

As Inflation Disrupts, Alternative Investments Take Center Stage to Stabilize

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After inflation in the month of May came in at nearly 9%,¹ the markets have been skittish in June.

Attempting to bring inflation under control, the Federal Reserve responded with an aggressive increase of 75 basis points.¹

While many believe that much of the immediate pricing pressures are likely to be more transitory, and with supply-chain related shocks from the pandemic lockdowns continuing to mitigate, the ongoing conflict in the Ukraine has had immediate effects on energy prices around the globe.

As expected, the immediate impact on the 10-year treasury has been dramatic, as it's now sitting well over 3% after touching just below 3.5% at mid-month. It is now up almost 200 basis points from the beginning of the year. In addition, the equity markets have been under heavy pressure, with the S&P now dropping more than 20% YTD, and the tech heavy NASDAQ down more than 30% as investors weigh the Fed's heavy actions with the potential for a recession.²

Accordingly, the appetite for alternative strategies has never been stronger. Private markets can provide volatility preservation and stability in times of immediate market stress.



Chart 1

Strategy	Monthly Return	YTD	Past 12 Months
Hedge Funds - Event Driven Strategies	-1.70	-4.57	-2.07
Hedge Funds - Relative Value Strategies	-0.50	-0.47	2.06
Hedge Funds - Multi-Strategy	-0.31	-1.38	-0.08
Funds of Hedge Funds - Multi-Strategy	-1.25	-3.92	-2.18
Hedge Funds - Value-Oriented	-0.77	-9.19	-11.87
Hedge Funds - Long/Short Equity	-0.45	-6.62	-4.66
Hedge Funds - Special Situations	-1.99	-8.25	-3.28
Hedge Funds - Event Driven	-1.63	-5.19	-3.87
Hedge Funds - Risk / Merger Arbitrage	-1.49	-1.63	-0.70
Hedge Funds - Convertible Arbitrage	-2.30	-6.29	-3.42
Hedge Funds - Fixed Income Arbitrage	-0.18	-1.33	-1.63
Hedge Funds - Relative Value Arbitrage	0.78	1.91	4.23
Hedge Funds - Equity Market Neutral	-0.85	0.00	3.26
Hedge Funds - Macro	0.24	3.04	3.23
Hedge Funds - Commodities	0.52	13.83	26.00
Hedge Funds - Fixed Income	-0.87	-4.33	-3.10
Hedge Funds - Long / Short Credit	-0.55	-2.56	-1.09

Source: Preqin Pro; performance as of 5/31/2022

Investors who are looking at shorter time horizons, however, can also account for stability with hedge funds. Look no farther than the returns of hedge funds as of May 31 (chart 1) to support—and prove—this downside mitigation strategy.

With inflation spiking, commodities are the clear standout strategy for both 2022 and the past twelve months. Ancillary commodity positions in areas such as global macro have also pushed that strategy to

positive performance. In addition, long/short equity, which has delivered annualized double digit returns over the past three years, has seen a renewed interest on PPB's platform. While it has been down in 2022, it has functioned exactly as intended to help mitigate broader equity losses and volatility.

We have seen a resurgence of interest in other hedge fund strategies as well: relative value, multi-strategy and equity market neutral. Generally speaking, these

were strategies that struggled in the low interest rate environment and the stimulus-fueled bull market run that evolved from the Great Financial Crisis. These performance issues were exacerbated by a higher fee strategy compared to basic indexing and with little net market exposure.

Obviously, the environment is vastly different now. Additional stimulus measures are off the table as the Fed's No. 1 priority is to fight inflation aggressively. Unfortunately, in a situation like this, a market selloff is considered collateral damage. When this happens, picking stocks based on fundamentals matters again. And, since many of these funds were forced to adapt, investor terms have become more favorable.

Relative to fund flows (chart 2), data from Preqin illustrates that hedge funds saw a net inflow of \$7.5B during the first quarter, offsetting the \$5B of outflows from the Q4 2021 market selloff. It's no surprise that the strategies with exposure to energy

Chart 2

Strategy	2017 (\$bn)	2018 (\$bn)	2019 (\$bn)	2020 (\$bn)	H1 2021 (\$bn)	H2 2021 (\$bn)	2021 (\$bn)	Q1 2022 (\$bn)	Q1 2022 AUM (\$bn)	% change in AUM - 2022
CTAs	25.2	-14.2	-11.3	-0.9	5.9	1.6	7.5	5.0	330.6	8.2%
Credit strategies	-4.7	13.8	7.1	-16.8	-2.4	-6.0	-8.4	3.4	307.1	0.0%
Equity strategies	-23.8	-23.7	-18.0	2.9	5.3	-2.2	3.2	-1.6	1,185.5	-4.3%
Event driven strategies	10.3	6.4	-24.7	-14.9	3.0	0.1	3.1	-4.5	204.4	-4.4%
Macro strategies	19.0	-16.2	-9.5	-30.1	8.0	5.5	13.5	8.5	1,265.3	3.5%
Multi-Strategy	18.6	7.4	-31.4	9.5	-0.8	-4.6	-5.4	-2.3	584.0	-0.6%
Niche strategies	3.8	13.0	-4.7	-9.2	9.3	7.9	17.1	2.2	54.6	-0.2%
Relative value strategies	-4.1	-20.4	-4.7	15.2	5.2	0.2	5.4	-3.3	404.9	-1.0%
Industry total	44.4	-33.9	-97.2	-44.5	33.4	2.5	36.0	7.5	4,336.5	-0.1%

Source: Preqin Pro

(macro and CTA) saw the greatest inflows (\$13.5B combined). Conversely, equity-based strategies saw a net decline of \$1.6B. Given the broader market selloff, that is also not surprising.

Simply putting your money in an index was a way to generate returns over the last decade, but that approach may not be enough now. The market is under pressure. Fears of a recession in the near term are being fueled every day and allocating to more hedged strategies is the prudent play.

All the noise around short-term volatility in the public markets has caused many sleepless nights for investors.

Fundamentals matter again. As the push to generate alpha gains traction, the top stock-picking talent may once again have its moment in the spotlight. Implementing strategies that are less tied to the broader markets can alleviate investors' concerns. Ideally, combining more hedged public positions with a dedicated private allocation can further mitigate some of the market noise that is dominating the news.

A positive byproduct of this strategy may be investors profiting from the illiquidity premium.

It's no secret that inflation pressures may make the next year or two challenging. More headline-generating market noise during that time may only cause added anxiety for investors. In these moments, advisors can look to alternative investments as stabilizers for their clients' portfolios.

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Important Disclosures and Footnotes

¹ <https://www.wsj.com/articles/us-inflation-consumer-price-index-may-2022-11654810079>

² Market and index data from the Wall Street Journal (wsj.com)

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