Sam Grobart: What do hedge funds tell us about 2023, and more importantly, the year ahead? This is The Markets.

Hi, I'm Sam Grobart. Today, I'm joined by Freddie Parker, co-head of Prime Insights and Analytics in Global Banking & Markets. Freddie, thanks so much for joining us today.

Freddie Parker: Hi Sam. Thanks for having me on.

Sam Grobart: So, Freddie, you recently published your annual hedge fund report, The Current State of the Hedge Fund Industry and the Outlook for 2024. How did hedge funds perform in 2023? Particularly compared to the traditional 60/40 allocations? And how did that compare with the year prior, 2022?
**Freddie Parker:** 2023, I think it's fair to say, was a muted year in terms of performance for hedge funds. Particularly when you consider the magnitude of the rally we had in markets into year end. Actually, if you look at performance at the end of October, both hedge funds and a 60/40 portfolio were up about 3 percent. And then we had the huge rally into year end. And after that, we had hedge funds up about 7 and the 60/40 portfolio up about 16. So, a huge gap in favor of the 60/40 portfolio. And really, the mirror image of what we saw in 2022 when we had a real challenge in the market and both equities and fixed income down significantly. And hedge funds, more or less, flat. So, protecting capital very well in that environment.

**Sam Grobart:** Freddie, obviously, we are in a higher interest rate environment right now. What are the typical expectations for hedge funds in a high rate environment? And did hedge funds meet those expectations in 2023?

**Freddie Parker:** I would argue that the era that we've come out of zero rates, was probably the worst set up that you could imagine for hedge funds where you had everything up and to the right, and equities and bonds, and really not a lot of room to add value in terms of alpha
or on stock selection or other security selection.

If you look at history and higher rate paradigms, generally speaking, hedge funds have done better in those environments. High rates tend to produce lower correlations between stocks, high dispersion of outcome, and with that, more opportunity for managers to generate alpha. And the gap is pretty significant.

Last year, we didn't see that being realized in practice. And I think a lot of that owes to, number one, the fact there was very little in the way of marking breadth. We know how much of the equity market performance was explained by a small handful of stocks.

**Sam Grobart:** The magnificent seven.

**Freddie Parker:** The magnificent seven stocks, exactly. So, beyond that, I would say also the fact that we had a number of violent reversals in the market. So, March, for example, when you saw the real backup in rates in the regional banking crisis. So, a few of those sorts of major rapid reversals, I think, created challenges for hedge funds. But beyond that, we still believe that the overall high rate
environment in the fullness of time should be better for hedge fund strategies.

**Sam Grobart:** So, based on this recent survey, which hedge fund strategies and geographies are most in favor in 2024? And how has allocator appetite evolved over the years?

**Freddie Parker:** If you had to point to one strategy that's definitely in favor at this point in time and has been consistently for the last two years, so we saw this in last year’s survey as well, it's credit. And that owes a lot to the high rates environment and the expectation that credit strategies should have a better opportunity set with higher rates and more dispersion of outcomes for companies that are borrowers.

The big change, I would say, year over year has been within multi-strategy. And this has been particularly multi manager. So, we're talking about firms here where you have lots of individual underlying PMs who get hired, paid on their individual performance, very diversified, often with leverage then applied to get to a good return. And something that has delivered very strong, consistent
returns for quite some time. We saw somewhat softer returns in that space last year. And we've also seen allocators slightly stepping back in terms of their interest there. So, a huge amount of capital's been deployed in that space in recent years. And maybe the new money into that space has slowed somewhat.

From a regional perspective, there's one very clear trend which has been over multiple years investors stepping back from Asia, and especially from China. So, if you go back to 2021, Asia was the most sought-after region by a wide margin. Every year since then, we've seen that interest consistently receding. And now, Asia is actually, of the three major regions, the least sought after.

**Sam Grobart:** I want to stick with Asia for a second. The recent net buying in Chinese stocks by hedge funds is the second largest over any three-week period for the past five years. What's driving that?

**Freddie Parker:** I think, if anything, you could probably point to the overall very low exposure that hedge funds have to China at this point in time.
Sam Grobart: So, they're coming off of a really low base, if you will.

Freddie Parker: Really, I think that's the primary driver at this point in time. If you look at our overall book of business, so all the hedge funds that we work with from a prime brokerage perspective inside of Goldman, we have seen the share of China as a proportion of their net exposure to the market fall from a high of 15 percent in the middle of 2020 to less than 7 percent. So, I think a lot of what we're seeing is just a little bit of a sort of technical bounce off the bottom of that.

The other thing that we see, generally speaking, is that over the last couple of weeks and into the Lunar New Year holiday, the pace of buying has slowed somewhat. So, it remains to be seen whether this is more of a sort of structural trend or really a sort of short-term tactical one.

Sam Grobart: Freddie, I asked you earlier about how allocators' appetite may be shifting between different hedge fund strategies. But I guess my broader question about allocators, of course the pension funds and others who are investing in hedge funds is, how is their sentiment
changing towards hedge funds themselves in relation to other kinds of investing?

**Freddie Parker:** Overall, I think hedge fund sentiment remains very constructive. We haven't seen much in the way of flows to the industry in many years. And that's in spite of the fact that sentiment towards hedge funds, for the last few years, has been improving broadly. I think the problem that we have when we think about allocators' portfolios more broadly is there is a shortage of liquidity right now. And that shortage of liquidity owes a lot to the boom of investing in private markets that took place over the last decade plus. And with that, what we've also seen is with the slowdown in IPOs and the availability of liquidity for private companies, the return of capital to investors from their privates portfolios has been meaningfully slowed. And that then weighs on the ability of investors to reallocate capital elsewhere in their portfolio.

So, to sum it up, what we're hearing from investors is they'd like to do more in hedge funds. But there's not a lot of available cash in portfolios to deploy into these strategies.
Sam Grobart: Is that investor base, the people who are investing in hedge funds, is that base changing?

Freddie Parker: It is to a certain extent. The one thing that you could point to as being a really meaningful trend is that pension funds as a share of hedge fund industry assets have fallen meaningfully in the last few years. And we don’t think that really has a huge amount to do with any negative view that they have on hedge funds, but more a structural change in the way that pensions have been investing.

Many pensions, particularly on the corporate side, and especially here in the US, have moved a lot closer to funded status. And with rates increasing, there a natural drive towards moving into more of a liability matching structure where they’ll invest more in fixed income and use that to be able to pay their liabilities. And derisk other areas of their portfolios, hedge funds included.

Sam Grobart: Freddie, your outlook is looking at the entirety of 2024. But I guess my last question for you is what is going to be on your radar in the weeks ahead?
**Freddie Parker:** So, if we had to point to one thing, we are, and have been for a while, at a very high level of gross exposure for the hedge fund industry. And you can think of gross exposure really as being a barometer of hedge funds overall risk appetite. So, high gross exposure tells you that hedge funds are seeing lots of opportunities, either on long or short sides of their books. Actually, we think a lot of the increasing gross exposure has been driven by more shorting. But overall, it's a very risk-on posture in terms of the opportunity set.

We've also seen year to date very strong alpha generation from our client base. And so, whenever we see extended positioning and strong performance, it always begs the question of are we moving towards some moment where there could potentially be a risk unwind?

So, Wednesday this week when we saw the CPI print come in hotter than expected and the backup in markets, all of those momentum reversals may trigger deleveraging from hedge funds. And that can then provoke some interesting risk dynamics in markets.

**Sam Grobart:** Freddie Parker, thank you so much.
Freddie Parker: Thank you.

Sam Grobart: That does it for another episode of The Markets. Be sure to find us on Apple Podcasts, Spotify, or wherever you get your podcasts.

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