GERBER | TAYLOR

**Taking Stock of Hedged Equity**

**An Interview with Alex Moore, Head of GT Public Markets Team**

In November of 2021, when the market was still flying high, we wrote about our diminished return expectations for traditional portfolios and the role of uncorrelated strategies[1] in a diversified portfolio. What a difference a few months can make. Geopolitical tensions have intensified with Russia invading Ukraine late in February. This has exacerbated commodity price pressures across the board, further fueling inflation fears. The Fed seems to have lost patience waiting for the "transitory" inflationary pressures to recede as labor market tightness, supply chain disruptions, and elevated commodity prices persist. Taking a more hawkish stance, following its March 16th meeting the Fed announced its plans for seven rate hikes in 2022 (in December of 2021 it was only planning three) and four more in 2023. This plan would bring the federal funds rate to 2.8%, higher than the neutral rate of 2.4%. The Fed plans for the rate hikes to be accompanied by reductions to its balance sheet which are likely to negatively impact market liquidity.

So, investors are adjusting to a very different set of conditions than what has persisted for most of the period since the 2008/2009 Great Financial Crisis: higher volatility, inflation, rising interest rates, reduced market liquidity, recession risk in the U.S., likely recessionary conditions in Europe, and a serious military conflict (though relatively contained to this point). We thought it timely to revisit the role of hedged equity in diversified portfolios. Hedged equity is a multifaceted strategy. It serves as a way to amplify equity exposure with less risk than pure long equity strategies. Hedged equity pairs well with multi-strategy exposure in a defensive basket for investors with at least an intermediate time horizon — returns from the two strategies tend to ebb and flow, not necessarily in sync with each other. Finally, hedged equity has highly valued antifragile characteristics, meaning that the strategy can actually get stronger, especially during prolonged market drawdowns.

Alex Moore, the head of our public markets team, is the perfect person to expand on these points. Alex graduated with Merit from the U.S. Naval Academy in 1990, and then served for eight years in the U.S. Navy as a SEAL officer. He then worked at the Central Intelligence Agency in Special Operations. In 2000, he received his MBA with Distinction from The University of Virginia's Darden School of Business. From there, Alex worked at McKinsey & Company serving private equity and financial clients, served as the Chief Investment Officer of The Riverstone Group, and as Managing Partner of Blackfish Capital LLC. Alex's unique background has engendered knowledge, experience, and critical thinking which he has applied to our research efforts since joining Gerber Taylor in 2010.

---

[1] *Exploring Uncorrelated Strategies, November 2021*.

**Alex, are you pleased with how long/short strategies have performed recently?**

*Yes, and no. We tend to evaluate performance over at least a three-to-five-year time horizon. On that basis, returns for hedged equity have been very solid. Very recent performance, meaning the last 18 months, has certainly been below expectations.*

*2021 posed unique challenges: a runaway bull market, which is always a tough environment for long/short managers to generate alpha; bouts of deleveraging, which is challenging from a portfolio risk management standpoint; and an economy with accelerating inflation. In the back half of 2021 and into the first quarter of this year (2022), inflation concerns grew to the point where they forced investors to reevaluate valuation multiples in the context of much higher interest rates in the future. Many of the widely held longs (i.e., great companies with high growth rates) have repriced to the point where they are now trading at compelling discounts to the market. Having said all that, the opportunity set now looks pretty good by historical standards.*

**There's a lot to dig into. Let's start with inflation. How do you expect hedged equity to perform in an environment marked by higher inflation and interest rates?**

*The inflation risks associated with equities are generally well known as is the Fed playbook of raising interest rates to combat inflation. However, I believe investors miss a critical point when thinking about long/short equity in this type of environment. Inflation tends to accelerate structural, competitive business trends similar, in some ways, to what we saw with COVID-19 and e-commerce. This facilitates our managers in making money on both the long and short sides of their portfolios. Companies with dominant market positions and good management teams are usually able to maintain pricing power in inflationary environments and simultaneously better manage costs. Weak companies with inefficient and expensive cost structures come under increasing financial strain in an inflationary environment, which negatively impacts free cash flow and ultimately their balance sheets. As our managers like to say, melting ice cubes melt faster. This compresses the time frame for shorts to work. Stock prices tend to react faster to fundamentals and this linkage increases returns from the short book.*

**So, you're saying that higher rates and inflation actually create a catalyst for price discovery for equities.**

*That's right. Another way to think about it is that rising interest rates directly increase the cost of capital for companies. This logically restricts the ability of bad companies to access credit and equity markets to fund on-going operations and disproportionately raises their cost of capital. One of our managers referred to the ensuing period he expects to be marked by "stratification in quality" of companies, a key input for long/short strategies. Such differentiation has been muted in recent years by exceptionally accommodative credit conditions. It is somewhat reminiscent of the period from 2009 to 2012 when managers often complained that they would find bad companies destroying capital, but their stock prices didn't go down because these companies could always access cheap money. Managers called these zombie companies. We believe that inflation and the corresponding increase in short and long-term interest rates will be zombie killers.*

**Can you talk more about hedge fund deleveraging?**

*Historically, deleveraging has occurred when equity market volatility suddenly increases contemporaneously with a significant market correction. What happens is that the most highly levered equity investors suffer disproportionate mark-to-market losses that force them to post more collateral to their prime brokers (i.e., reduce borrowing). This results in managers de-grossing their portfolios by selling longs and covering (i.e., buying) shorts regardless of fundamentals.*

*It becomes a circular, self-reinforcing cycle until prices stabilize and excess leverage is removed from the system. The founder of one manager described it as a circle of people in which one person is shoved from behind and then pushes the person in front of them just a little harder in an attempt to break the cycle before it gets back to them. Broad-based deleveraging has the perverse effect of driving down the share price of widely held, quality stocks lower and driving up the price of heavily shorted, bad companies. Hedge funds exist in an ecosystem — when some members of that ecosystem get in trouble from a leverage perspective, there is the potential to impact all the other members, at least in the short term.*

**So, what do you do at your level to mitigate the impact of deleveraging?**

*We believe these deleveraging periods are, at least for the time being, a characteristic of the long/short ecosystem. They are even healthy for functional markets as excessive risk-takers tend to get punished the most. Our most important work is on the front end when we spend a lot of effort in our hiring process understanding how managers manage risk and utilize leverage in their portfolios. We also look at the stability of their investor bases and their overall fund liquidity. Ideally, we want managers that have the capacity to hold onto their positions and to play offense when this material volatility and deleveraging occurs because it inevitably leads to a great stock picking environment on both the long and short sides. It is worth noting that the managers in our portfolio have consistently shown the willingness to take advantage of extreme volatility to add to high-conviction longs and shorts during periods of weakness. In many ways, these periods of underperformance set the stage for future alpha generation.*

**At the beginning of our conversation, you mentioned that many of the widely held longs have repriced to a large degree. You'd never know that by looking at the S&P 500 Index, which is down a relatively modest -6.0% from its 12-month high through the end of March.**

*In contrast to the S&P 500 Index, the average stock is down -16% from its respective 12-month high. The broader pain in the equity markets has really been masked by the extreme concentration in the S&P 500 Index, which is the highest it's been since 1957. Ten stocks now represent 31% of the entire S&P 500 Index's market capitalization. Compounding the risk, the price-to-earnings ratio for these ten stocks is a lofty 31x, compared to just 17x for the remaining 490 stocks. And this scenario is not unique to the S&P 500 Index. While the Nasdaq Composite Index was down -12% from its 12-month high through March, the average stock is down a whopping -42%.*

*A couple of takeaways for us: first, there has been some indiscriminate selling, indicative of deleveraging and attractive opportunities on the long side; and second, the concentration of the S&P 500 presents passive investors with significant risks going forward, particularly given the potential for further multiple compression as interest rates are set to rise at a pace not seen since the late '70s.*

**A number of market commentators have suggested that many fast-growers captured investors' attention and reached excessive valuations before being brought down to earth by normalizing interest rates. Has this been a factor in hedged equity?**

*We have a mix of managers by size, style, and sector specialty by design. While our growth-oriented managers have suffered in the face of rising interest rates, they primarily underwrite their long positions based on a long-term (5-year plus) time horizon where the business fundamentals are the primary driver of future value. Here is a quote from one of our managers that highlights the advantages of growth: "The main benefit of investing in growth companies is their ability to buy down valuation multiples quickly.*

*Compare a growth portfolio trading at 25x, growing 30% per year and a traditional value portfolio trading at 10x, growing 7%. Three years in, the growth portfolio will have brought down its multiple by over half to 11x, whereas the value portfolio will be closer to its starting point at 8x. The effect is more pronounced as growth rates increase or time horizons extend."*

**Why don't managers trade around their longs more to avoid these periodic pull-backs?**

*Frequent trading to adjust portfolio exposures is a specific skill that is very difficult to time correctly. Most of our long/short managers tend to maintain their fundamental investment process, focusing on information more within their control. One manager answered this question best: "We often get asked why we don't trade around positions. For example, why not sell some shares when one of our core holdings has performed strongly in the short-term and then look to buy them back at a future date if the share price corrects? In practice, this is just very hard to do and involves a different skill set from fundamental analysis. There are myriad drivers of share price performance on a daily, weekly, and monthly basis. We are in no way equipped to predict share prices consistently and accurately over these shorter timeframes."*

**What else would you tell investors about hedged equity?**

*The hedge fund ecosystem, as I've been calling it, is really a talent game and finding the best manager talent is our highest priority. One of the aspects of talent we seek is adaptability. Conditions, such as inflation and the level of interest rates, change and the structure of markets evolves over time. The best managers are able to adapt their approach as needed. GT's experience over the last 30 years is that static strategies or investment processes don't survive dynamic markets over the long run – period. However, adaptable talent alone is not sufficient.*

*As I mentioned earlier, we spend a lot of energy in our hiring process to determine the stability of the organization to try to ensure our managers can respond to difficult market conditions from a position of strength. We view time horizon arbitrage as the greatest source of alpha for long/short equity managers, especially given the market's extreme focus on the short-term.*

*To reap the benefits of this arbitrage takes patience and a commitment to assiduously avoid the traps of making portfolio decisions based on myopic timeframes. Our team continues to have great confidence in our lineup of managers. We don't anticipate any material structural changes in the near term and believe the risk posture of our lineup of managers is appropriate in the context of the current macro-economic environment.*

**Thank you, Alex.**

April 2022
Tara Elliott & Margaux Moze

## Disclosures

*Information contained in this presentation is based on the views and opinions as they exist as of the date this presentation was made available. Information in this presentation does not constitute advice or a recommendation or offer to sell or a solicitation to deal in any security or financial product. It is provided for information purposes only and on the understanding that the recipient has sufficient knowledge and experience to be able to understand and make its own evaluation of the proposals and services described herein, any risks associated therewith and any related legal, tax, accounting or other material considerations. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to their specific portfolio or situation, they are encouraged to consult with the professional adviser of their choosing, and recipients should not rely on this material in making any future investment decision.*

*We do not represent that the information contained herein is accurate or complete, and it should not be relied upon as such. Opinions expressed herein are subject to change without notice. Certain information contained herein (including any forward-looking statements and economic and market information) has been obtained from published sources and/or prepared by third parties and in certain cases has not been updated through the date hereof. While such sources are believed to be reliable, we do not assume any responsibility for the accuracy or completeness of such information. We do not undertake any obligation to update the information contained herein as of any future date.*

*The statements in this presentation, including statements in the present tense, may contain projections or forward-looking statements regarding future events, targets, intentions or expectations. Due to various risks and uncertainties, actual events or results may differ materially from those reflected or contemplated in such forward-looking statements. Past performance is no guarantee of future results. Investments are subject to risk, including the possible loss of principal. There is no guarantee that projected returns or risk assumptions will be realized or that an investment strategy will be successful. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this document, will be profitable, equal any corresponding indicated performance level(s), or be suitable for your portfolio.*

*All referenced indices or financial benchmarks are for illustrative purposes only, are unmanaged, assume reinvestment of dividends and income, and do not reflect advisory fees.*