GCM Grosvenor

HEDGE FUND STRATEGIES

In Brief

Q&A with David Richter

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Past performance is not necessarily indicative of future results. No assurance can be given that any investment will achieve its objectives or avoid losses.

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IN THIS EDITION OF *IN BRIEF*

David Richter discusses the likely impact of rising rates on hedge funds and how we are positioning our portfolios in the current environment.

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Assessing the Likely Impact of Rising Rates on Hedge Fund Portfolios

Nine years after the global financial crisis and ensuing period of record low interest rates, the U.S. economy continues to show considerable resilience. While GDP growth rates have been relatively modest, the economy appears to be at or near full employment, with the unemployment rate recently reaching its lowest level in sixteen years. Inflation has been generally benign, but is approaching the Federal Reserve Board's stated target of 2%. Against this backdrop, the Fed has been adopting a more restrictive monetary policy through further increases in the target federal funds rate and has indicated that it will gradually phase out the reinvestment of maturing securities in its portfolio.

Q HOW WOULD YOU EXPECT HIGHER U.S. INTEREST RATES TO IMPACT THE BROAD FINANCIAL MARKETS?

The market's reaction will depend, in part, upon the Fed's actual policy moves relative to current expectations. While pricing pressures have been relatively subdued thus far, any unexpected pickup in inflation will likely force the Fed to become more aggressive – if that occurs it will negatively weigh on bond and stock markets.

The Fed has been effective in communicating and preparing investors for a less accommodative stance. As such, we think there is presently a low probability of the FOMC catching the market by surprise, which should prevent a repeat of the "taper tantrum" that occurred in 2013. However, as noted above, a meaningful increase in inflation would heighten volatility and could reverse investor sentiment.

Generally, a sustained and material increase in interest rates would be expected to have an adverse impact on capital markets. For equities, higher discount rates would reduce the value of future earnings streams and, thereby lower company valuations. This effect, however, could be offset in whole or in part by the prospect of stronger corporate earnings. Similarly, credit markets would be impacted by higher debt service costs and potentially higher default rates, resulting in spread widening and losses for bond investors.

Q HOW WOULD YOU EXPECT A RISING RATE ENVIRONMENT TO IMPACT DIVERSIFIED HEDGE FUND PORTFOLIOS?

Our experience has been that hedge fund managers have generally performed well and generated alpha, relative to traditional long-only bond and equity funds, in a rising rate environment. Hedge fund managers generally i) operate under a more flexible mandate and have a broader tool set to manage downside risk and ii) earn additional income on their short portfolios when rates rise. Moreover, the ability of hedge funds to effectively use short sales and derivative contracts to hedge portfolios is a key differentiator that can often result in more favorable performance in declining markets.

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One needs to go back a decade or more to find a period in which rates trended higher for a sustained period. Historically, however, hedge funds have exhibited low correlation and low beta with traditional fixed income indices.

Overall, we expect rising rates to have a minimal direct impact on our hedge fund portfolios. The effects may be positive or negative, but tend to be more strategy- and/or manager-specific. Higher short-term rates represent a modest positive for equity long/short managers (due to a higher short rebate as mentioned above) and for managers operating in strategies that make extensive use of derivatives and thus maintain high levels of unencumbered cash, such as global macro, CTAs, and certain relative value strategies.

In addition, many credit hedge fund managers are active investors in corporate debt and some are also involved in direct lending. A meaningful portion of this activity would be expected to generate higher "carry" amid a series of rate increases as these loans typically reprice based upon the level of short-term rates.

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Q ARE THERE PARTICULAR STRATEGIES OR TYPES OF MANAGERS THAT YOU THINK ARE BEST EQUIPPED TO RESPOND TO A RISING RATE ENVIRONMENT?

We believe select global macro managers (both discretionary and systematic) and CTAs may be best equipped. We also expect relative value managers that engage in fixed income or volatility arbitrage to be well-positioned to generate attractive returns.

Global macro managers and CTAs generally have no persistent directional bias and tend to perform well in markets that exhibit price trends. Thus, we would expect this group of managers to position their portfolios to benefit from any sustained increase in interest rates. In addition to establishing positions directly in interest rate markets, these managers are also generally active in global currency markets. To the extent that currencies are impacted by interest rate differentials, these markets often represent an alternative, liquid approach to expressing an interest rate view.

While we expect global macro and CTA managers to capitalize primarily on directional moves in interest rates, certain relative value managers may also profit from changes in the shape of individual yield curves and/or the spread between yield curves in different currencies. As central banks begin to shift policy, opportunities in interest rate curve and spread trading are often enhanced, leading to improved profitability. However, due to the generally high levels of leverage employed in fixed income arbitrage, manager selection is critical and one must size such positions prudently given the potential for losses in adverse markets.

Lastly, we expect a rising rate environment could create opportunities for volatility trading in various interest rate option markets. After an extended period of quantitative easing by global central banks, which was intended to dampen volatility, a move towards normalization of interest rates and the associated hedging activity is likely to have profound implications for both the absolute and relative prices of interest rate options.

Q WHAT TACTICAL ALLOCATION CHANGES HAVE YOU MADE EITHER TO HEDGE PORTFOLIO RISK OR TO CAPITALIZE ON A RISING RATE ENVIRONMENT?

Over the past year, we have gradually reduced exposure to strategies and managers that we perceive as vulnerable to a rising rate environment and/or declining equity markets and we have increased exposure to those that we believe are capable of generating trading gains and/or reducing our overall portfolio risk.

In particular, we have modestly increased our exposure to global macro and relative value option volatility managers that we believe have the skills to navigate a rising rate environment and generate outsized returns through a combination of directional and relative value positioning.

At the same time, given current equity market valuations, we have adopted a more defensive posture and trimmed exposure to longer biased equity managers in favor of less-correlated equity managers whose portfolios are less vulnerable to declining equity markets. Concurrently, we have maintained or increased exposure to certain specialist equity managers focused on sectors we believe are conducive to alpha generation. One such sector includes financials, as this sector i) can benefit from rising rates and/or a steepening yield curve, ii) is undergoing consolidation and regulatory change (creating opportunities both long and short) and iii) has generally lagged the broad markets. ■

David S. Richter, CPA

Mr. Richter is Chair of the Public Markets Investment Committee, is Co-Head of Public Markets Research and serves on the Global Investment Council. Mr. Richter is also a member of the Special Opportunities Investment Committee. Mr. Richter approves public markets portfolio allocations and shares responsibility for the evaluation, selection and monitoring of various investment strategies and investment managers. Prior to joining GCM Grosvenor, from 1994 through 2002, he was the Founder and Managing Partner of Chicago-based Waveland Capital Management, L.P., a U.S. long/short equity hedge fund affiliated with GCM Grosvenor. From 1988 to 1994, Mr. Richter was a Vice President of JMB Realty Corporation in the Corporate Acquisitions Group. Prior to 1988, Mr. Richter was a Manager of KPMG Peat Marwick. He graduated summa cum laude with his Bachelor of Science in Accountancy from the University of Illinois at Urbana-Champaign in 1983. Mr. Richter is a Certified Public Accountant and received the national AICPA Elijah Watt Sells Award from the American Institute of CPAs for his scores on the Uniform CPA Examination.

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GCM Grosvenor has offered alternative investment solutions since 1971. The firm is headquartered in Chicago, with offices in New York, Los Angeles, London, Tokyo, Hong Kong and Seoul. GCM Grosvenor serves a global client base of institutional and high net worth investors.

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