Hedge Funds: Oasis in View?

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The three trillion-dollar hedge fund industry has spent the past decade traversing a barren desert, experiencing disappointing performance and dried up returns.

An oasis, however, may be in view!

TrackMacro ™ is a software tool providing equity risk signals in 40 countries

Download TrackMacro for PC from the company website

Hedge Funds Compete Against Antifragile Assets

The hedge fund world is a complex one, regrouping widespread investment strategies. Hedge funds, however, all face competition from a specific asset class: the antifragile assets. 'Antifragility' is a fundamental concept invented by Professor Nassim Taleb in 2012. In a nutshell, fragile objects suffer from stressful periods, while antifragile objects actively benefit from them! And, to say the least, the last ten years have not been very stressful for financial markets.

Gavekal Intelligence Software revisited the concept in 2019, from a scientific standpoint, and discovered a way to measure assets' fragility or antifragility, be they traditional assets, synthetic assets, or investment strategies.

A hedge fund has two targets. The first is to mitigate equity risks. The second is to provide higher returns than traditional hedges. The former of these targets resembles the nature of antifragile assets.

The two main antifragile assets in the marketplace are gold and government bonds from developed economies, the latter being the most prudent investment in terms of liquidity and volatility. Government bonds, however, are not safe anymore, given unconventional monetary policies decided by all major economies, bar China.

Hedge funds are better positioned than bonds, today and for the first time in ten years, to fulfill their duty of mitigating equity risks.

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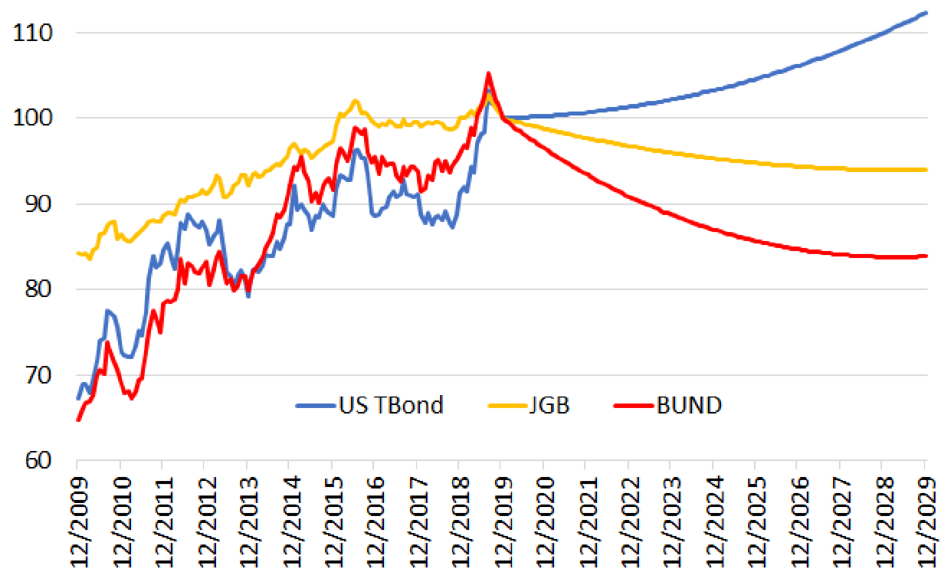
Government Bonds Now at Risk

The last ten years will likely be remembered as the *el dorado* of traditional equity/bonds portfolios, especially in the US. They will be remembered for fast-growing company profits in a deflationary environment, and strong support from governments to expand debt, and from major central banks to provide liquidity at low cost.

Since 2009, the 10Y US Tbond yield dropped circa 200bp, the Bund 360bp and the JGB 130bp. This is despite the longest post-18th century US expansionary cycle ever recorded. The problem is that major bond markets have now exhausted almost all potential capital gains moving forward. If the yield downtrend were to simply reverse at the same rate in the coming decade, a US 10Y bond investment would return a mere 110bp per annum, a Japanese one would lose 60bp p.a., and a German one would lose 175bp p.a.

Fig 1. Simulation. 10Y Bonds NAV if the next decade reverses the previous decade yield trend



Source: Bloomberg data, Gavekal Intelligence Software

A bond yield trend reversal is, of course, speculative. Figure 1, however, shows that savings' industries are at risk all over the developed world, with a specific highlight on the Euro Zone.

Resultantly, institutional investors are likely to search for investment alternatives.

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Passive Investment alternatives

Given the Keynesian turn of US monetary policy in 2019, gold and real assets are well-positioned in the passive and antifragile investment spectrum to outperform.

The Chinese bond market is a second investment alternative. Already the third-bond market in the world, it is rapidly opening to international investors. It is backed by a Central Bank's decision NOT to experiment with unconventional monetary policies, and to focus on the long run. As detailed in our latest publication on Global Portfolio Solutions (GPS)−Gold and the Chinese Yuan−the Chinese bond market's take off is likely to go hand in hand with gold. China has become the gold buyer of last resort.

Long-term investors with fiduciary duties may also reconsider active managers such as hedge funds, or tactical asset allocators.

Active Management Alternative: **Hedge Funds**

Let us first admit that hedge funds, on average, have performed better than bonds over 25 years, albeit with a higher drawdown in 2008.

Fig 2. CSFB Hedge Fund Index vs. 10Y US Tbond

Source: Credit Suisse, Bloomberg data, Gavekal Intelligence Software

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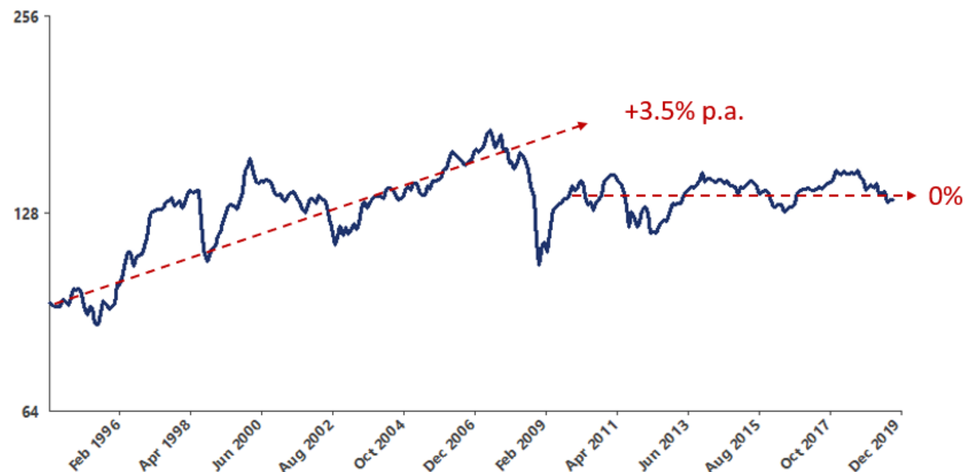
Something, however, changed in the last decade: the alpha generation of hedge funds over bonds flattened, from 3.5% per annum to… **zero!**

Fig 2. Alpha generation. CSFB Hedge Fund Index vs. 10Y US Tbond



Source: Credit Suisse, Bloomberg data, Gavekal Intelligence Software

Why did hedge funds face headwinds over the last decade? Probably because of the concentration of monetary power in a few hands−the central banks of major economies− who were ready to use their balance sheets to the fullest in order to prevent developed markets' drawdowns.

This time is different. In currency debasement periods, such as the one entered in 2019, real assets, equities from commodity exporters, and hedge funds tend to outperform, simply because of the flexibility they use to rebalance exposures to the most attractive asset classes and regions.

Active Management Alternative: **TrackMacro**

The TrackMacro application is a cash, bond and global equity allocator across the world. It differs from macro hedge funds in three crucial manners:

- (i) it does not use leverage,
- (ii) it does not take short positions,
- (iii) it takes re-allocation decisions based on long timescales.

The consequence is a position turnover 10 to 100 times lower than hedge funds.

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TrackMacro massively outperformed bonds and hedge funds in the last decade. The model even managed to compete with equities, returning 9.0% p.a. versus 10.3% for the MSCI World, but with a bond risk profile.

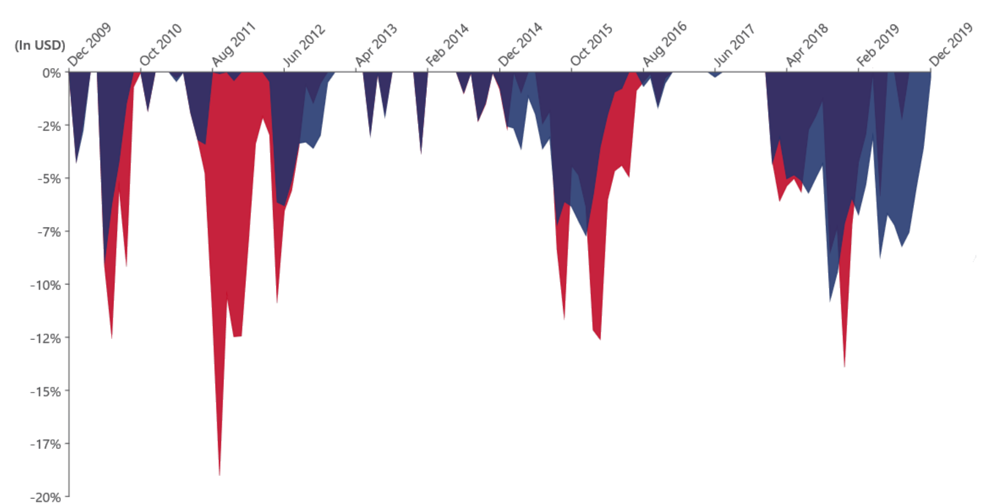
The first half of the decade is the last leg of a 60-year back-test period, and the second half, since June 2015, is live track-record.

Fig 3. TrackMacro (in blue) vs. MSCI World (in red) in the last 10 years

Source: TrackMacro by Gavekal Intelligence Software

TrackMacro also managed to control equity drawdown, as expected by an alternative strategy competing with passive antifragile assets.

Fig 3. TrackMacro drawdown(in blue) vs. MSCI World drawdown (in red)



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Conclusion

Alternative investments suffered from the heightened power of central banks in control of market prices in the last decade. They also suffered, as TrackMacro did, from the political volatility induced by the trade war in 2019. If centralized monetary and political powers fade in the future, which is our preferred scenario, hedge funds could well see the end of the desert.

An oasis is in view!

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