The Long and Short of Hedging Late-Cycle Risk

Recent volatility increases, expensive valuations across most asset classes, and the global cycle transitioning to a later stage have contributed to a challenging asset-price backdrop. For qualified investors, looking forward, we believe that the lower-return, higher volatility environment that we expect has the potential to prove constructive for Long/Short Strategies, particularly Equity Hedge.

Since 1990, the U.S. has experienced three recessions. The Equity Hedge strategy (as measured by the HFRI Equity Hedge Total Index) has helped preserve capital on the downside and outperformed the S&P 500 Index for the period 12 months before these recessions, during the recessions, and in the 12 months after. Investors should keep in mind that each cycle is different, and past performance is not an indicator of future returns.

What it may mean for investors

We believe that the expected environment of lower returns and increased volatility will present a compelling opportunity for Long/Short Strategy investors. Historically, the Equity Hedge strategy has performed particularly well during recessions.

James Sweetman, Senior Global Alternative Investment Strategist

This chart was excerpted from the Investment Strategy report dated September 30, 2019.
Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve.

Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities.

Alternative investments, such as hedge funds, are speculative and involve a high degree of risk that is suitable only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

Hedge fund strategies, such as Equity Hedge, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Definitions

HFRI Equity Hedge Total Index: Investment Managers who maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. EH managers would typically maintain at least 50% exposure to, and may in some cases be entirely invested in, equities, both long and short. The HFRI Equity Hedge Index is a composite of the hedge funds that employ the alternative strategies and who report their performance figure to HFRI. The number of hedge funds reporting may vary between each reporting period.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the U.S. stock market.

An index is unmanaged and not available for direct investment.

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