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*The lack of hedge funds’ excess returns since the financial crisis put the industry under rising pressure. In this 12th edition of the White Paper, we review the causes and identify the key hedge fund performance drivers. We put to test these drivers under 3 long-term macro-economic scenarios. It is reasonable, in our view, to expect hedge funds to deliver an annual excess returns in the 5-6% range above the Libor 3M, with low volatility.*



**A NEW ERA FOR HEDGE FUNDS?**

**>> Criticism against the lack of hedge funds outperformance climaxed in 2014.** Hedge funds have underperformed traditional asset classes since the financial crisis. Despite its outstanding track record over recent decades, the industry has come under rising pressure.

**>> The collapse in volatility and yield might be the main culprits.** Volatility neared the mid-90’s all time lows in 2014 as a result of a combination of factors. The unprecedented global monetary reflation was undoubtedly the most powerful one. Subject to growing risks constraints and a positive correlation between equity and bonds, hedge funds only partially benefitted from the asset reflation which unfolded since the financial crisis. Meanwhile the plunge in volatility and asset dispersion shrunk the potential for alpha generation. **We emphasize that the Volatility / Correlation / Dispersion regimes are key hedge fund return factors.** For instance, a low volatility environment is negative for alpha generation and this has hurt hedge fund performance during the time the Fed has tamed volatility with its QE programme. One response of the hedge fund industry was to significantly lower both management and performance fees.

**>> A sustainable inflection in market regimes unfolded since mid-2014.** Reflation policies have indeed inflated DM financial assets. Valuations are stretched in most classes. The economic cycle is maturing, and the Fed policy is about to normalize. **As a result, the alpha environment has improved,** while that of the traditional asset management is getting more challenging. As of end-May, the Lyxor Hedge Fund Index is up 4% year to date, while the S&P 500 in total return is up 3.2% and 10y sovereign bond prices are in negative territory both in Europe and in the US. It is no coincidence that **hedge fund assets keep on breaking their highs,** going north of $3tn.

**>>** In this white paper, we evaluate the drivers of hedge fund returns. We test their structural exposures under 3 macro-economic scenarios over the next 5 years. Using conservative assumptions, we estimate that **hedge funds could deliver annual excess returns in the 5-6% range over the Libor 3M, with lower volatility** than that of risky assets. In order to reach these expected returns, hedge funds would have to deliver alpha in the range of 3-4% per year, the rest being market beta. We make several scenarios for market developments and their influence on hedge fund returns and found that a scenario in which the Fed tightens faster than expected by the market would boost hedge fund returns. Meanwhile a scenario in which the US economy would face secular stagnation, leading to continued monetary easing would be the less supportive.

**>>** **We believe that diversifying portfolios with an increased allocation to alternatives is particularly attractive at this stage of the cycle**. Hedge funds have demonstrated their ability to protect portfolios against wide market fluctuations, a scenario that we cannot exclude when the Fed turns the screw.

**References:** Asseraf-Bitton J., Berthon J., Ferreira P. and Stenger J. (2015), *A New Era for Hedge Funds?,* Lyxor White Paper Series, 12, July 2015.

[Link to the full paper](http://www.lyxor.com/fileadmin/_fileup/lyxor_wp/document/455/)

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| **Hedge funds have underperformed recently but their long term track record is outstanding** |
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| Rebased at 100 as of December 1989. \*The diversified portfolio is 60% MSCI World in USD (total return) and 40% Barclay’s Global Aggregate bond index, rebalanced every month. Source: HFR, Bloomberg, HFR, Lyxor AM |

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