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The Dramatic Effect Of Interest Rates On Hedge Fund Performance

Interest rates inform a significant portion of the news coverage we consume – and for good reason. As the fundamental building blocks of financial valuation, they affect the performance of the stock and bond markets, savings rates, mortgages, and many other aspects of our lives.

Importantly, they also significantly impact hedge fund performance and not necessarily in all of the ways you might expect. In building trust and partnerships with both hedge funds and institutional investors, PivotalPath has developed a comprehensive (>$2.5tn in hedge fund AUM) and representative set of hedge fund data, creating a unique window into evaluating strategy performance across various regimes.

This analysis is the first of a series where PivotalPath will parse hedge fund performance under various macroeconomic regimes, considering inflation, interest rates, and markets among other macro variables.

Our suite of Hedge Fund Indices enables us to directly analyze the performance of hedge fund strategies relative to interest rate levels using the 3-month Treasury bill rate (T3M) as a proxy for the risk-free rate. In an environment of rapidly rising rates, this data can be very informative for asset allocation decisions.

For example, the table below uses data from January of 2000 – November of 2022 and computes annualized returns for each Hedge Fund Index and the S&P 500 Index to observe differences in performance when rates were above and below 3%. It then calculates the annualized returns adjusted for the risk free rate, by subtracting out the T3M.

The spread in conditional performance is stark:

PIVOTAL PATH	Conditional Performance			Adjusted Performance		
Interest Rate Regime	T3M<3%	T3M>3%	spread	T3M<3%	T3M>3%	spread
# Months	*223*	*52*		*223*	*52*	
MACRO VARIABLES						
Mean T3M	0.78%	4.63%	3.85%	*0*	*0*	0.00%
S&P 500 Index	9.27%	2.36%	-6.91%	8.49%	-2.27%	-10.76%
HEDGE FUND PERFORMANCE						
PPATH Composite	8.09%	14.63%	6.54%	7.31%	10.00%	2.69%
PPATH Credit	8.18%	13.53%	5.35%	7.41%	8.91%	1.50%
PPATH Equity Diversified	8.09%	16.15%	8.07%	7.31%	11.53%	4.21%
PPATH Equity Quant	5.75%	5.43%	-0.33%	4.98%	0.80%	-4.18%
PPATH Equity Sector	9.55%	26.68%	17.13%	8.77%	22.06%	13.28%
PPATH Event Driven	8.10%	15.21%	7.11%	7.32%	10.58%	3.26%
PPATH Global Macro	8.31%	8.49%	0.18%	7.53%	3.86%	-3.67%
PPATH Managed Futures	7.85%	11.80%	3.95%	7.08%	7.18%	0.10%
PPATH Multi-Strategy	7.39%	16.73%	9.33%	6.62%	12.10%	5.48%
PPATH Volatility	6.60%	22.20%	15.61%	5.82%	17.58%	11.76%

**risk-free rate = 3-month Treasury Bill Rate **All returns are annualized*

Since 2000, the level of the 3-month Treasury bill rate has coincided with big differences in performance – which historically favors many hedge fund strategies relative to the S&P 500 Index. Here are some core observations:

- Using 3% as the threshold – the **S&P 500 Index** exhibited a large difference in performance, generating ~7% less per annum when rates were above 3% vs. when they were below.
- The **PivotalPath Hedge Fund Composite Index** not only generated 650bps more in periods of high rates, but it increased its excess return above risk free rate from 7.3% to 10%, an improvement of 270bps.
- The **PivotalPath Volatility Index,** which includes primarily tail risk strategies, have thrived in higher rate environments returning 22% per annum when rates were above 3% vs. 6.6% when below 3%, along with increased excess returns of almost 12% per annum.
- Interestingly, **PivotalPath Equity Sector** sub-indices had the largest improvement when rates were high, where even its growth dominated **Technology / Media / Telecom Index** increased returns by almost 11% per annum while improving excess returns by 7%. While significant, these differences may be partially attributed to the general euphoria

around growth over the last decade, which may be less likely to repeat itself given the change in investor sentiment between value and growth.

What can we learn from this? While historical data is never completely indicative of future performance, it can be informative, especially when representing changes to structural inputs such as interest rates.

As the Federal Reserve continues to maintain rates well above zero, representative Hedge Fund Indices and proper context should serve as a valuable guide to asset and strategy allocation.

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.