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INVESTMENT MANAGEMENT

All About Alpha: Capturing Returns in Today's Market Environment

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As we approach the final months of 2024, it's easy to have a vague sense of déjà vu about financial markets. In some ways, 2024 looks eerily similar to 2023: equity indexes posted a strong first half of the year, driven by a handful of technology stocks, markets continue to reprice central bank policy expectations, which has driven ongoing volatility, while geopolitical tensions and other macroeconomic concerns remain.

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Today's environment stands apart from prior growth-led markets in a crucial way: it has been—and remains—a ripe environment for hedge fund alpha generation.

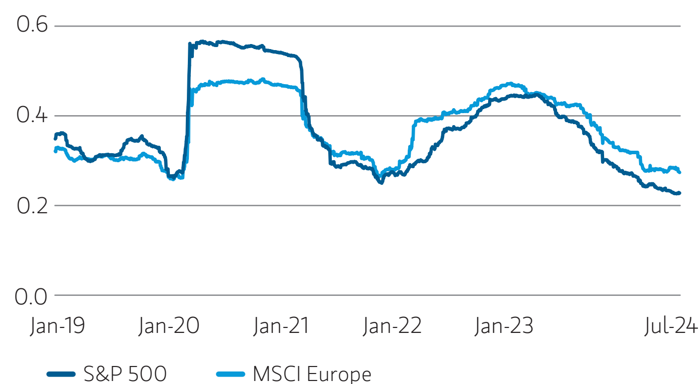
From Macro to Micro

AI and tech euphoria has seemingly taken hold of markets once again. Even after the volatility in late July and early August, which pressured many year-to-date high flying tech stocks, the market cap weighted S&P 500 index has outperformed the equal weighted S&P 500 by large margins year to date, through August 5. With more than 40% of the S&P 500 market cap

DISPLAY 1

Fundamentals Are Influencing Stock Prices Over Macroeconomic Factors

Equity Risk On/Risk Off Index



Source: Morgan Stanley AIP. January 1, 2019 - June 30, 2024.

Rolling Stock Specific Risk

Source: Morgan Stanley Research. December 31, 2019 - June 5, 2024.

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concentrated in TMT sectors, it's easy for these headlines, and headline-level returns, to mask the pronounced dispersion in other areas of the market.

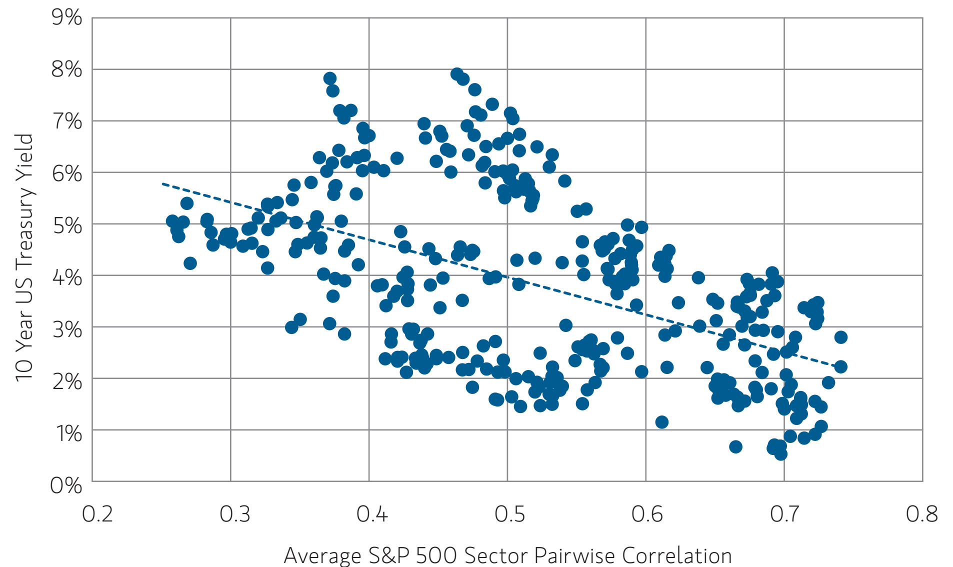
In the macro-driven environment that persisted for much of 2022 and 2023, assets moved largely in response to inflation, interest rates and other macroeconomic factors. 2024 has increasingly seen an environment driven more by micro fundamentals. In fact, an internally maintained S&P 500 risk-on/risk-off model, which quantifies the degree of shared risk and market-wide co-movements, has declined this year, suggesting that macroeconomic factors are weighing less on equity markets. This has coincided with an uptick in stock-specific risk, suggesting that fundamentals are increasingly influencing stock prices. We believe that these dynamics are a direct result of the higher interest rate environment, which has resulted in increased opportunities for alpha production conducive to hedge fund strategies seeking to deliver skill-based returns to investors.

We wrote last year about the higher interest rate environment and its myriad impacts on hedge fund strategies. In addition to higher yields on unencumbered cash for derivatives-oriented strategies, plus the benefits of the short rebate in long/short equity strategies, higher rate environments have historically coincided with lower levels of correlation in the market, as elevated costs of capital have disparate impacts across sectors, industries and individual issuers.

These environments have led to outsized performance by long/short equity market-neutral hedge funds which are reliant on stock picking to generate their returns. In periods during which markets showed the highest cross-sector correlation, the average equity market-neutral fund monthly return was 0.18%. During periods when markets showed the lowest average pairwise correlation—here dispersion was apparent—the same funds generated an average monthly return of 1.08%.

DISPLAY 2

Average S&P 500 Sector Pairwise Correlation Decreases with Higher Yields



Source: Morgan Stanley AIP. Rolling 36-month S&P 500 sector pairwise correlations. January 1, 1991 - June 30, 2024.

DISPLAY 3

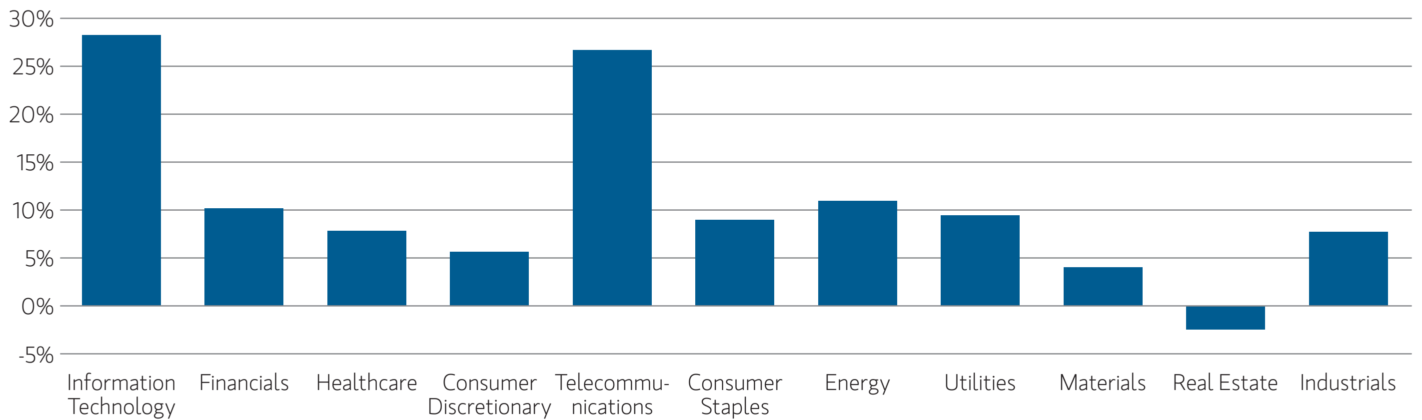
Equity Market-Neutral Funds May Outperform in Markets with Low Levels of Cross-Sector Correlation

S&P 500 SECTOR PAIRWISE CORRELATION	AVERAGE EQUITY MARKET NEUTRAL MONTHLY RETURN
Pairwise correlation – top quintile (highest correlation)	0.18%
Pairwise correlation – 2nd quintile	0.43%
Pairwise correlation – 3rd quintile	0.68%
Pairwise correlation – 4th quintile	0.70%
Pairwise correlation – bottom quintile (lowest correlation)	1.08%

Source: Morgan Stanley AIP. Rolling 36-month S&P 500 sector pairwise correlations. Long Short Equity hedge fund returns represented by HFRX EH Market Neutral Index. January 1, 1991 - June 30, 2024.

DISPLAY 4

Year-to-Date Returns by Sector Highlight Performance Dispersion



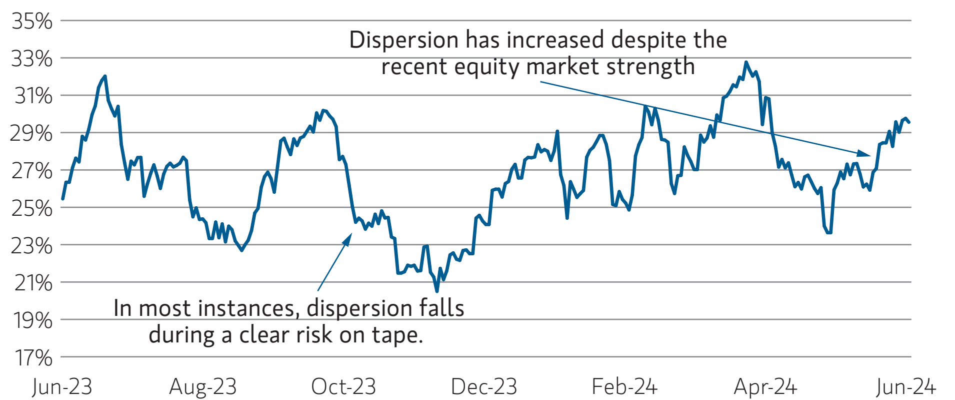
Source: Bloomberg. January 1, 2024 - June 30, 2024.

Current Market Dynamics

While certain secular themes remain—notably the artificial intelligence boom—2024 has seen clear evidence of performance dispersion both across and within sectors, as fundamentals are increasingly driving asset prices. Interestingly, stock dispersion has increased since the equity market rally that began in late April. In many instances, during a clear 'risk-on' environment, we would expect to see dispersion fall, as stocks broadly move based on sentiment and less so on underlying fundamentals.

DISPLAY 5

CBOE S&P Dispersion Index



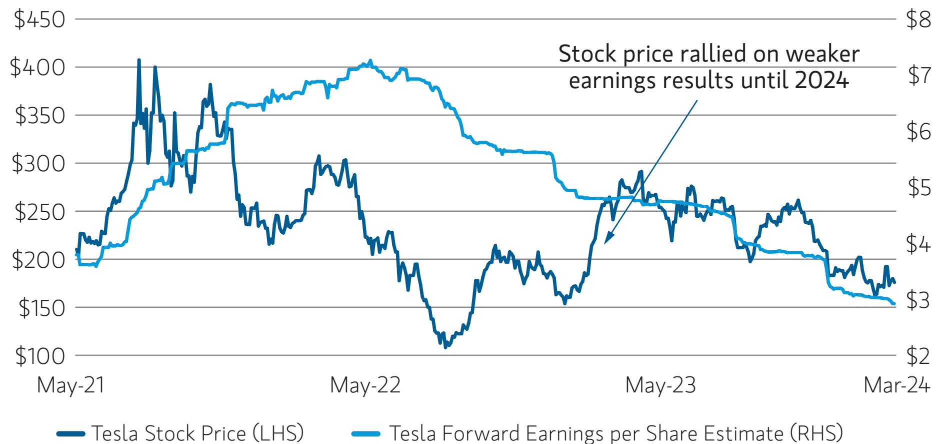
Source: Bloomberg. July 1, 2023 - June 30, 2024.

Dispersion Has Increased Despite the "Risk On" Environment

Examining the performance of several individual equities illuminates this point further. Prior to 2024, Tesla's stock price remained on an upward trajectory, rallying even on weak earnings prints for much of 2023. In 2024, however, price has become much more aligned to earnings results despite outperformance of the consumer discretionary sector.

DISPLAY 6

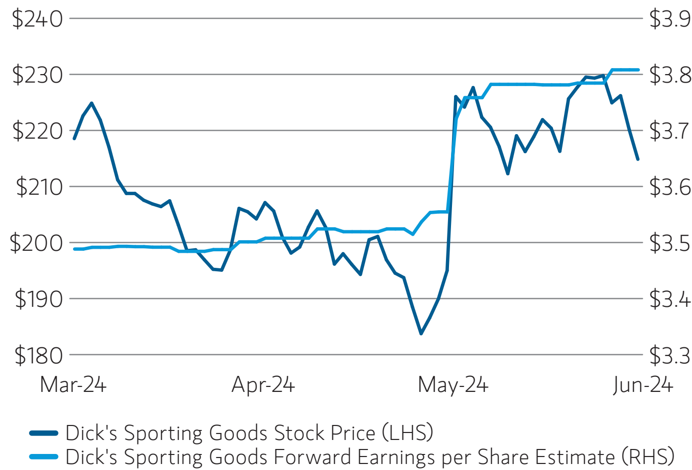
Tesla Stock Price Has Aligned to Earnings Results



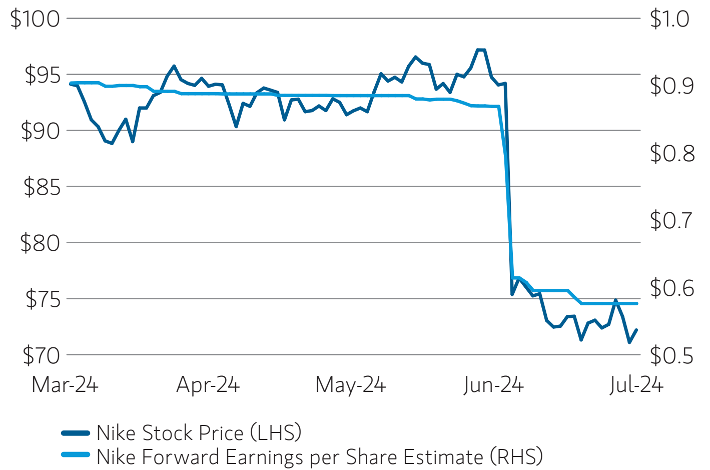
Source: Bloomberg. May 25, 2021 - March 31, 2024.

DISPLAY 7

Dick's Sporting Goods and Nike Tell A Similar Story



Source: Bloomberg. March 26, 2024 - July 25, 2024.



Source: Bloomberg. March 28, 2024 - July 25, 2024.

Elsewhere in the consumer sector, Dicks Sporting Goods' rallying on strong earnings and Nike's dropping on a weak print tell a similar story.

All About Alpha

This fundamentally driven environment has resulted in prolific hedge fund alpha generation over the past 12 months: on average, equity market-neutral hedge fund managers have generated alpha of 8.47%. However, this has not translated to improved alpha production by long-only equity managers, who have seen negative alpha of -3.60%, on average, over that same time period.

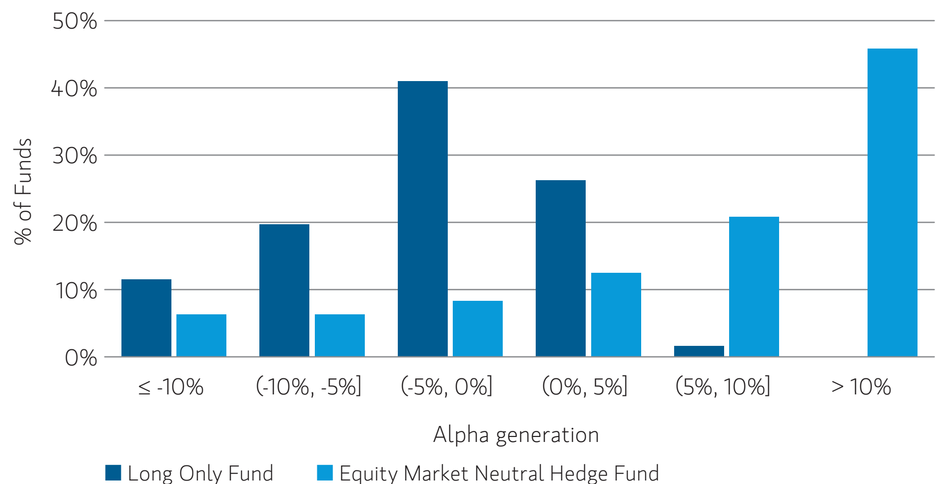
In our view, this dynamic provides evidence of two other reasons that hedge funds are uniquely well-positioned to deliver skill-based returns to investors: their ability to generate both long and short alpha, and hedge funds' unconstrained approach versus traditional benchmarks.

1. HEDGE FUND ABILITY TO GENERATE BOTH LONG AND SHORT ALPHA

Long only active managers are primarily able to express their fundamental views through relative under- or overweighting of securities. While underweighting a security versus a benchmark is a means for a long only manager to generate alpha, hedge funds are able to add additional alpha by monetizing declines in security prices through short positions. The relatively steady decline of the short interest factor for much of this year has contributed to the alpha-rich environment. We believe that this dynamic, in which heavily shorted stocks underperform, benefiting those who hold the short positions, further corroborates our view that fundamentals are driving equity prices.[1]

DISPLAY 8

Alpha Distribution: Long Only versus Hedge Funds



Source: Morgan Stanley AIP as of March 31, 2024. Long Only Fund universe comprised of Morningstar Category Global Blend Equity Managers (onshore). Hedge Fund universe comprised of HFRI EH Market Neutral constituents.

[1] Results do not normalize for use of leverage.

2. UNCONSTRAINED VERSUS TRADITIONAL BENCHMARKS

Often, long only manager performance is benchmarked versus traditional market capitalization-weighted indexes, which can lead to performance-chasing behavior, especially in environments where only a handful of stocks contribute a meaningful portion of index-level returns. NVIDIA, for instance, contributed 34.5% of the S&P 500's return in the first half of 2024. Put simply, long only managers who were not long NVIDIA, likely underperformed their benchmarks. Thus, these benchmark-constrained investors find themselves faced with the decision to either 1) chase index performance by including these market heavyweights, resulting in less active selection alpha, or 2) underperform the market cap- weighted indexes to which they are being compared. Hedge funds are not typically benchmarked versus these same market cap-weighted indexes, making them less susceptible to these same pressures.

For these reasons, we find the current market construct particularly conducive to lower net or market-neutral strategies, with the ability to generate alpha on both the long and short sides of portfolios. Higher net exposure strategies, or those whose performance is benchmarked to market returns, may struggle to generate meaningful alpha given concentration at the index level.

DISPLAY 10

Short Interest Factor Performance Year-to-Date

Source: Bloomberg. January 1, 2024-June 30, 2024.

Conclusion

We believe the environment will remain rich with alpha opportunities for hedge funds. Although the Federal Reserve is likely to begin cutting interest rates, we expect base rates to remain higher from a historical standpoint, continuing to support dispersion and stock-picking opportunities. Additionally, looming elections and the potential for changing leadership in the U.S. could create further opportunities for individual stock selection based on policy implications. Plus, broad macroeconomic uncertainty, which drove pronounced bouts of volatility in July and August, illuminates the need for uncorrelated, diversifying sources of return. We remain confident that hedge funds will capitalize on the ongoing opportunity set and that the inclusion of market-neutral strategies may benefit a well-balanced portfolio.

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