  When will inflation pressures ease?
- **VOL:** Still elevated and hovering near 25
  What could draw the VIX back toward the mean?

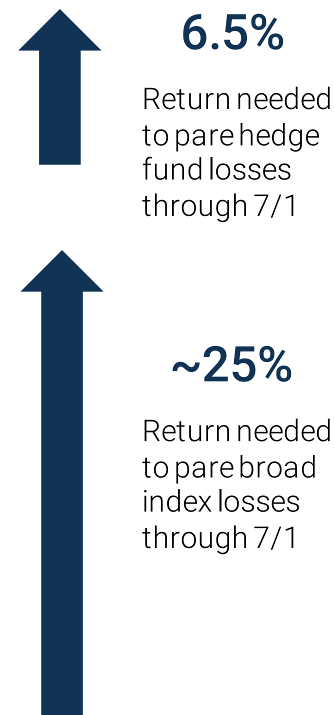
And yet hedge funds reasserted their value proposition - their outperformance has helped facilitate capital preservation

Key Points

- 2022 has reminded allocators of the value of capital preservation, with funds considerably outperforming benchmarks
- As of July 1, 2022, the HFR FWC Index was down -5.78%, while the S&P was off ~20.6% and the MSCI ACWI also down ~20%
- Investors in these indices needed to bounce back with 25% returns in the back half of the year, whereas hedge fund investors need only recoup ~6.5% to pare losses
- Particularly in an era of rising rates, capital preservation and outperformance is top of mind for allocators

Performance of Hedge Funds in 2022's Down Market





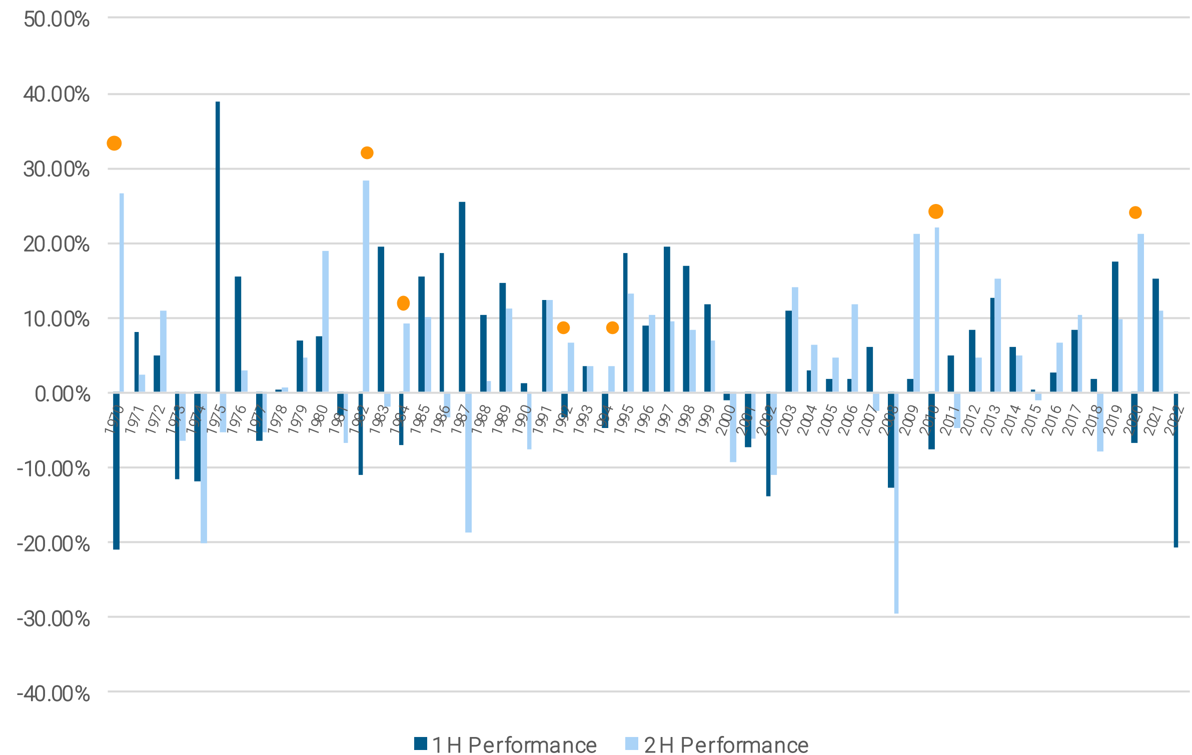
Source: HFR, Jefferies

How are investors thinking about a potential second half rebound?

Key Points

- Since 1970, the S&P has had a down first half **16 times**
- In about **half of those cases, it reversed in 2H**, delivering positive returns. July returned +9%, giving hope the back half of the year could see a rebound.

S&P Performance in 1H vs. 2H



● Signifies years with negative 1H S&P performance but positive 2H (1970, 1982, 1984, 1992, 1994, 2010, 2020)

Source: Bloomberg. All numbers as of July 27th 2022

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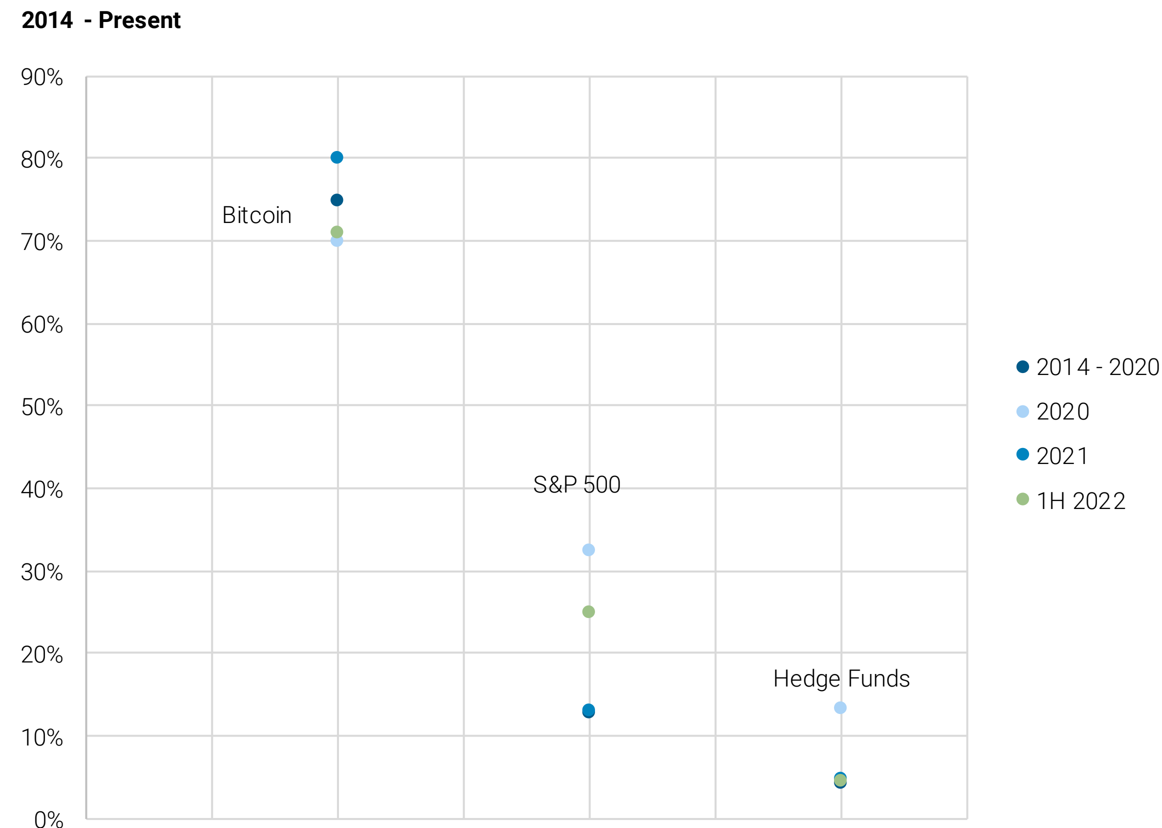
Navigating volatility is a critical dimension of risk management and investing

2022 reminded us how much more volatile some asset classes are than others

- The annualized volatility of BTC (the most liquid cryptocurrency) is elevated over the S&P and hedge funds across nearly all periods
- In some cases, the volatility of BTC can be more than 15 times higher than hedge funds
- Hedge funds are typically half (or lower) the S&P vol

Annualized Volatility for BTC vs. S&P 500 vs. Hedge Funds



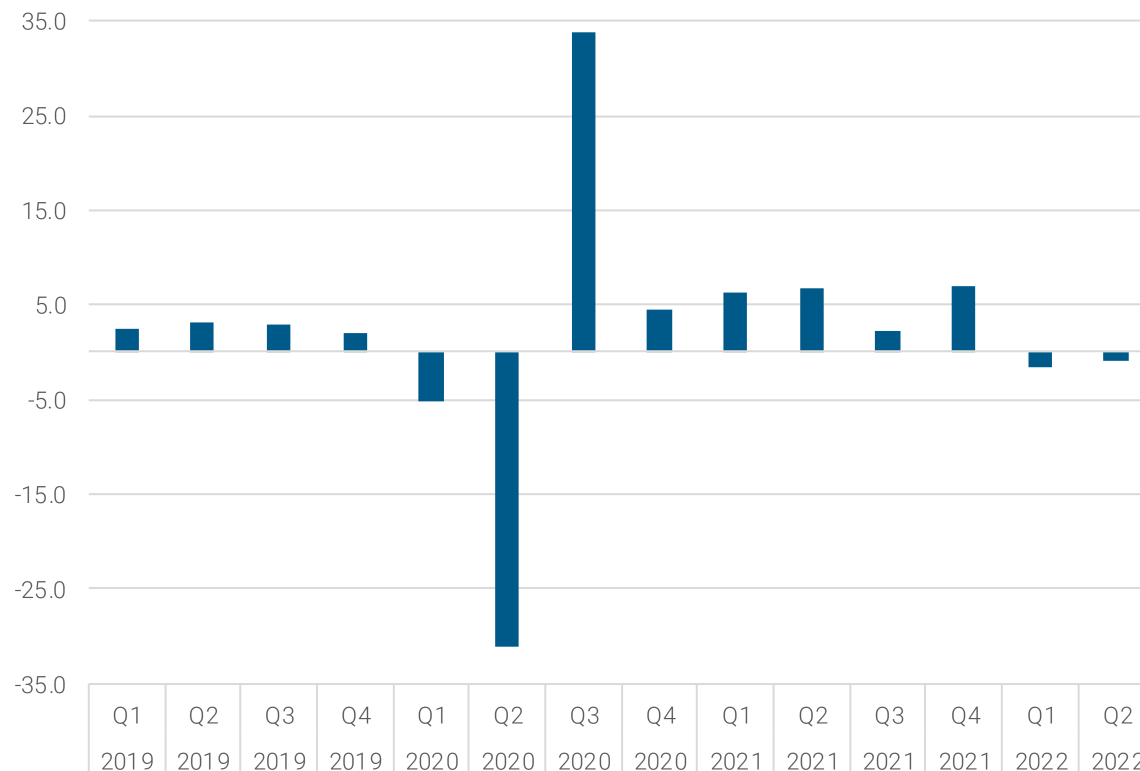
Sources: Jefferies, Factset, HFR, CoinGecko

GDP: Managers Are Poised to Deal with Potential Recessionary Periods

Key Points

- The U.S. economy contracted for the second straight quarter, establishing one of the criteria for a technical recession
- After shrinking 1.6% in 1Q, the U.S. economy contracted again, falling 0.9% in 2Q
- Yet, the National Bureau for Economic Research (NBER) has not officially declared a recession and all eyes remain on the labor market and other inflationary metrics

Real GDP: Percent Change from Preceding Quarter



Source: U.S. Bureau of Economic Analysis. Seasonally Adjusted at Annual Rates

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At the same time: Strengthening dollar complicates global economy

Key Points

- The value of the U.S. dollar is as strong as it's been in nearly 20 years
- Growth in multinational corporations and U.S. companies with large international operations creates new complications for earnings – and potential for greater stock dispersion

U.S. Dollar Index (DXY) 2012 - Present

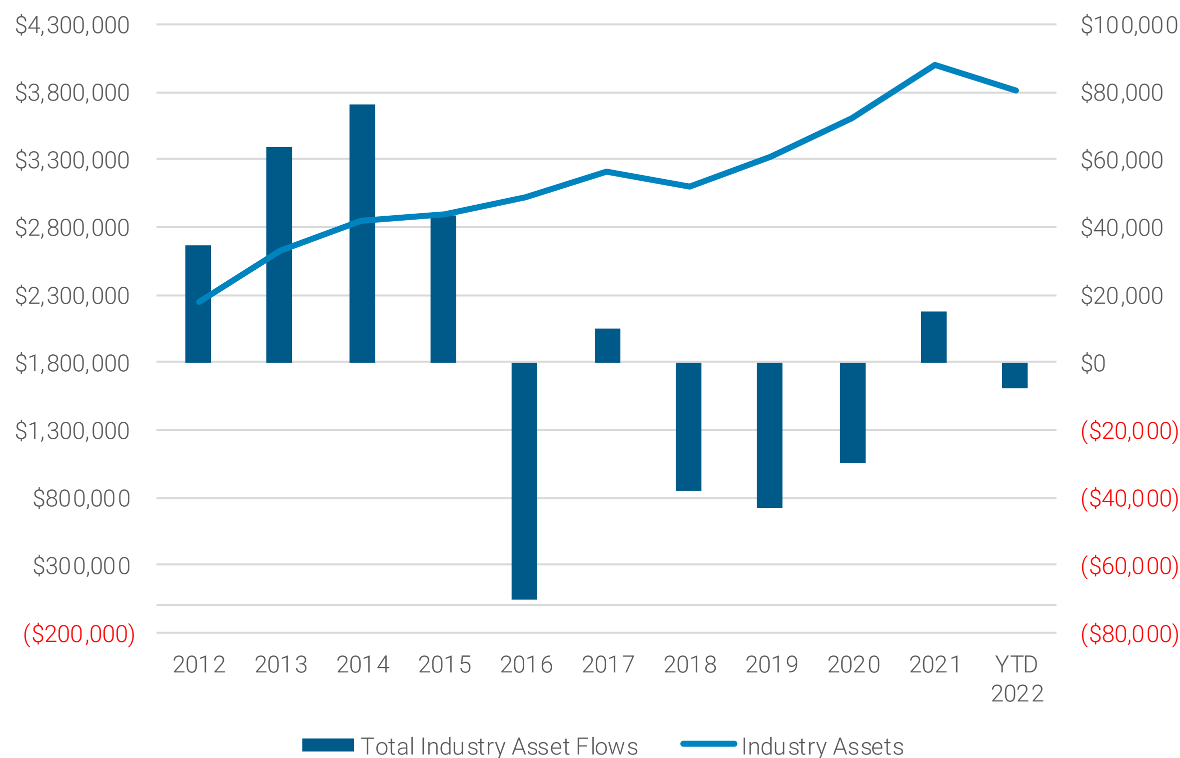
Source: Trading Economics

Poised for a steady second half of 2022: Hedge funds' organic growth has built durable asset base for alternatives

Key Points

- Hedge funds have created $700 billion in value since 2018, a 25% expansion
- The industry has become less vulnerable to flow numbers, as these flows (both positive and negative) have accounted for a maximum of ~2% of industry growth or decline in the last decade
- Industry assets peaked at $4.0 trillion, before declining in the 1H22
- Managers are finding often their next dollar comes from the same place as their last one, with allocators re-underwriting managers they are convicted about
- And more strategic reviews of LP bases and pipelines are leaving managers less vulnerable to concentrated redemption cycles
- This allows managers more stability for managing portfolios in challenging and volatile markets

Asset Flows and Industry Asset Growth 2012 - Present



Source: HFR, Jefferies

Other bullish industry signs: Despite whipsaw markets, appetite to launch remains robust

Key Points

- With the overall number of funds remaining steady at ~8,200, new entrants continue to emerge
- Net new launches were the highest since 2014
- After competitive war for talent in the last few years, a small but growing number of founders are choosing to go out on their own, reversing the trend of the late 2010s
- This is also indicative of the continued success of existing funds, as they elect to roll out new products
- There is energy and innovation in these new products come to market as allocators look to funds to create products that solve current market needs

Net New Launches for 1Q22 Were the Highest Since 2014

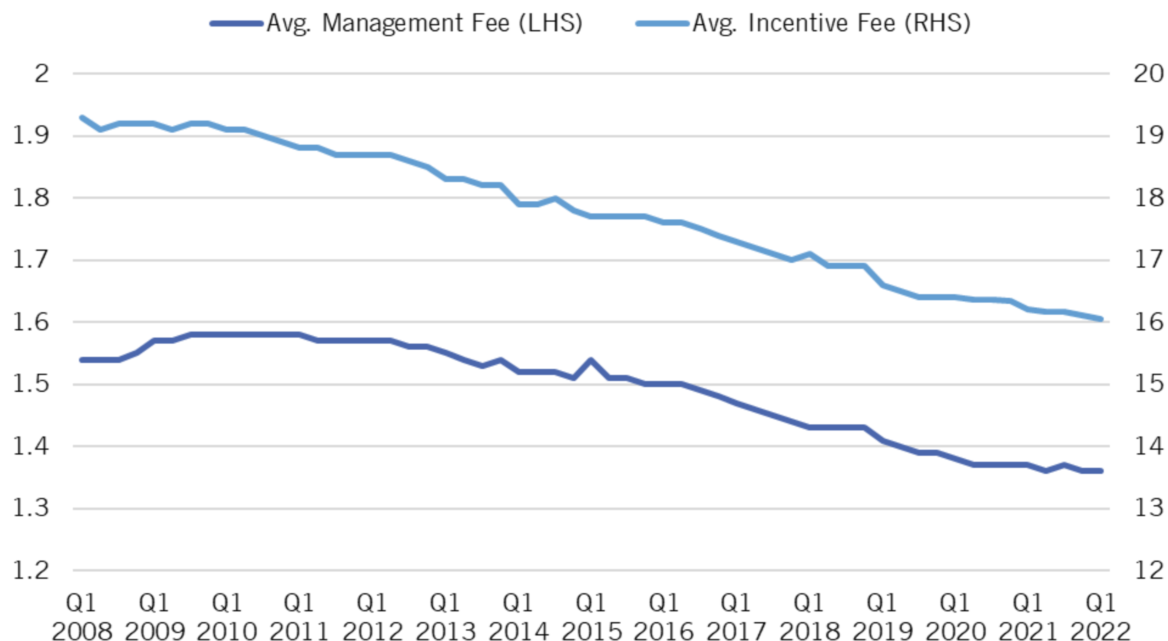
Source: HFR, Jefferies

And a strong launch environment continues despite fee compression

Key Points

- Managers have learned to launch more agile, streamlined businesses
- Outsourcing trends have created numerous new ways to structure an emerging manager's operating footprint
- There is a perception that the "costs" of launching a new firm have risen substantially
- But this is not borne out in the robust new launch environment – either by quality or quantity of managers coming to market

Average Hedge Fund Industry Fees (%)



Source: HFR, Jefferies

What has the first half of 2022 indicated as the path forward for hedge funds?

Tailwinds

- In markets experiencing considerable and broad based drawdowns, hedge funds not only performed well, but have materially outperformed
- Broad based index investors need to recoup at least twice and in some cases 5 times more of the upside than hedge fund investors to cover losses and return to their January baseline
- New launches are continuing to come to market – in some of the highest volume in years
- Capital preservation has helped reassert the value proposition of hedge funds – you can't compound capital you didn't protect.

Headwinds

- Ongoing macro challenges – from Russia's invasion of Ukraine to heightened tensions with China and in southeast Asia
- Potentially missing a rebound. The first half's drawdowns and market volatility left many taking down gross and in some cases, moving much more heavily into cash. Managers must now contend with navigating either prolonged down markets or potential rebounds.
- Ongoing skepticism of alternatives funds. Despite the nearly $4 trillion in the industry – headlines continue to post skepticism given perceived "high fees" or underperformance.
- Yet, anecdotal data seems to suggest allocators want more exposure to alternatives funds, not less.

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