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Hedge Funds: Is Now Their Time to Shine?

A Commonfund Forum Spotlight

From left to right: John Delano, Paul Britton, David Kim and Tobias Moskowitz

Diversification may be underappreciated when both equity and fixed income allocations have been broadly positive. With both these allocations facing significant and potentially long-lasting adversity, the case for uncorrelated strategies is receiving renewed investor consideration.

The benefits of portfolio diversification are often easy to underappreciate, which may be particularly true when both equity and fixed income allocations within a portfolio seem to be simultaneously working. The recent historic equity bull market, which took place over an extended period alongside generally positive returns and benign conditions for fixed income, might have even suggested that not only was everything working, but that it would continue to work. More recently, however, market conditions have shifted in potentially long-lasting ways, with traditional equity-fixed income portfolios leaving many investors with the very opposite impression – that nothing is working. With the outlook for core allocations continuing to face significant headwinds, the benefits of uncorrelated strategies have for many investors taken on renewed focus.

Commonfund Forum 2023 convened a panel discussion to take a closer look at several such uncorrelated strategies, and to discuss the role of these strategies in institutional portfolios. Panelists were Paul Britton, CEO, Capstone Advisors; David Kim, Founder and CIO, Ghost Tree Capital; and Tobias Moskowitz, Principal at AQR Capital Management, a Chaired Professor in Finance at Yale University and a Commonfund Trustee. The panel was moderated by John Delano, Managing Director, Commonfund OCIO.

John Delano: We have three very different approaches to uncorrelated investing represented by our panelists so let's start by asking them to introduce their various approaches. Paul, please start us off.

Paul Britton: We run some $9 billion and have about 275 people globally across eight offices. Our strategy is centered around trying to understand structural alpha. When you think of Capstone, think of one large derivatives house—that's our skill, that's our expertise. I set the firm up this way because ultimately I felt as though it was the best way of building longevity. In other words, if I could deliver uncorrelated absolute return to investors our firm would be around for a long time.

David Kim: Ghost Tree is a long/short equity firm focused on healthcare innovation. We seek to identify leading companies pushing the boundaries of medicine and science to redefine treatment paradigms. I have a medical background and once was a doctor. Today I study medicine even more closely, trying to understand how technology can reshape human disease. Healthcare innovation—and biotechnology in particular—serves as an excellent backdrop for a long/short equity strategy. Drug development is high risk/high reward—there are more failures than successes, making it conducive to identifying long and short opportunities that are the building blocks of a balanced, diversified portfolio.

Toby Moskowitz: AQR Capital Is a quantitative hedge fund based on systematic strategies. Our approach is rooted in academia, so as well as being a principal at AQR I am a professor at Yale and formerly at the University of Chicago. The firm was started by Cliff Asness and some of Gene Fama's PhD students who took academic research and put it to work in a long/short context to exploit things like value, momentum and quality—basically, all the things that academics have been writing about for the last 50 years.

> *"The experiment is over. Liquidity is coming out of the system ....*
>
> *– Paul Britton, Capstone Advisors*

Delano: Macro conditions and the macro outlook affect all three of your strategies very differently. Paul, macro views probably affect your strategy the most. So, tell us about how you view where we are and share some of your thinking about structural changes in terms of the relationship of the Fed to the economy.

Britton: Take a step back and look at where we've come from: The experiment of 2008/2009, with its regime of easy monetary policy and fiscal support, has resulted in a situation in which global central banks have injected about $35 trillion into the system and that has unreservedly injected

inflation into asset prices. That is where we sit today. We pat ourselves on the back and say, look how much money we've all made. Indeed, we've been in the largest multi-generational wealth creation event that we will see in our lifetimes. That's a bold statement, but I stand by it.

Now what's occurring? The experiment is over. Liquidity is coming out of the system and that means we have to adjust how we think about generating returns. We have had the largest structural shift in the market cycle in the last 20-30 years. So, we are at a powerful moment in time when we have to think about how that impacts our asset allocation.

The $35 trillion coming into the system has been the largest tailwind for asset prices that we've ever experienced and now we have a headwind that ultimately will be the decider of economic conditions and market returns for the next three to five years. Is the headwind going to be a light breeze in our face, will there be intermittent gusts or are we going to be faced with a full-scale hurricane? That's the trillion-dollar question on our minds at Capstone. But let me make it very clear: We are not going to see the same environment that we've seen for asset prices over the past 12 or 13 years. So, you have to adjust your portfolio to protect the wealth that has been created.

Delano: David, the same question for you. I know you don't directly bet on macro environments but talk a little bit about how it can affect your strategy and deep fundamental expertise.

Kim: Macro is something that we don't spend a ton of time deliberating about but it certainly impacts fundamental investing. Our focus is on identifying innovative companies. But when no one cares and there is no risk aversion in your sector or in the broader market it creates a problematic situation in terms of how stocks behave. So, one of the challenges we face when we identify interesting opportunities is understanding whether these are, in fact, catalyst-driven events where we try to isolate different scenarios and structure our investments accordingly. If things don't react to fundamental news in a predictable, rational way it makes my job difficult. We've been in a prolonged bear market for biotech equities. The XBI, the biotech ETF, serves as a proxy for biotech and it was down 20 percent in 2021 and 26 percent last year. When you see that type of wholesale liquidation, it creates a lot of irrational asset price movements and therein lies opportunity.

Ultimately, our goal is not only to go after "value" opportunities but to Invest in pioneering companies that are going to redefine treatment paradigms. We're very focused on risk management and stripping out systematic risk, so we were well prepared to live through a difficult period. We stayed in the pocket on our highest conviction, catalyst-driven opportunities and being able to identify those fundamentally- driven, idiosyncratic names paid dividends as we had a pretty productive 2022.

> *"Tail hedging ... is unconditionally uncorrelated to equity markets and particularly when equity markets globally are doing poorly.*
>
> *– Toby Moskowitz, AQR Capital Management*

Delano: I want to ask Toby about macro as well. AQR is known for participating in trend following. Last year was a very good year for trend following broadly speaking, but generally you're not turning knobs based on what the environment is. So, talk a little bit about how some of those strategies interacted last year and what you see going forward.

Moskowitz: It depends on which trades in our portfolio you're talking about. So, take our equity strategies. We're

long/short equities and what we try to do there is remain relatively macro neutral. That's impossible because you're always going to have some macro, but the reason we do that is because it's hard to be right twice, right? It's one thing to be able to try to predict what the macro environment is going to be, let alone then predict which stocks will be more affected or less affected. So, on the equity side, we think of this approach as trying to maintain macro neutrality.

We also have a whole macro side that we trade, as John mentioned. This includes commodities, currencies, fixed income and all kinds of other non-equity asset classes where you're clearly making macroeconomic bets. The way we do it is not from a discretionary perspective. Instead, we follow certain models, one of which is trend following. Most people think of that as price momentum or technical analysis. It's much more involved than that. What we do a lot of is what I would call macro trends but more on the fundamental side. These would be trends in inflation, trends in GDP growth across countries, trends in lots of other economic fundamentals where we're making specific macro bets, but we're making it using a systematic strategy and a systematic set of signals.

Last year we had a confluence of events making it the perfect storm. Trend following strategies are not just based on prices, but economic fundamentals. Those strategies did phenomenally well, probably the best they've done in three or four decades.

The second piece is in the design of our trend following strategies and is what we call tail hedging. This tends to do extremely well when equity markets are doing very badly. Coming back to the first point about uncorrelated returns, here's a strategy that unconditionally is uncorrelated to equity markets and particularly when equity markets globally are doing poorly. Going forward, I think we are looking at a relatively low expected return environment, making uncorrelated strategies much more important.

Delano: Paul, I might query you on that as well. Trend following is a strategy you've allocated to within your multi-strategy approach, so tell us about macro and trend following in terms of your overall mix of strategies.

Britton: We've got a mix of real value, macro and others. To Toby's point, we actually do have a large allocation to a trend rooted in the theory that there is going to be less intervention by central banks in the coming years. That should be good for trend following, meaning that trend has been subdued over these past 10 years. Why? Because trends have been cut short by the intervention of central banks—and ultimately to the downside. I would make a strong case that this market is capped because equity prices are going to scare the Fed and other central banks and they will be more active if they see a continuation of equity prices. So, you've been in an environment for these past 10 or 12 years where trend has been subdued. That has changed now and markets will be less constrained. They will have less participation in and intervention by central banks and for that reason we're very constructive on trend. We're also constructive on foreign exchange in the same way—FX has been very subdued over these past 10 years because you've had central bank intervention.

Toby also mentioned commodities. I happen to believe that we are in an environment in which you will see large institutional investors look at commodities to balance their portfolios. Commodities have been incredibly underinvested these past 10 years, so it's not going to take a lot to see a meaningful move. For most institutional investors a small allocation to the commodity sector for inflation protection will make sense and if that happens you're likely to see interesting opportunities from a relative value standpoint.

> *"Healthcare technology and innovation is extraordinarily fertile for alpha generation.*
>
> *– David Kim, Ghost Tree Capital*

Delano: David, can you talk about the opportunities in the biotech sector and about some secular trends and how technology is changing the sector in momentous ways?

Kim: As a starting point, healthcare technology and innovation is extraordinarily fertile for alpha generation. When we think about opportunities, we first identify key areas of unmet medical need. Unfortunately, as we all appreciate, there are horrible diseases that inflict all of kinds pain around the globe. At the other end of the spectrum are human ingenuity and technology innovation. It's at that intersection where we see extraordinary alpha opportunities, both long and short.

Our goal is to apply our technical expertise—our ability to analyze complex data sets—to figure out whether a medicine is going to work or fail. Everyone on our investment team has a medical background. We're all super analytical, we love healthcare technology and I think we have the ability to apply our clinical expertise to identifying opportunities in areas of unmet need as well as new medicines that are emerging to address them. We are not looking for the next billion-dollar drug. We are thinking and looking way beyond that--for the next cure for cancer or something that can actually modify the course of Alzheimer's disease.

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Published April 2023

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