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Hedging Recession Risk in Equity Allocations

December 2023

KEY TAKEAWAYS

- With the threat of recession growing, we examined hedge fund performance during recessionary periods over the last three decades, finding that they have demonstrably outperformed when stocks have declined.

- Macro and multi-strategy funds have been the strongest performers, with the former generating positive returns even as markets have fallen in three of the last four recessions.

- Investors looking to mitigate downside equity risk during an economic contraction—and more broadly enhance their portfolio's risk-return profile—may want to consider carving out an allocation to hedge funds from their equity allocation.

The last few months have—to put it mildly—been tough on public market investors. The S&P 500 is down 19.3% year-to-date, and the Nasdaq Composite Index has fallen even more sharply, down 27.2% this year.[1] Fixed income has offered little shelter, amid signs that the negative correlation between stocks and bonds of the last two decades is turning positive. Investment grade bonds have returned -14.6% over the same period, with high yield bonds returning -13.5%.[2]

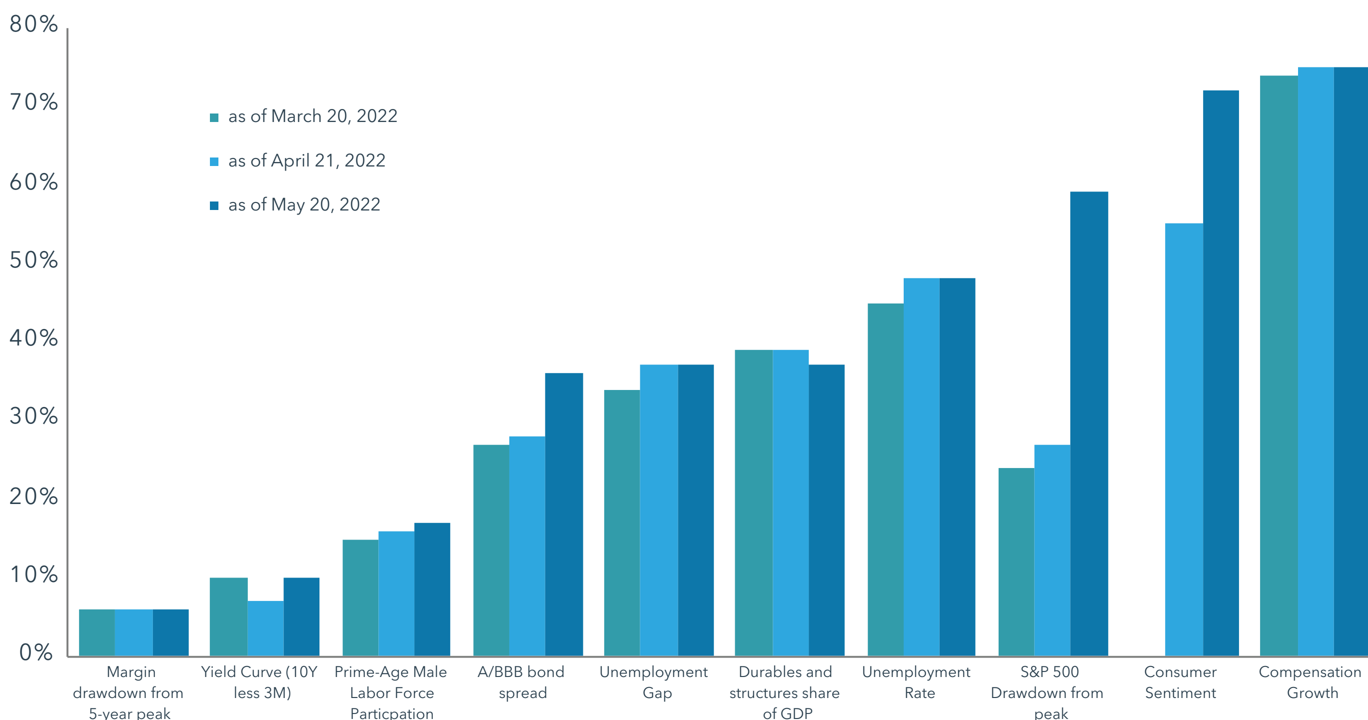
The U.S. Federal Reserve (Fed) continues to nevertheless reiterate its determination to raise interest rates to bring soaring inflation under control.[3]

Technically, the U.S. economy contracted in the first quarter of this year—and one more quarter in negative territory would signal we are in fact in a recession—though the contraction was driven by a widening of the trade deficit and a slowdown in inventory accumulation, with domestic demand metrics still robust.[4] Further, GDP growth is forecast to turn positive (+2.3%) in the second quarter, so commentary on recessionary fear remains firmly in the future tense, for now.[5]

Unfortunately, the data suggest the chance of a U.S. recession in the year ahead remains relatively high[6]—though there is a narrow path to Fed Chair Jerome Powell's "soft-ish landing."[7] Historically predictive measures of recession risk have increased over the last couple of

Exhibit 1: Year-ahead recession probabilities derived from indicators

Probability of U.S. recession based on background and economic risk indicators



Source: JPMorgan. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

months, with recent growth in compensation levels and shifts in consumer sentiment both suggesting a roughly 75% chance of a recession in the coming 12 months (See Exhibit 1). The recent market drawdown is, among other things, suggestive of and a reaction to perceived rising recession risk.

Other measures may suggest a bit more confidence in the economy's ability to avoid a recession, but the level of uncertainty argues for a more defensive portfolio stance.

A fall in the market by no means guarantees the economy will follow—Keynesian economist Paul Samuelson once quipped that the stock market had predicted nine of the past five recessions—but the market does typically fall during a recession (See Exhibit 2).

Clearly there is huge economic and market distortion unfolding as we tentatively emerge from the COVID-19 pandemic. We note that history does not necessarily repeat itself, and there are always exceptions. During the recessionary period from July 1990 through March 1991, for example, the S&P 500 actually returned a positive 7.6%.[8] However, decades of data suggest that should we enter a recession, the stock market is likely to fall.[9]

All of which is to say that, should you assess that a recession is increasingly likely, it would seem prudent to prepare your portfolio for a fall in the market by incorporating strategies that can generate positive performance when long-only equities falter.

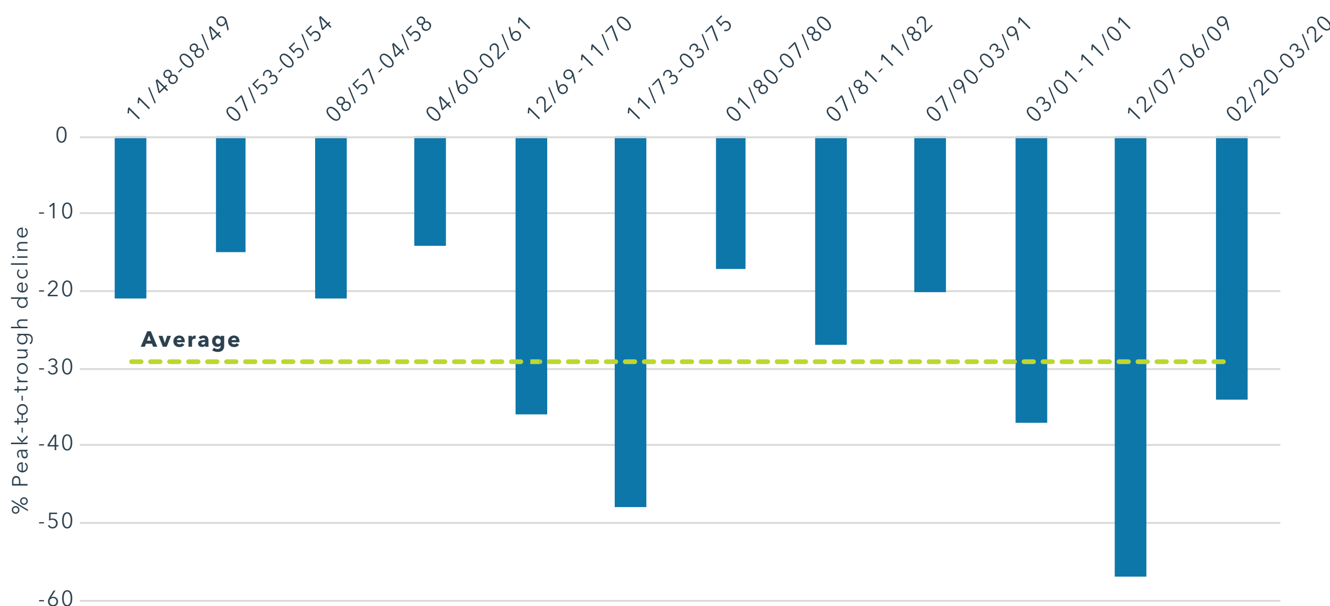
HEDGE FUND PERFORMANCE IN A DOWNTURN

Many hedge fund strategies have faced challenging market conditions over the last few years. Ongoing quantitative easing since the Global Financial Crisis (GFC) has kept money cheap, which limited equity market dispersion.[10] Put another way, stocks generally rose along with the market, with limited distinction based on fundamental quality. Long-only approaches therefore did well, while hedging tended to dilute returns as much as manage risk.

As the market has turned this year, however, the value of hedging has become much more apparent. This year to the end of April, the S&P 500 was down 12.9%, while hedge funds in aggregate outperformed by more than 10 percentage points, losing just 2.3% on average.[11] Notably, macro hedge funds strategies were up 9.7% over the same period, while multi-strategy funds also produced positive returns for investors.[12]

Exhibit 2: The stock market typically falls during recessionary periods

S&P 500 peak-to-trough declines during recessionary periods



Source: Truist, May 2022. For illustrative purposes only. Past performance is not indicative of future results.

This is not a historical anomaly. We analyzed hedge fund performance during the four most recent recessionary periods and found that during each period, hedge funds consistently provided downside protection when equities fell (See Exhibit 3).

According to the data, hedge funds collectively outperformed the broader stock market during down months in the last four recessionary periods (acknowledging that the most recent, two-month-long, COVID-fueled recession contained only one month of equity decline—albeit steep). On an aggregate basis across the four periods, the HFRI Fund Weighted Composite Index[13] outperformed the S&P 500 by over 80 percentage points.

This reduced downside from hedge funds relative to the stock market is captured in returns data across the period from January 1990 to the present day (See Exhibit 4).

Exhibit 3: Hedge funds have outperformed the stock market in down months during recessionary periods

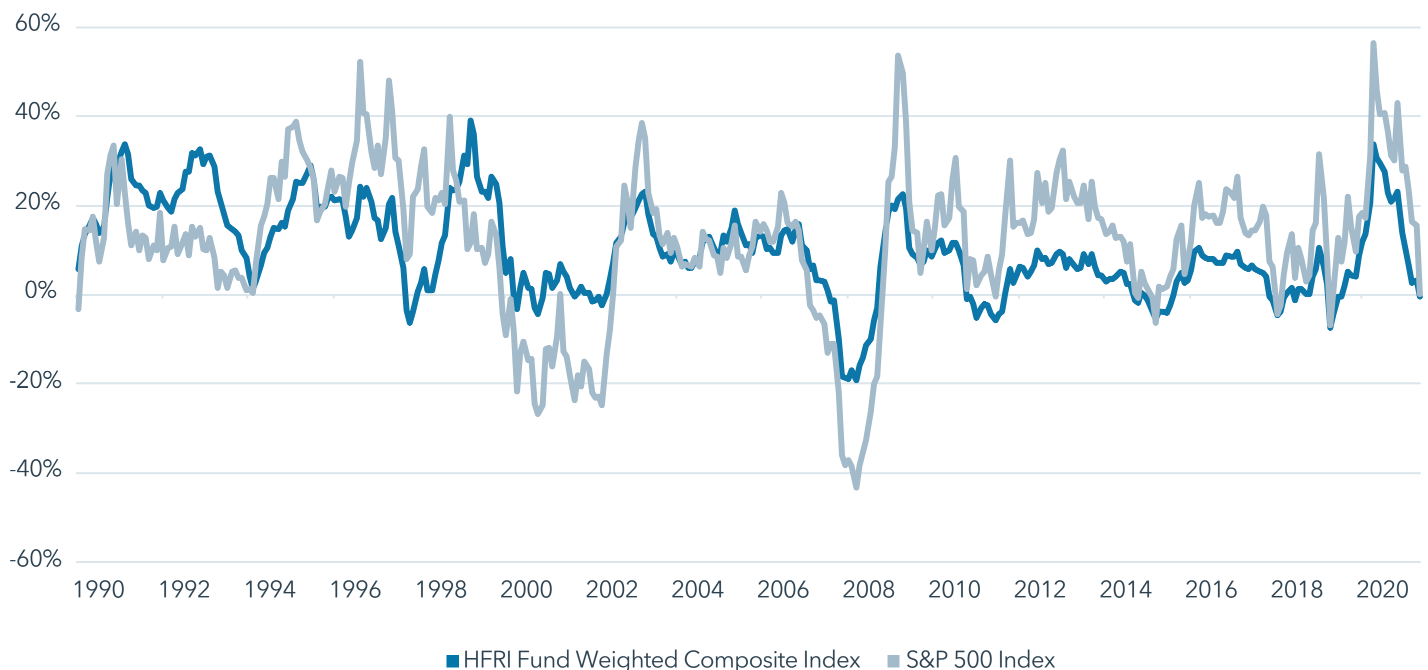
Cumulative returns in months with negative S&P 500 performance during recessionary periods (%)

Dates	Hedge Funds	S&P 500	HF Outperformance
7/90-3/91	-4.0%	-14.7%	10.7pp
3/01-11/01	-4.2%	-23.4%	19.2pp
12/07-6/09	-21.2%	-69.0%	47.8pp
3/20-4/20	-9.1%	-12.4%	3.3pp

Source: HFRI, eVestment. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed. Based on monthly returns data. Hedge Fund returns calculated from HFRI Fund Weighted Composite Index.

Exhibit 4: Smoother ride from hedge funds versus the broader stock market

Rolling 12-month returns, HFRI Composite vs. S&P 500 (%)



Source: Macrotrends, as of May 25, 2022. For illustrative purposes only. Past performance is not indicative of future results.

A less volatile ride is evident: The standard deviation of returns for the period in the chart is just 6.8% for hedge funds, against 14.7% for the S&P 500.[14] The maximum drawdown across the period was 21.4% for hedge funds, versus 51.0% for the S&P 500, with hedge funds collectively capturing just 28.7% of down markets (and 45.7% of up markets).[15]

The chart also illustrates the clear trade-off to this protection. During the bull market that has stretched across much of the post-GFC era, hedge funds have lagged, though modestly. Overall annualized returns are consequently slightly lower, at +9.3% against +10.1% for the S&P 500.[16]

However, the bigger picture from a portfolio risk-return perspective is that, across the whole period, hedge funds have outperformed the stock market with a Sharpe Ratio—return per unit of risk assumed—of 0.99 versus 0.51 for the S&P 500.

Of course, the hedge fund asset class comprises many different strategies. Drilling deeper into the data, we broke out recessionary performance by the major strategy categories (See Exhibit 5).

What we found was that macro strategies can provide significant diversification benefits during recessions. These funds not only outperformed equities during stock market down months in the last four recessionary periods, but also produced positive total returns in three.[17]

The stronger relative performance of macro and multi-strategy funds in these periods reflects the fact that they are generally more diversified across asset classes.[18] Equity hedge and event-driven strategies tend to be more long-leaning approaches, which is a tailwind during bull markets but becomes a drag when the market turns.[19]

A GOOD TIME TO HEDGE?

The case for hedge funds certainly seems to have strengthened as we wave goodbye to a largely uni-directional stock market and bonds seem less and less capable of providing an adequate portfolio hedge. And with the Fed determined to raise rates and take away the quantitative easing punch bowl, the economic outlook has become increasingly uncertain.

In recessionary environments, hedge funds (particularly macro strategies) have protected investor portfolios from stock market declines. They could therefore play a constructive, downside-mitigating role for those investors concerned that a recession is looming, perhaps as a small carve-out from an existing equity allocation.

Exhibit 5: Macro strategies have provided good protection from equity downside in the last four recessions

Cumulative returns in months with negative S&P 500 performance during recessionary periods (%)

Dates	Equity Hedge	Event Driven	Macro	Multi-strategy	S&P 500
7/90-3/91	2.5%	-7.8%	1.7%	-1.7%	-14.7%
3/01-11/01	-7.7%	1.1%	2.1%	1.8%	-23.4%
12/07-6/09	-32.4%	-24.2%	5.7%	-18.3%	-69.0%
3/20-4/20	-10.9%	-12.4%	-0.5%	-6.4%	-12.4%

Source: HFRI, eVestment. For illustrative purposes only. Past performance is not indicative of future results. Based on monthly returns data. Hedge Fund returns calculated from—Equity Hedge: HFRI Equity Hedge (Total) Index, Event-Driven: HFRI Event-Driven (Total) Index, Macro: HFRI Macro (Total) Index, Multi-Strategy: HFRI RV: Multi-Strategy Index.

END NOTES

1. Source: Bloomberg, as of July 15, 2022.
2. Source: Bloomberg, as of July 15, 2022. Data for representative ETFs– Investment Grade: LQD, High Yield: HYG.
3. Source: FOMC Press Conference, as of May 4, 2022.
4. Source: Reuters, "U.S. economy shrinks in first quarter; trade, inventories mask underlying strength," April 28, 2022.
5. Source: Federal Reserve Bank of Philadelphia, "Second Quarter 2022 Survey of Professional Forecasters," May 13, 2022.
6. Source: JPMorgan. See Exhibit 1.
7. Source: FOMC Press Conference, as of May 4, 2022.
8. Source: eVestment.
9. Source: Macrotrends, as of May 25, 2022.
10. Source: Connor, Gregory, and Li, Sheng, "Market Dispersion and the Profitability of Hedge Funds," 2009.
11. Source: HFRI, based on Fund Weighted Composite Index, as of May 18, 2022.
12. Source: HFRI, as of May 18, 2022.
13. The HFRI Fund Weighted Composite Index is a global, equal-weighted index of single-manager funds that report to HFR Database. Constituent funds report monthly net of all fees performance in U.S. dollars and have a minimum of $50 million under management or $10 million under management and a 12-month track record of active performance. The HFRI Fund Weighted Composite Index does not include hedge fund of funds.
14. Source: HFRI, eVestment. Hedge Fund returns calculated from HFRI Fund Weighted Composite Index.
15. *Ibid*.
16. *Ibid*.
17. *Ibid*.
18. Source: CAIA, "Hedge Fund Strategies."
19. *Ibid*.

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