THE INVESTMENT FUND FOR FOUNDATIONS

pursuing investment excellence on behalf of endowed non-profits

To: TIFF Members and Friends
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January 2017

The Case for Hedge Funds

It seems of late that few investors have a kind word for hedge funds. Most people like bonds. In TIFF's opinion, this imbalance sets up a scenario going forward that could favor hedge funds.

We have asserted before that endowed charities, most of which aim to earn a return of at least 5% above inflation, require meaningful exposure to equities. Our view has not changed. We believe equities will continue to be the predominant driver of long-term returns in endowed charitable portfolios. The key to capturing those returns will be to position the non-equity portion of the portfolio to mitigate the drawdowns that invariably come with meaningful equity exposure. Over the last 30 years, bonds provided good total returns and provided excellent diversification to equities. But, we do not believe they are likely to do either very well in the next several years. Why?

Yields on the 10-year Treasury peaked in 1981 at 15%. Since then, yields have pretty much gone in one direction, i.e., lower. This decline in yields enabled investors to realize generally attractive total returns from bonds for a very long time. After dropping to below 1.4% in early July of 2016, the 10-year Treasury yield has recently moved up to about 2.4%. This recent rise in yields has hurt fixed income investors, causing prices to decline by 8% over the last six months or so. If yields turn around and go back down to the old lows (or lower), bond owners will realize gains. Instead, if we are right and the secular decline in yields is largely over, then price declines on bonds are something that may continue to occur. For sure, investors will be earning a near 2.5% yield that will help cushion any price declines, but if we are correct, total bond returns would at best be very modest. At our TIFF Investment Forum in October 2016, we showed members a chart of the 10-year Treasury yield and subsequent 10-year returns. That chart showed that the best guess of what 10-year bond total returns might be is approximately equal to starting yield. Today, that suggests likely total bond returns over the next decade will be something around 2.5%. Unless inflation is meaningfully negative over that period (i.e., we get sustained deflation), returns on 10-year Treasuries will not help an endowed charity achieve overall returns that are 5% above inflation.

The other role bonds have played well over the years is one of diversifying stock returns. When the stock market has suffered bouts of weakness, bonds have generally benefited, as investors have flocked to bonds, driving prices higher. We believe two main drivers have contributed to this behavior. First, stocks have declined predominantly when investors have feared an economic slowdown that would push earnings lower. In these scenarios, inflation typically declined. Second, in a declining inflation environment, any given level of bond yield became incrementally more attractive. This scenario could certainly recur in the future, but with starting yields and prospective bond returns as low as they are today, and prospects for inflation increasing, we believe the diversifying properties of bonds may be significantly diminished going forward.

But, will inflation actually increase materially? We don't know, but we do think the Trump administration's desire to stimulate the US economy fiscally at a time when unemployment is quite low is inflationary. Starting with an unemployment rate below 5% and adding fiscal stimulus should cause wage inflation, buttressing overall inflation in the US. If this does come to pass, then any given level of bond yield becomes incrementally less attractive, leading to rising yields and falling bond prices. Though yields may need to rise several percentage points before making bonds an attractive alternative to stocks, such a condition has occurred in the past. Finally, as rates rise, the discounted value of future cash flows generated by stocks becomes smaller, potentially leading to lower equity market prices. All this describes a scenario in which bond price declines can be correlated with equity price declines rather than diversifying away from those declines. While probably still some way off, in our opinion, such a scenario could unfold if interest rates on the 10-year Treasury were to rise above 4%.

So, what is a charity to do? And, how can non-profit investors attempt to side-step such a scenario? This is where we think hedge funds enter the picture as attractive diversifying strategies. In the past, TIFF has managed hedge fund strategies that have shown modest correlation to equities, with betas of about .30 to .35 to the equity market, and total returns around that of equities. Recently, hedge fund strategies (both ours and others) generally have not fared nearly as well. Nevertheless, we believe hedge funds will provide an attractive avenue of diversification and return going forward. Better than fixed income, in our opinion.

Since the great financial recession of 2008-9, hedge funds generally have underperformed stocks and bonds.[1] Most folks have forgotten how well hedge funds protected capital during the '08/'09 downturn and how well they performed prior to the 2008-9 period. The global printing of money utilized to stabilize financial systems and drive interest rates down also depressed equity market volatility and forced some investors out of money market funds into stocks. As stocks and bonds both marched higher in price, the hedging characteristics associated with hedge funds were not helpful in generating returns. In fact, diversification away from US equities in any form was punished with lower returns. Back in 2008-9, anyone who could foresee what has transpired since would likely have also perceived that hedge funds would have a difficult time competing with long-only investments. So, as we transition from the environment of the last eight years into a new capital markets environment, the important investment question is what vehicles are most likely to outperform in the future. Our experience suggests that future opportunity often can be found in those places where investors are currently the most negative. Today one of those places is hedge funds. We think that hedge funds being out of favor will thin the herd and that more will go out of business. Fewer funds chasing an expanding opportunity for alpha in a

[1] From 3/31/2009 through 12/31/2016, the HFRI Fund of Funds Composite Index lagged the Bloomberg Barclays US Aggregate Bond Index and the MSCI All Country World Index. The source of the HFRI index is Hedge Fund Research, Inc. www.hedgefundresearch.com,

rising rate environment is a good fact pattern. This negativity regarding hedge funds also increases the probability of partnering with exceptional managers at fee levels somewhat lower than might have otherwise been available. We believe long-term investors should be trying to take advantage of this environment.

Because hedge funds are not an asset class but rather an implementation wrapper, the decision making process is further complicated. Nevertheless, we believe all the elements are present to make hedge funds a more important portfolio holding in the future. Long-term returns are pretty good. We presented a chart at our 2016 Forum that showed rolling 10-year returns for hedge funds over the 25-year period through the end of 2015. The average rolling 10-year return to investors from hedge funds (measured by the HFRI Fund of Funds Composite Index) was 7.3%. The most recent rolling 10-year return was 2.3%, an all-time low. While returns for stocks (Dimson, Marsh, Staunton Dataset via Morningstar) are higher over the long term, they have also performed much better over the recent past, gaining 7.4% over the latest rolling 10-year period. We expect stocks to continue to outperform hedge funds, but not by the margins of recent years. Bonds, on the other hand, have not performed as well as hedge funds over longer periods of 10-year rolling returns. During the most recent 10 years, however, bonds (Bloomberg Barclays US Aggregate Bond Index) produced returns twice that of hedge funds, 5% vs. 2.3%. We do not expect this pattern to continue going forward.

Predicting the future is always difficult, but in this case we believe high bond valuations and a clear regime change in capital markets provide the catalysts for lower bond returns and a wider cone of outcomes that hedge fund managers can take advantage of for the first time in several years. You may not read anything nice about hedge funds today, but we believe they are more important in a diversified endowment-style portfolio today than they have been in years. We also believe you will read good things about hedge funds in the future, but by then it will be too late. Today is an important time to invest in hedge funds.

Jay