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Banking Turmoil Implications for Hedge Funds:

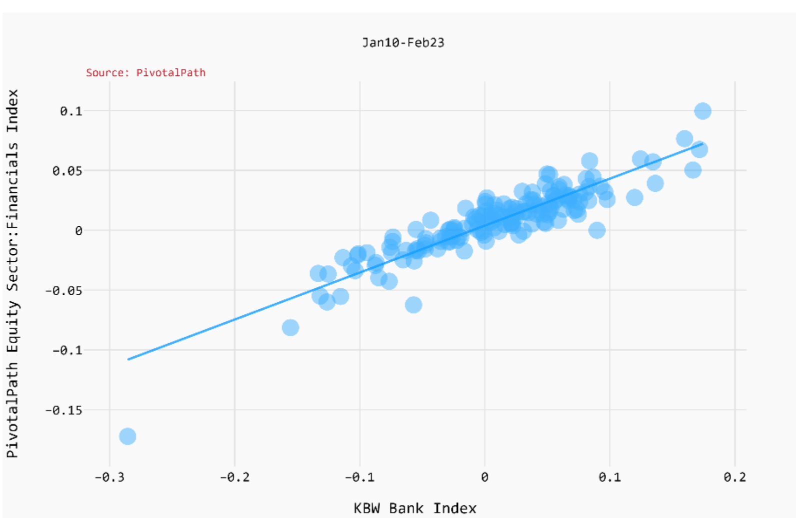
Hi all: in view of the recent banking turmoil we just wanted to show to our clients how to use PivotalPath tools to quantify banking sector exposure in the hedge fund industry. Using the KBW Index (MTD -24% as of Mar 16,2023) as proxy of the banking sector in our correlation tracker, we can screen for the highest exposure among funds and sector indices. This is what we found:

Indices	Beta to KBW	Corr to KBW
PivotalPath Index: Equity Sector: Financials	0.25	0.93
PivotalPath Index: Equity Diversified :U.S. Long/Short	0.28	0.76

Funds	Beta to KBW	Corr to KBW
Fund 1 (Equity Sector/ Financials)	0.42	0.93
Fund 2 (Equity Sector/Financials)	0.51	0.9
Fund 3 (Equity Sector/Financials)	0.7	0.88
Fund 4 (Equity Diversified/U.S. Long/Short)	0.61	0.86
Fund 5 (Event Driven/Equity Special Situations)	0.97	0.86

The highest correlation at the index level is observed for Equity Sector: Financials (EQSFIN), as expected. (Within this strategy group, 3 funds exhibit dangerously elevated exposure to KWB.) Digging deeper, we find that the strong relationship between KBW and EQSFIN holds pretty much steady after the great financial crisis of 2009, independent of the SP500.

An OLS regression for the period 2010-2023 yields EQSFIN=0.39*KBW+4.59% (R2=0.83), in annualized terms. The high R2 indicates a strong linear fit as evidenced by the scatter plot of monthly returns, while an annualized 4.59% alpha is what the sector is able to deliver, on average, on top of its 40% exposure to the KWB.



Notice that, during the period considered, there were 11 months of ‘bad’ (i.e. <-10%) performance months for KBW, and EQSFIN responded with negative performance in each of these 11 months. The worst being Mar 2020 (KWB -28.5%, EQSFIN -17.2%): of 25 ‘constituent’ funds within EQSFIN sector, two generated positive returns, one was essentially flat, while the rest returned between -6% and -36%. (Incidentally, these three ‘outperforming’ managers are once again best placed within their peer group to weather the current storm – at least as reflected in their exposure up until Feb 2023.)

The month is not over yet and hopefully the banking sector bounces back, but it would be interesting to monitor the spread in performance for this sector. Lastly, the situation changes once we consider the entire hedge fund universe. Here we find a broad distribution of exposures, with a beta ranging from -1 to +1.8, centered around 0.13 and with a positive skew.

Please let us know if you would like to learn more about our tools by emailing inquiry@pivotalpath.com.

About PivotalPath

PivotalPath is a trusted hedge fund industry expert. Harnessing its hedge fund research portal, PivotalPath enables a diverse set of institutional investors with over $300 billion in combined hedge fund investments with valuable insights and necessary tools for informed investment decisions.

Through our dedicated research team, we have built significant trust and lasting partnerships with hedge funds through transparency and by ensuring that allocators evaluate each manager in the right context. PivotalPath protects confidential manager information and only shares insights with its institutional investor clients.