HEDGE FUNDS IN THE 2020S: A NEW PARADIGM?

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Executive Summary

- The 2020s have so far ushered in a new environment for global markets, marking a significant departure from the post-Global Financial Crisis era. This shift has been driven by the Covid-19 pandemic and its wide-ranging economic impacts, the subsequent rise in global inflation rates and the responses from central banks through their monetary policies.

- Geopolitical risks, like the Russia-Ukraine conflict and Middle East tensions, have further destabilized markets, impacting global energy markets and geopolitical alliances.

- For financial assets, this has resulted in higher volatility, wider return distributions, and shifting cross-asset correlations.

- In this volatility reset, Hedge fund strategies have maintained their role as diversifiers in multi-asset portfolios, especially for equity-related risk, as fixed income's effectiveness has decreased when the correlation between both is positive.

- Macro and Relative Value sub-strategies -the core allocations of our HF portfolios- have been bright spots. Macro benefited from increased market dislocations and global monetary policy shifts, providing macro managers with more opportunities to capitalize on global, diverging economic trends. Relative Value strategies have also benefited from the greater dispersion of returns, allowing managers to exploit pricing inefficiencies across and within asset classes.

- As market uncertainty persists and trading opportunities arise from the evolving inflation and rate narrative, the outlook for these strategies remains favorable, however execution and risk management will remain key at the manager level. Long/Short Equity strategies face a mixed outlook, with opportunities in sectors and geographies specialists. Event Driven strategies may benefit from increased corporate activity, while Credit strategies face a nuanced outlook with muted distressed debt prospects.

- Given the wider dispersion of returns within the HF industry, a deep and skeptical due-diligence process to select skilled and experienced hedge fund managers remains crucial.

A New Market Environment Marked by Higher Volatility & Dispersion

The 2020s have provided a new backdrop for global markets, characterized by higher volatility, greater dispersion, and wider distributions of returns.

This shift is a stark contrast to the relatively stable environment that prevailed in the decade before when persistent low inflation and sluggish growth enabled Central Banks to suppress volatility by slashing interest rates to zero, indicating low rates ahead, and employing Quantitative Easing (QE) as needed.

Several key factors have contributed to this new paradigm:

- COVID-19 Disruption
- Inflation and Central Bank Responses
- Geopolitical Risks

Figures 1 & 2 illustrate how both fixed income and equity markets saw a shift in volatility from 2010 to 2024, with the period from 2020 to 2024 showing higher average volatility and more frequent spikes compared to 2010 to 2019:

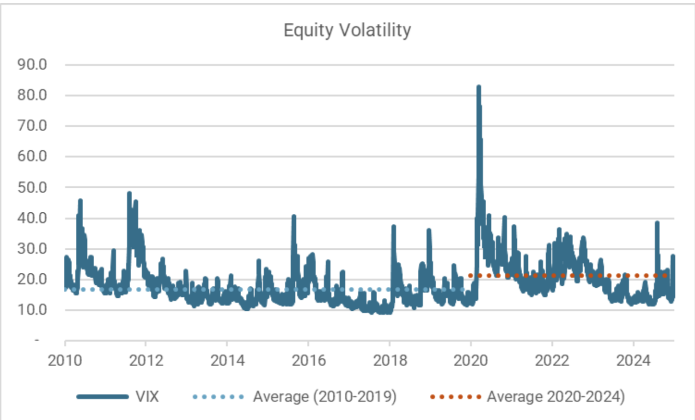

Figure 1: Equity volatility measured by VIX Index
Source: Bloomberg, Novum Capital Partners

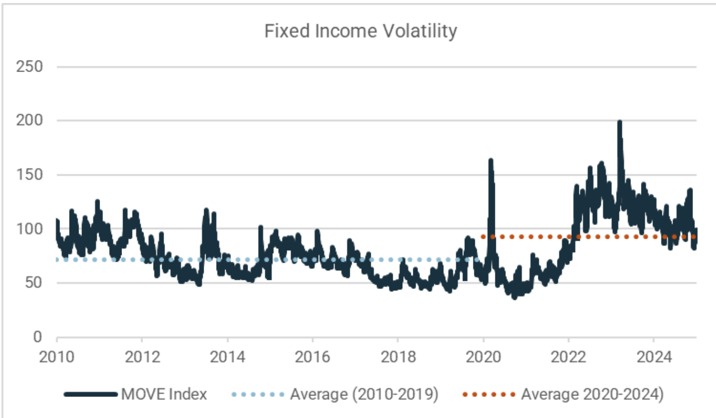

Figure 2: Fixed Income volatility measured by MOVE Index
Source: Bloomberg, Novum Capital Partners

1. Pre-2020 Period: Both fixed income and equity markets experienced relatively stable volatility with occasional spikes (Euro debt crisis, CNY devaluation, Brexit…).
2. 2020 Spike: Both markets saw a significant increase in volatility around 2020, due to the global impact of the COVID-19 pandemic.
3. Post-2020 Period: Volatility in both markets has reset higher compared to the pre-2020 period.

The combination of these factors has resulted in a market environment characterized by higher volatility, wider distributions of returns, and fatter tails suggesting that the market has become less predictable and more prone to significant fluctuations (Figure 3). These fat tails bring an abundance of risk and opportunity. While the increased dispersion of returns has made it more difficult for funds to consistently outperform on a beta basis, it has also created opportunities for skilled managers to generate positive alpha.

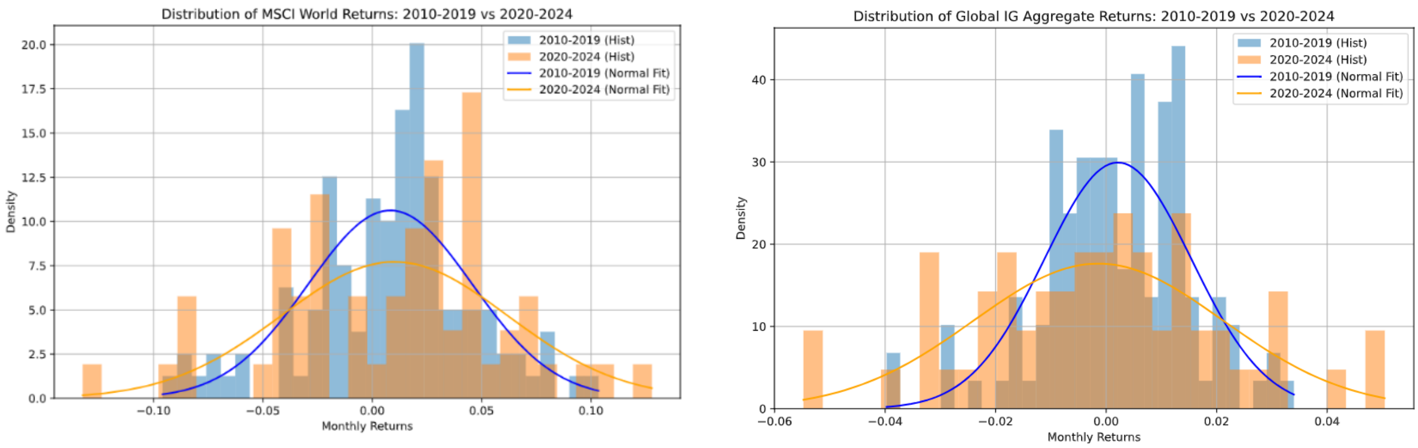

Figure 3: Return distribution of the MSCI World Index and Barclays Global Aggregate Index (2010-2019 vs. 2020-2024)
Source: Bloomberg, Novum Capital Partners

Hedge Fund Strategies Amidst in a Higher Volatility Environment

The new market environment prevalent since 2020, marked by higher volatility and dispersion, has created favorable conditions for hedge fund strategies to play their role in diversified multi-asset class portfolio, particularly in mitigating equity-related risks. This is especially true as fixed income investments have become less effective in providing diversification when their correlation with equities is positive.

Figure 4 highlights the role of hedge funds in providing diversification and downside protection within a multi-asset portfolio, particularly during market downturn.

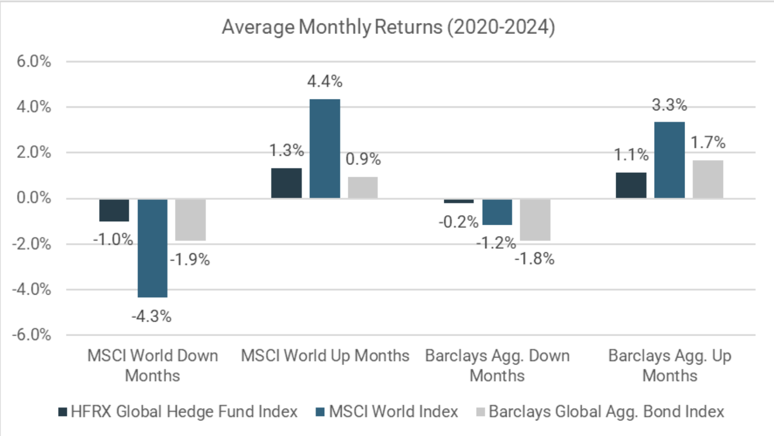

Figure 4: Average indexes monthly return for the period 2020-2024
Source: HFR. Bloomberg, Novum Capital Partners

When looking at sub-strategies, Macro and Relative Value strategies, which are core allocations for us, have stood out in this environment and displayed some of the characteristics we value most for our portfolios: lower market correlation, focus on idiosyncratic performance and asymmetry of returns.

Figure 5 illustrates the performance of various hedge fund strategies (Macro/CTA, Relative Value Arbitrage, and Equity Hedge) under different levels of market volatility, as measured by the VIX (for equity volatility) and MOVE (for interest rate volatility) indices over the period 2010-2024:

VIX Levels	**HFRX Macro/CTA Index**	**HFRX Relative Value Arbitrage Index**	**HFRX Equity Hedge Index**
10 < VIX ≤ 15	0.27%	0.53%	0.81%
15 < VIX ≤ 20	0.17%	0.30%	0.32%
20 < VIX ≤ 25	0.21%	0.54%	0.12%
VIX > 25	0.39%	-0.74%	-0.60%

MOVE Levels	**HFRX Macro/CTA Index**	**HFRX Relative Value Arbitrage Index**	**HFRX Equity Hedge Index**
MOVE < 50	0.71%	0.77%	1.57%
50 < MOVE ≤ 100	0.19%	0.38%	0.59%
100 < MOVE ≤ 150	0.15%	0.42%	0.05%
MOVE > 150	0.32%	-0.24%	-0.27%

Figure 5: Average index returns for the period 2010-2024 under different levels of market volatility, as measured by the VIX (for equity volatility) and MOVE (for interest rate volatility) indices.
Source: HFR, Bloomberg, Novum Capital Partners

1. **Macro Strategies:** Macro strategies involve taking positions based on global economic trends and events. In a high volatility environment, macro managers have more opportunities to capitalize on market dislocations and mispricings. The increased uncertainty and rapid market movements have created fertile ground for macro managers to generate alpha through directional bets on interest rates, currencies, commodities, and equity indices. The Covid-19 pandemic, inflation dynamics, and geopolitical risks have all provided macro managers with ample opportunities to deploy their strategies effectively.

2. **Relative Value Strategies:** Relative Value strategies aim to exploit pricing inefficiencies between related securities across and within asset classes without taking directional risk. In a high volatility environment, the increased dispersion of returns creates more opportunities for relative value managers to identify and capitalize on these inefficiencies to generate alpha. Arbitrage strategies, such as fixed income arbitrage, convertible arbitrage, and statistical arbitrage, have thrived in this environment.

While Equity based strategies tend to do better in lower volatility environments they struggle as volatility increases. Relative Value Arbitrage strategies have shown in turn shown their ability to perform consistently well across different volatility regimes, excluding extreme volatility spikes. Macro/CTA strategies have historically shown moderate performance across different volatility levels but display convexity features in very high volatility environments for both equity and interest rate volatility.

Outlook Across Strategies

The new paradigm of higher volatility and dispersion has different implications for various hedge fund strategies.

Here is an outlook for some of the key strategies that are part of our universe:

1. **Macro:** The outlook for Macro strategies remains positive, given the continued uncertainty and volatility in global markets. Discretionary Macro managers will have ample opportunities to capitalize on market dislocations and mispricings driven by geopolitical risks, inflation dynamics, and other macroeconomic divergences: US exceptionalism, the incoming Trump administration and the path forward for inflation/rates, a negative feedback loop in Europe, and Japan following a path of rates normalization given reflation pressures. Similarly systematic macro strategies should be able to capture these trends. Dispersion coupled with geopolitics, and elevated volatility have typically proven to be rich trading environments. However, the increased complexity of the macro landscape and its propensity to macro shocks will also require macro managers to maintain trading and risk management discipline.

2. **Relative Value**: The prospects for Fixed Income Arbitrage strategies remain attractive as forces impacting monetary policy (fiscal policy & increasing supply, liquidity drain given market structure and regulations, QT, bank capital rules) and the divergence of central bank activity should reignite elevated rates volatility ahead. Convertible Arbitrage continues to benefit from a sustained opportunity set marked by new issuances, refinancings, M&A, and from gamma trading & volatility. The prospects for Statistical Arbitrage and Quant strategies remain positive for a variety of sub-strategies as elevated volatility, retail flows, and innovations in trading signals and execution, should continue to create compelling opportunities.

3. **Long/Short Equity:** The outlook for LS equity remains mixed, given ongoing macro dynamics and de-leveraging risks due to crowding. Still, the higher dispersion of returns driven by corporate fundamentals tends to be a great stock picking environment and has continued to offer attractive prospects, particularly for market neutral and low-net managers. We have also remained positive on certain sector and geographies specialists as several themes are likely to provide opportunities both long and short with managers able to tilt towards these: AI, Obesity, Energy Transition, Japan.

4. **Event Driven:** We have become gradually optimistic on the prospects for event driven equity and credit strategies. The strategy should benefit quickly from a pick-up in capital markets activity (M&A and a significant IPO backlog) while the incoming US administration could relax the regulatory pressure. Yet we believe that a fundamental-

driven approach to complex mergers should provide a much more sustained and fruitful opportunity set as managers can deploy capital away from crowding and momentum while still being able to capitalize on the volatility created by the risk-arbitrage community. Sustained higher rates should also provide a sustainable level of idiosyncratic opportunities for catalyst-driven managers with corporate restructuring, refinancings, exchanges, etc., without necessarily depending on a true/protracted distressed cycle.

5. **Credit:** Credit strategies outlook remains average, and we are looking to deploy capital selectively rather than chasing opportunities. Distressed credit strategies face a nuanced outlook as the prospects for distressed debt continues to be muted and the handful of situations that arose recently saw significant crowding increasing the prospects of a negative outcome from creditor-on-creditor violence. Event activity and out-of-court restructurings (so called "Liability Management Exercises") are indeed picking up and yet a true and protracted default cycle may still be many quarters away. However, as opposed to the previous decade, in today's environment managers are being paid to wait for that stressed/distressed opportunity set. Long/short credit strategies continued to benefit from higher yield and positive credit picking environment with alpha opportunities, yet spreads are tight relative to historical averages. Weakness in CRE and the resulting stress on the banking sector are also creating an attractive environment for certain structured credit managers.

We would be remiss if we didn't highlight multi-strategy funds given their growing importance across financial markets. We continue to view multi-strategy funds as one of the building blocks of a diversified hedge fund portfolio given their ability to dynamically allocate across strategies coupled with strong risk management, operational leverage and their ability to access top talents. That said, capacity issues have started to arise recently, and we also remain careful with the extension of liquidity terms. The growth of the space has also effectively created barriers to entry and many investment talents end up deciding to either join these firms rather than launch on their own or receive an external allocation and trade almost exclusively for them, therefore making multi-strategy firms hardly avoidable. The flipside of the growth we have witnessed over the past years for that part of the industry has also been a growing market footprint, positions crowding and the increased occurrence of deleveraging events which all bear careful monitoring

In terms of strategy allocation, we intend to largely maintain our current approach and adhere to our core/opportunistic allocation framework. This framework allocates approximately 70% of our portfolios to a core, diversified set of Relative Value and Macro strategies and sub-strategies. The remaining 30% is allocated to our Opportunistic bucket, which includes equity- and credit-centric allocations as well as event-driven strategies. While we do not anticipate significant changes to this framework, we do expect some turnover at the manager level, consistent with previous years.

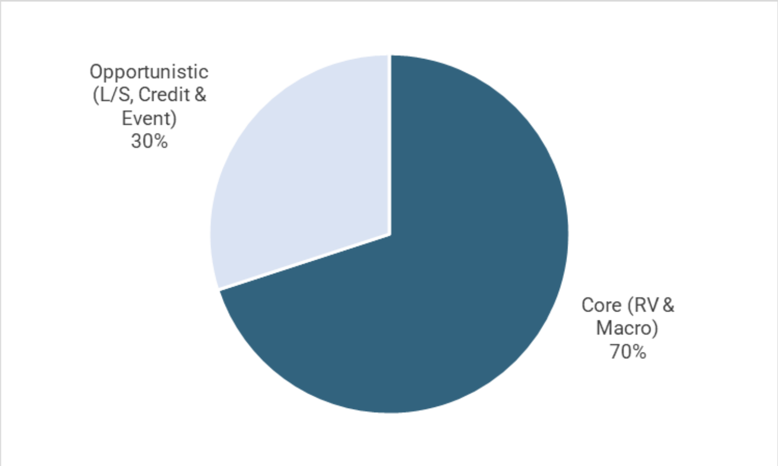

Figure 6: Strategy allocation framework
Source: Novum Capital Partners

With the current market backdrop, we are confident that this strategy mix will position us to achieve our target return, which is to generate 400 to 500 basis points above the prevailing cash benchmark while maintaining limited correlation to traditional equity and fixed income markets. Figure 7 outlines our expectations per strategy:

	Target Return	Target Sharpe Ratio*
Credit	7-9%	0.9
Long / Short Equities	10-12%	1.0
Event Driven	8-10%	1.0
Opportunistic / Macro	10-12%	0.8
Relative Value	7-9%	1.8

*Risk free rate used to calculate the Sharpe Ratio is the CME Term SOFR 3m.

Figure 7: Target Return / Sharpe Ratio by strategy
Source: Novum Capital Partners

Manager Selection and Portfolio Management in a Wider Dispersion Environment

Given the wider dispersion of returns (figure 8) within the hedge fund industry, manager selection and portfolio management have become even more critical. The increased volatility and uncertainty of the new market environment have created a wider range of outcomes for hedge funds, making it essential for investors to carefully select managers and construct portfolios that can navigate that backdrop.

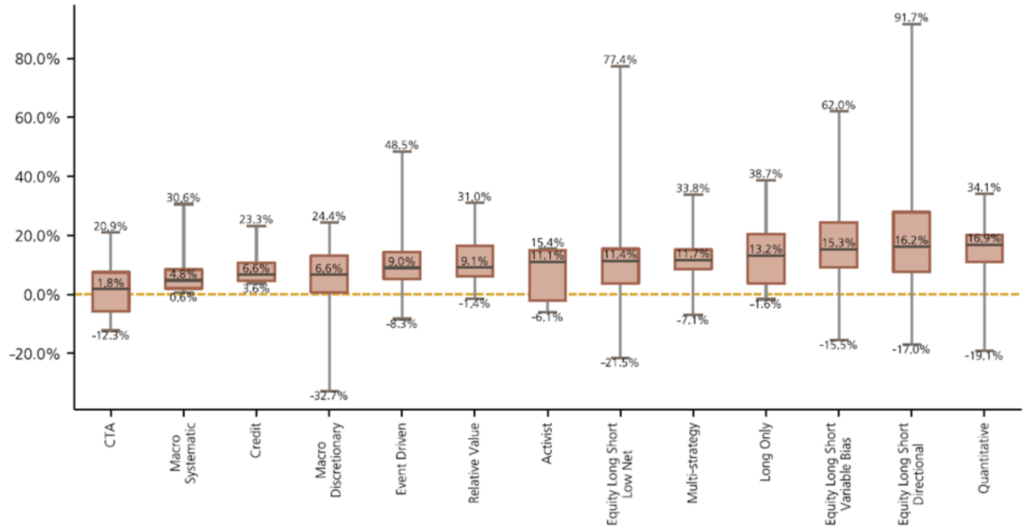

Figure 8: YTD 2024 sub-strategy returns as of December 2024
Source: UBS Capital Consulting Group

Conclusion

The 2020s have introduced a new era of higher volatility and wider return dispersions in global markets, shaped by the COVID-19 pandemic, rising inflation, central bank policies, and geopolitical tensions. Hedge fund strategies, particularly Macro and Relative Value, have proven effective in diversifying multi-asset portfolios, especially against equity-related risks. These strategies have benefited from increased market dislocations and greater dispersion of returns, offering more opportunities to generate alpha.

Long/Short Equity and Event Driven strategies continue to face a mixed outlook, with sector-specific opportunities and potential benefits from increased corporate activity, respectively. Credit strategies require a more selective approach due to muted distressed debt prospects.

Given the broader dispersion of returns within the hedge fund industry, a rigorous due-diligence process remains crucial for selecting experienced managers.