The following article was co-written by Jon Caplis of PivotalPath and Mike Jacobellis of New Holland Capital. The article features data and analysis drawn from multiple PivotalPath indices and offers commentary on hedge fund performance highlighting several key strategies throughout 2021. Together, the authors challenge underlying narratives about performance during the year and offer a much deeper context for many key drivers of returns and opportunities going forward.

2021 Was Better For Hedge Funds Than Many Realize. Here's Why.
By Jon Caplis, CEO of PivotalPath, and Mike Jacobellis, CIO of New Holland Capital

Overall hedge fund performance in 2021 was moderately better than its long-term average. While top-line performance in 2021 may not have turned heads, a deeper look under the surface reveals that there was significant dispersion in performance by strategy, providing an unusually attractive environment for allocators to outperform (or underperform) based on their positioning. 2021 also presented a vastly different set of challenges and risk factors from 2020, completely shuffling the leaderboard of hedge fund strategies.

As with most alternative investments, evaluating performance requires the right context. The PivotalPath Composite Index, (an asset-weighted index which tracks ~1,200 funds, across 44 strategies representing $2trillion+ in hedge fund capital) generated returns of 7.9% in 2021 with 4.0% volatility – comparing favorably to its 10-year average return of 6.7% with 4.8% volatility. The index also generated positive alpha of 3.0% (compared to 10-year average of 2.4%) relative to the S&P 500.

Of PivotalPath's 44 underlying hedge fund strategies/indices, only three had negative performance for 2021. However, these three strategies - healthcare, Technology Media and Telecom (TMT) and consumer/retail (which has high overlap with TMT) represent a large portion of the hedge fund universe and have been top contributors in past years. Indeed, PivotalPath's Equity Sector Healthcare and TMT Indices in particular sat at the top of the leaderboard for performance and alpha generation in 2020 and 2019; 2021 was the first down year for both indices since 2008. We drill into the drivers of the underperformance of healthcare and technology managers later in this article.

Given their consistent outperformance prior to 2021, the healthcare and TMT peer groups have grown to encompass ~$250bn, or over 10% of total hedge fund capital and 25% of equity capital that PivotalPath covers. Anecdotally, based on the numerous institutional hedge fund portfolios and indices that NHC monitors, there was a larger than normal variation between the top and bottom quartile performers in 2021, driven in large part by the size and nature of their exposure to the technology and healthcare sectors. Allocators that were overweight high growth / momentum technology strategies (which have increasingly ventured into late-stage private equity), as well as long-biased biotech strategies, suffered as these funds experienced meaningful losses during 2021 (which have continued into January).

Accordingly, institutional investors with a preference for relative value and arbitrage strategies tended to outperform (and importantly while taking minimal beta exposure). While PivotalPath's Event Driven index had a strong year (up 10.2%), certain sub-strategies meaningfully outperformed the headline number, including SPAC arbitrage, Equity Capital Markets and non-US merger arbitrage. Additionally, managers focused on commodity RV and quantitative equity strategies had strong returns (e.g., the PivotalPath Commodity Index was up 28.6% and the Quantitative Equity Index was up 16.5%).

A notable highlight (that also supports the benefit of a diversified hedge fund portfolio) is the multi-strategy peer group, which continues to generate strong risk-adjusted returns and meaningful alpha, while minimizing drawdowns. The PivotalPath Multi-Strategy Index (which includes over $250bn in capital comprising hedge funds that utilize multiple investment strategies across asset classes), returned 9.7% in 2021 and 12.9% in 2020, with little sensitivity to equity markets. While the Multi-Strategy Index performed well, many of the largest and best-known multi-strategy firms that have a bias towards the RV, arbitrage, commodity and quantitative strategies noted above enjoyed particularly outsized returns.

Deep Dive on Equity Long/Short

The negative performance of healthcare and TMT may seem counterintuitive given the S&P and Nasdaq's return of 28.7% and 21.4%, respectively, in 2021. It turns out, the explanations are bit more nuanced and sector specific.

Regarding healthcare, PivotalPath's Healthcare Index was the worst performing index in 2021 – losing 6.2% while generating negative alpha of -13.8% relative to the S&P. This compares to a return of 25.4% in 2020 with alpha of +15.5%. So, what drove negative healthcare performance? As it turns out, a lot of the same reasons for positive healthcare performance over the past few years, such as:

- *The SPDR S&P Biotech or XBI, which is a good proxy for smaller cap biotech, was down 20% in 2021 after being up 48% in 2020*
- *For healthcare managers playing in the Covid vaccine maker space, PivotalPath's SMID-cap Vaccine Basket was up only 8.6% in 2021 after being up an astounding 860% in 2020*
- *2021 also contained a confluence of healthcare factors including the lack of M&A in the space, an FDA operating without a head in the midst of a pandemic, bad data results, drug pricing concerns, along with possible corrections after significant returns in years prior*

PivotalPath's TMT Index lost 0.8% in 2021, exhibiting negative alpha to the S&P of -10.4%. It was the third worst-performing index after Consumer/Retail (down 4.4%), which typically has high overlap with TMT. This follows TMT's return of 35.9% in 2020 with an alpha of +23.9%, both topping all other strategies.

One might question why TMT managers significantly underperformed broader technology benchmarks such as the Nasdaq (+21.4%) and the Technology Sector SPDR (+34%) for the year. Again, many of the factors that contributed to longer term outperformance became significant drags in 2021, including the following:

- *Many TMT funds prioritized smaller-cap names, for example in SaaS and Mobile Payments*
  - *PivotalPath's SaaS Basket was up only 4% in 2021 after returning 124% in 2020*
  - *PivotalPath's Mobile Payments Basket was down 3.8% in 2021 after returning 101% in 2020*
- *PivotalPath's Social Distance Winners Basket was down 9.4% in 2021 vs up 127% in 2020*
  - *This includes Zoom and Peloton which were down 45% and 76%, respectively, in 2021*
- *The story of re-opening narrative toward the end of 2021 did not bode well for TMT compared to the social distancing 2020 environment*
- *Hedge funds in the space were also hurt by the Reddit short squeeze in January, rising rates, and growth rotations throughout the year*

In both healthcare and TMT, smaller funds (under $500 million) outperformed larger funds (over $500 million) in 2021 on both an absolute return and alpha basis. This is another reversal from 2020, when larger funds in both strategies outperformed. This divergence can be at least partially explained by underperformance in private investments and IPOs in these sectors in 2021, as larger managers are more likely to participate (and in larger size) in these markets.

Outside of Healthcare and TMT, the broader equity long/short universe faired better. Equity managers focused on the energy, industrials, and utilities sectors generated strong performance in both 2020 and 2021 (PivotalPath's Index was up ~15% in each year). After a challenging performance period lasting almost a decade, 2020 and 2021 represented back-to-back years of the strongest performance for these managers since 2013.

The Takeaway

So, what does all this mean for the way we evaluate hedge fund performance, especially as we think about the year ahead? Even with complete hindsight, understanding performance across 44 actively managed strategies requires meaningful context. As demonstrated above, digging below the surface with appropriate benchmarks can often lead to very different conclusions than headline performance and broad market benchmarks might suggest. Moreover, significant differences by strategy can lead to meaningful dispersion in the performance of hedge fund portfolios, even if they are all managed with low betas.

Hedge funds, when viewed in the right context, have continued to navigate unprecedented and challenging environments over the past few years. The healthy level of dispersion across a broad set of lowly correlated strategies bodes well for their ability to continue to perform, no matter the set of risk factors they face. Whether you believe equity valuations are too high, have concerns about runaway inflation, or merely want to mitigate volatility and losses in your overall portfolio, a well-diversified hedge fund portfolio can play an important role.