2025 HEDGE FUND OUTLOOK

As we begin 2025, we are excited about the opportunity set for hedge funds and are confident that strong performance can persist in what promises to be a dynamic and volatile market environment. With U.S. markets at or near historic highs, the potential for substantial change under a new Presidential administration, and evolving monetary policies globally, we believe hedge funds are poised to play a key role in investor portfolios, offering both valuable returns and essential downside protection. The detailed views that follow represent our opinions on recent industry trends as well as the prospects for hedge fund strategies in 2025.

Industry-Wide

Relatively high valuations underscore the need for diversification. Following a strong rally over the past year, valuations in U.S. equities are high relative to history on almost every metric,[1] and U.S. high yield credit spreads have reached lows not seen since 2007, before the Global Financial Crisis ("GFC").[2] These relatively rich starting points temper our forward-looking return expectations for passive beta exposure, and we believe alpha from active management will be an (even more) essential component to overall performance results in the years ahead. In our opinion, hedge funds, specifically, have a bright outlook with continued tailwinds from higher interest rates and with their flexible mandates, including the crucial ability to sell short securities that have unjustifiably high prices and poor fundamental prospects. Indeed, since the Federal Reserve's final rate hike in July 2023, hedge funds have delivered attractive "cash plus" returns while also living up to their diversification potential, protecting capital well when equities or bonds have sold off, as shown below and on the next page.

	HFRI Fund-Weighted Composite Index*	S&P 500 Index	U.S. Aggregate Bond ETF
Annualized Return	9.8%	22.2%	3.1%
Annualized Volatility	4.8%	13.0%	7.2%
Sharpe Ratio	0.85	1.21	-0.29

Data from July 2023 through December 2024.
**HFRI Fund-Weighted Composite Index returns are estimates based on preliminary data and subject to revision, which may be material.*
PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

[1] https://www.marketwatch.com/story/yes-stocks-are-crazy-expensive-right-now-these-5-charts-show-just-how-extreme-valuations-have-become-9b51857f
[2] Ice Data Indices, LLC, ICE BofA US High Yield Index Option-Adjusted Spread [BAMLH0A0HYM2], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/BAMLH0A0HYM2

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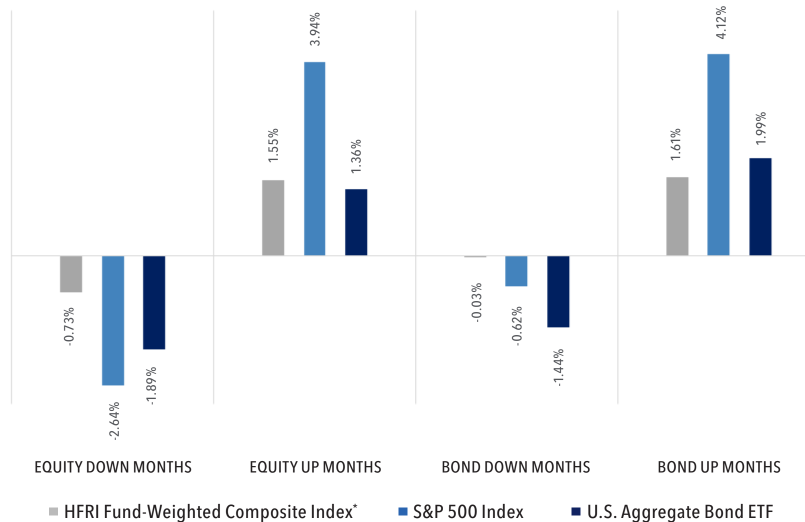
Average Monthly Returns in Up/Down Months for Equities or Bonds



Data from July 2023 through December 2024.
**HFRI Fund-Weighted Composite Index returns are estimates based on preliminary data and subject to revision, which may be material.*
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The hedge fund industry seems to have reached "peak pod." Numerous data points suggest that we may have reached an apex in the growth of multi-portfolio manager ("multi-PM") platforms or "pod shops." First, data from Goldman Sachs show that multi-PM firms are allocating significantly more capital to external portfolio managers (*i.e.*, single-manager hedge funds) today than they have in prior years.[3] At recent industry conferences, we have noted multiple pod shops in attendance as allocators, looking for external hedge funds with which to invest as opposed to marketing their firm to hedge fund investors. In our view, this suggests the pod shops likely have exceeded their optimal capacity and are either struggling to manage their existing asset base with internal PMs alone or are struggling to attract and retain incremental talent. In addition, asset growth has leveled off recently,[4] and numerous surveys have shown allocator demand for multi-PM firms has waned compared to 2023.[5] We believe a stabilization in the growth of pod shops is healthy for the hedge fund industry, though their presence remains palpable. We continue to see exaggerated short-term moves in individual securities, given the sheer amount of total capital managed in these highly leveraged strategies with similar risk models and drawdown limits. While this creates additional mark-to-market volatility, we believe that skilled managers with longer-term investment horizons can take advantage of these dislocations.

We have seen a robust new launch environment. Perhaps related to the peaking interest in pod shops, as noted above, the new launch environment was strong last year,[6] in both quantity and quality, including a notable pick-up in launches outside of the U.S. We continue

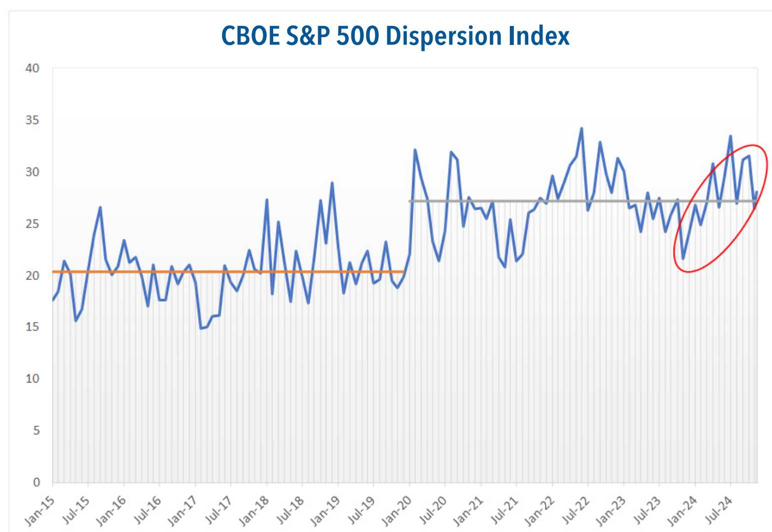
[3] Goldman Sachs Prime Services–Hedge Fund Insights & Analytics Team, *The Evolution of the Multi-Manager Landscape*, September 2024
[4] https://www.bloomberg.com/news/articles/2024-11-19/citadel-s-ken-griffin-says-multistrategy-hedge-fund-boom-is-over
[5] https://www.institutionalinvestor.com/article/2doixx00a4crrqa811kow/corner-office/multistrats-are-no-longer-the-hottest-thing-in-hedge-funds
[6] https://www.hfr.com/media/market-commentary/hedge-fund-launches-surge-to-begin-2024-as-industry-assets-rise-to-record/

to believe that many of the most talented and driven PMs ultimately strive to launch their own fund, not just manage a sleeve or portfolio within a larger firm. In addition, we believe there are alpha sources accessible through single-PM funds that are less commonly or effectively captured by the pod shops, particularly strategies that may be less liquid or more directional in nature.

Alignment is improving in hedge fund fee structures. Last year, we wrote that we believe a fair incentive fee structure for many hedge funds includes a performance-fee hurdle that is tied to the risk-free rate, and if short-term rates remained meaningfully higher than zero for an extended period, hurdles would become more topical across the hedge fund industry. We have seen that start to play out, with more institutional investors advocating for cash-based hurdles,[7] and we are pleased with the progress we have made on that front as well.

Long/Short Equity

A higher cost of capital is driving better stock selection opportunities in long/short equity. When borrowing costs are near zero, as they were for many years post-GFC, companies with low returns on invested capital ("ROIC") and/or heavy debt loads can survive or even thrive, leading to less meaningful differentiation between companies of varying fundamental quality. However, when there is a meaningful cost of capital, as there is today, companies with low ROIC or capital structures that are not sustainable at higher levels of interest rates are more heavily scrutinized. This leads to more notable winners and losers, driving increased dispersion between stocks, which is precisely what long/short equity strategies thrive upon. One measure of dispersion, the CBOE S&P 500 Dispersion Index, shows that dispersion, on average, materially increased following the onset of the pandemic in 2020, compared to the prior five years, and it has been trending higher since 2023, when policy rates peaked.



Source: Bloomberg. Monthly closing price data from 1/30/2015 to 12/12/2024.

[7] https://www.wsj.com/finance/investing/investors-in-hedge-funds-extract-lower-fees-for-subpar-returns-df29cf49

… and long/short equity alpha has been strongly positive. According to data from Morgan Stanley through November 2024, last year was one of the strongest years for long/short equity alpha since 2010. Furthermore, aggregate long and short alpha were both positive, contributing about equally to total alpha for the year through November.[8]

A lack of competition, higher short rebates, and the potential for meaningful change keep us bullish on long/short equity's prospects. We expect this favorable backdrop for fundamental long/short equity to continue in 2025. First, policy rates, while beginning to decline, seem likely to remain structurally higher compared to recent history, enabling the tailwind from meaningfully positive short rebates to persist.[9] Second, we believe there is high potential for fundamental change in many industries due to ongoing innovation and the rapid adoption of AI, which could lead to both new revenue and cost-cutting opportunities. Plus, the new Presidential administration seems intent on shaking up established policies. Such changes could be complex, challenging to analyze, and have profound implications for different economic sectors and individual companies. Thus, in our opinion, dispersion is likely to remain higher, with many fundamental winners and losers. Despite this favorable set-up and long/short equity's good recent results, we have not seen any data suggestive of meaningful changes in investor allocations. Within equities, the trend toward passive, long-only strategies continues, and within active management, a lot of capital remains in short-term, trading-oriented strategies, such as quantitative approaches and the multi-PM platforms. To us, competition for traditional long/short equity with a medium- to long-term investment horizon feels the lowest it has been in 20 years. We believe this should pave the way to greater alpha potential for the most skilled fundamental stock-pickers.

A power(ful) theme has emerged within the AI story. The growth in AI is driving a rapid rise in demand for data centers and the electricity that fuels them. McKinsey forecasts that global demand for data center capacity could more than triple by 2030, primarily driven by AI workload needs, and "to avoid a [supply] deficit, at least twice the data center capacity built since 2000 would have to be built in less than a quarter of the time."[10] Hyperscalers, such as Google, Amazon, and Microsoft, are in a race to secure data-center and power capacity that can support the substantial investments they have already made in AI semiconductors and technology.[11] These trends led to a sharp rally in certain power utilities in 2024. Even with that strong performance, this remains a theme among hedge fund equity portfolios as many believe current stock prices are more than justified by future growth potential. In addition, there are other potential beneficiaries of a build-out in data center capacity, such as industrial and telecom companies involved in the construction and improvement of electrical infrastructure, as well as green energy companies that are developing sustainable power sources. The new administration's quest for reduced regulation and other pro-cyclical domestic economic policies may supercharge this trend.

[8] Morgan Stanley Prime Brokerage–Strategic Content Group, *November 2024 Hedge Fund Recap*, December 4, 2024.

[9] Refer to this piece for more on how higher risk-free rates impact the total return expectations for hedge funds: https://www.evanstoncap.com/uploads/downloads/Evanston-Capital-Modeling-the-Expected-Return-for-Hedge-Funds-Should-It-Be-Higher-Today.pdf

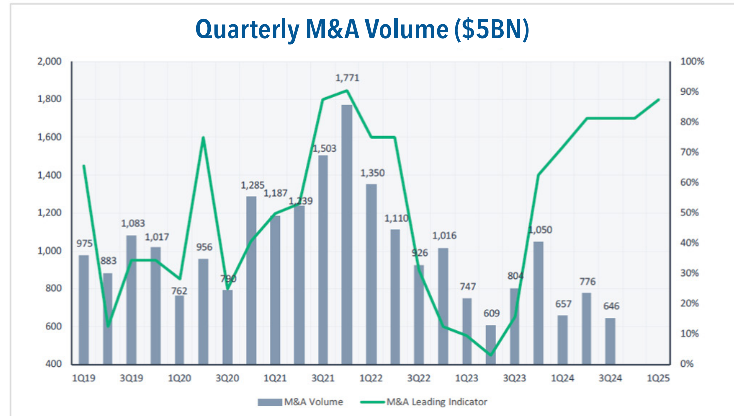
[10] https://www.mckinsey.com/industries/technology-media-and-telecommunications/our-insights/ai-power-expanding-data-center-capacity-to-meet-growing-demand

[11] https://www.cnbc.com/2024/10/14/google-inks-deal-with-nuclear-company-as-data-center-power-demand-surges.html

Investors would be wise to look beyond U.S. large-cap, growth stocks for alpha opportunities. As referenced above, equity valuations are high relative to history, especially within the U.S. large-cap, growth stocks that increasingly dominate market cap-weighted indices. While the Magnificent 7 certainly may continue to perform well, we think there is a limit to how much further their valuation multiples can expand. We like the idea of hunting for stock-selection opportunities in corners of the market where valuations are less demanding, such as domestic small-cap and value stocks as well as equities listed in Europe and Asia. These market segments often have sparser research coverage, too, increasing the chance that managers can develop meaningfully differentiated views through deep fundamental research. For example, investor sentiment in Europe remains low, and its equity markets have continued to starkly underperform the U.S. Yet, in speaking with bottom-up long/short equity managers, many see attractive opportunities to buy individual European-listed stocks of what they believe to be high-quality companies, some with global businesses, at attractive valuations. We also continue to see a dynamic backdrop in Asia with varying macro themes in individual countries. Our managers continue to be excited about stock selection opportunities in Japan given improved economic conditions, rising interest rates, and a renewed focus on corporate governance and shareholder returns. In India, our managers are cautiously optimistic: a compelling growth case with favorable demographics and a generally constructive policy approach is tempered by relatively rich valuations and softer near-term data points. China, meanwhile, remains complex. A second Trump presidency and the potential for punitive tariffs must be considered alongside a Chinese government that has signaled it will pursue stronger stimulus measures in 2025.

Event-Driven

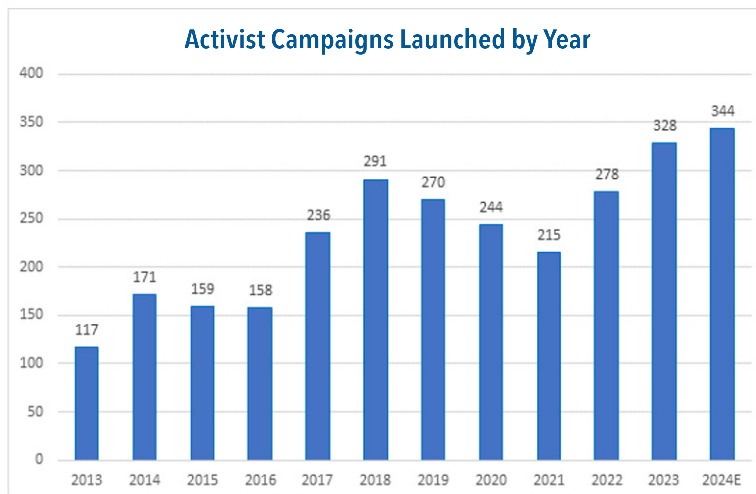
Corporate event activity seems likely to rise. Several factors point to increased mergers and acquisitions ("M&A") this year. Financing costs have stabilized, and the U.S. economy has remained resilient, increasing confidence in the broader macro backdrop, a necessary ingredient for a healthy deal-making environment. In addition, election uncertainty is now behind us, potentially relieving one logjam, and the new administration seems intent on reducing regulatory and antitrust constraints that could have thwarted some deals previously. Beyond strategic buyers, private equity also continues to have substantial dry powder, some of which has been committed and awaiting deployment for years. Indeed, Morgan Stanley's M&A leading indicator, shown on the next page, suggests deal activity could pick up materially in 2025.



Source: Tribune Investment Group and Morgan Stanley. M&A Volume data is for the period 1Q 2019 – 3Q 2024. The M&A Leading Indicator is a proprietary Morgan Stanley Index advanced two quarters which considers 32 different variables that measure how conducive the financial environment is for future M&A. Variables include CEO confidence, equity market performance, volatility across different asset classes, level of interest rates, credit conditions and spreads, as well as liquidity conditions across banks and corporates.

More M&A would translate into a greater number of corporate catalysts and the kind of transformational change that event-driven hedge funds can exploit, whether by anticipating such events, taking advantage of mispriced implied probabilities that announced deals close, or developing differentiated views of companies' post-transaction fundamental prospects (*e.g.*, the extent of realized synergies). In addition, distributions from private equity and venture capital funds have slowed in recent years as interest rates rose, valuations corrected, and the market for initial public offerings ("IPOs") stalled. We could begin to see exit activity and IPOs pick up in 2025 if market-friendly conditions persist.

Heightened shareholder activism also contributes to a rich event-driven opportunity set. According to data compiled by Tribune Investment Group, the number of activist campaigns rose substantially over the last couple of years and, as of the end of September, was on track to set a record in 2024.



Source: Tribune Investment Group and Bloomberg. Data is for the period 1/1/2013 – 12/31/2024 (estimated). 2024E is annualized based on results through 3Q 2024.

A greater number of recent campaigns have focused on operational or strategic initiatives versus advocating for a sale of the business.[12] In particular, with today's higher cost of capital, activism has increasingly emphasized improving capital allocation discipline and streamlining companies with multiple business lines or geographic footprints—for example, via divesting or spinning off non-core assets. However, we may see future campaigns shift back toward M&A objectives, assuming the macro backdrop is as conducive for M&A as we expect. Not all these campaigns will be successful, of course, but they do advocate for catalysts that have the potential to unlock meaningful shareholder value, creating opportunities not only for the activists leading the charge but for other event-driven investors, too. And, after a banner year for stocks, laggards may feel more pressure to bend to activist demands.

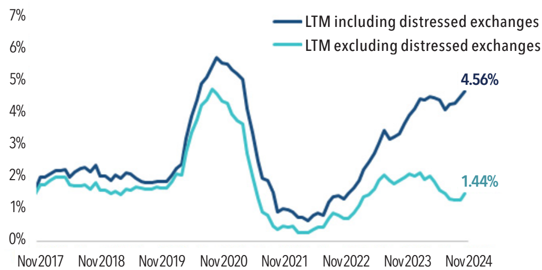
Although overall credit spreads are tight, we still see plenty of stressed/distressed situations, particularly within leveraged loans. Resilient economic growth and corporate earnings as well as supportive supply/demand dynamics have buoyed credit markets, and credit spreads now sit near historic tights. Still, overall yields remain relatively healthy, and there is ample dispersion by credit rating and sector, enabling credit managers to hunt for individual names that offer attractive risk-adjusted return prospects. In particular, the lower-rated segment of the leveraged loan market offers a wide spread differential.

Falling interest coverage ratios, impending maturities, liquidity needs, and related downgrades have plagued some borrowers in the (floating rate) loan market, leading to numerous stressed and distressed opportunities, and we expect this to continue. A relatively high proportion of the leveraged loan universe is lower rated, and according to a report by S&P Global Ratings, refinancing needs remain high for this cohort with approximately $53 billion of CCC-rated loans maturing in 2025 or 2026.[13] The structural characteristics of the loan market also can lead to significant mispricings. Specifically, the loan market is dominated by collateralized loan obligations ("CLOs"), which have a 7.5% cap on the amount of CCC-rated loans they can hold. This can lead to non-economic trading in the lower-rated segment of this market as loans are downgraded and/or CLOs begin to bump up against this threshold. In addition, we have seen increased selling pressure tied to fears of "creditor-on-creditor violence," which has become more commonplace. Hedge funds can take advantage of these sources of forced selling, building positions in the secondary market at potentially attractive discounts.

The prevalence of distressed exchanges and liability management exercises ("LMEs") reinforce the need for restructuring expertise. The troubles at the bottom end of the leveraged loan market, combined with weak credit documentation, have led to a record-setting volume of distressed exchanges and LMEs over the past year.[14] Though loan payment defaults have been declining recently, LMEs have continued apace, painting a very different picture of overall defaults in U.S. leveraged loans.[15]

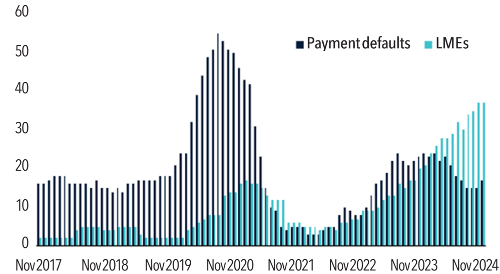
[12] https://www.ib.barclays/our-insights/shareholder-activists-record-pace.html#link4
[13] S&P Global Ratings, *U.S. BSL CLO And Leveraged Finance Quarterly: Cautious Optimism, But Still a Credit Picker's Market*, November 7, 2024.
[14] https://www.reuters.com/markets/us/ignoring-risk-investors-still-buying-us-junk-debt-with-weak-protections-2024-09-17/
[15] https://pitchbook.com/news/articles/us-leveraged-loan-default-rate-rises-after-three-november-bankruptcy-filings

Dual-track U.S. loan default rate: issuer count



Sources: PitchBook | LCD; Morningstar LSTA US Leveraged Loan Index. Data through Nov. 30, 2024.

U.S. leveraged loan defaults: trailing 12-month count



Sources: PitchBook | LCD; Morningstar LSTA US Leveraged Loan Index. Data through Nov. 30, 2024.

LMEs are out-of-court restructurings that can be contentious and potentially result in varying treatment of the company's lenders, even if they are involved in the same loan—thus earning the label of "creditor-on-creditor violence." From discussions with our managers, this dynamic is expected to continue in 2025, and we believe it favors hedge fund managers with scale and deep restructuring experience as well as relationships across the investor, financial sponsor, and advisor communities. Forming ad-hoc creditor groups or signing a more inclusive cooperation agreement can be the best defense in these situations, strengthening negotiation power with the company and its shareholders, and creditors left out of the majority group are at higher risk of a negative outcome.

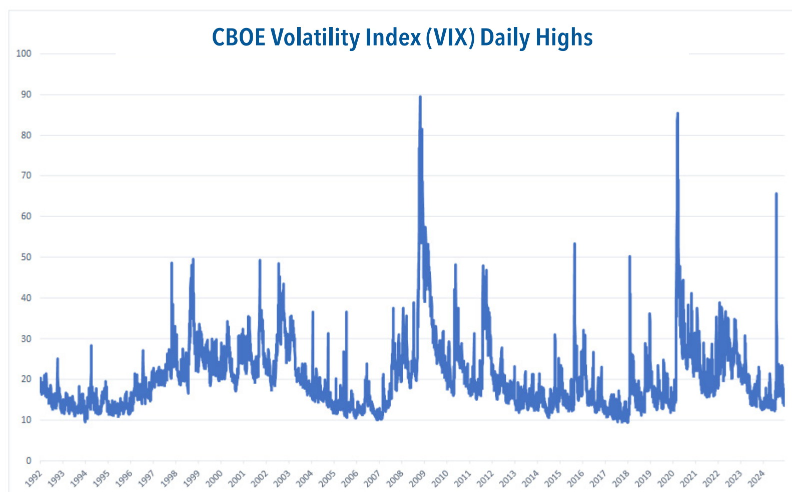
Global Macro

A less interconnected world leads to increased dispersion. Trends toward deglobalization and trade protectionism seem to be driving us toward a less interconnected world with a higher chance for meaningful divergence between individual countries and regions. We have already started to see this with more varied economic conditions and central bank actions across the U.S., UK, Europe, Japan, and China in the past year. We believe this will extend a stretch of more diverse trading opportunities for global macro managers compared to the years of more globally coordinated monetary policy that saw rates almost universally pinned near zero. The flexibility to look across different geographies and asset classes, including their derivatives, to find the best risk/reward way to express macroeconomic views will be an increasingly important source of alpha, in our opinion.

Managers may find more opportunities in currency trading. With the heightened probability of tariffs and trade wars in 2025, currencies could become more important shock absorbers. For example, China or other exporting nations subject to tariffs could consider devaluing their currencies to help offset the tariffs' impact on export prices, and multinational businesses may need to hedge currency exposures more carefully amid evolving trade policies. These types of tactics and flows could lead to larger moves in exchange rates and a more dynamic currency trading environment for macro managers. In addition, the new U.S. administration

seems likely to promote a more favorable regulatory environment for digital currencies, and crypto markets already responded with a dramatic run-up into year-end. While our managers generally remain skeptical that we will see the creation of a U.S. strategic bitcoin reserve in the near future, some see the potential for a continued renaissance in digital currencies given a more crypto-friendly stance among policymakers and the prospect of broader investor participation in these assets—for instance, BlackRock recently recommended interested investors consider allocating up to 2% of their portfolio to bitcoin.[16]

New governments and a greater probability for policy change portend higher volatility and fatter tail risks. After the "super year" of elections, which saw incumbent political parties commonly defeated, it seems that change may be the one thing we can count on in 2025. The proposed policies of the new U.S. administration alone could have significant implications for trade, inflation, monetary policy, and economic growth in the U.S. and globally. Indeed, our macro-oriented managers all agree that the world is decidedly more "macro" under a second Trump Presidency, and the potential for disruptive policies likely leads to higher market volatility as well as an increased probability of tail events in the year ahead. We view this as a source of both opportunity and risk for macro managers. We believe macro managers should place a premium on identifying mispriced optionality and building positive convexity into their portfolios to guard against, or potentially even benefit from, seemingly low-probability scenarios. For the same reason, we also believe managers need to approach crowded trades with caution, as sudden trend reversals and deleveraging activity could exacerbate short-term price moves. For example, one may be surprised to see in the chart below the next page that the CBOE Volatility Index (VIX) reached highs in August 2024 that approached levels seen in 2008 and 2020, yet there was no exogenous event on par with the GFC or COVID at that time. Rather, the spike in volatility in August 2024 was positioning-induced, driven in part by a sharp unwinding in Japanese yen-funded carry trades. And, it's worth noting that the S&P 500 Index ended that month *up* 2.4%!



Source: CBOE Global Markets. Data from 1/2/1992 to 12/9/2024.

[16] https://www.reuters.com/markets/us/blackrock-recommends-bitcoin-portfolio-weighting-up-2-interested-investors-2024-12-12/

Relative Value

Heightened volatility and dispersion generally benefit relative value strategies, too, but beware highly leveraged strategies that overly rely upon historical relationships. Relative value ("RV") strategies seek to exploit pricing inefficiencies between related securities or some second order aspect of the market, such as implied volatility. In general, the return potential of these strategies rises when the spread or dispersion between correlated securities is higher, and they can capture that spread as prices revert toward their historical mean. Heightened market volatility can lead to bigger dislocations triggered by unusual volume in particular securities, option exercises, or stop-losses. Relative value strategies can capitalize upon those situations if they enter such events from a position of strength. However, historical risk models and correlations may break down in an environment that seems unusually ripe for change. We believe that presuming predictable or static risk in the year ahead could be dangerous, especially for highly leveraged RV strategies.

We are constructive on the opportunity set for convertible bond arbitrage. Convertible bond arbitrage is a good example of an RV strategy that often benefits from higher volatility, as it provides more opportunity to generate returns from delta hedging (*i.e.*, adjusting the size of equity short positions relative to long positions in convertible bonds as stock prices rise/fall). In addition, two central themes aided performance in convertible bond arbitrage in 2024, and we expect both to continue this year. First, new convertible bond issuance has been robust via both refinancings as well as new entrants attracted to convertibles' generally lower coupon rates relative to straight debt. When setting aside the anomalous COVID period (2020-2021), convertible bond issuance last year was the largest since 2007,[17] and from conversations with our managers, issuance is expected to remain healthy in 2025 so long as market conditions remain benign. Second, we have seen a rise in corporate actions, such as bond buybacks and exchanges, as the large swath of convertible bonds issued in 2020-2021 begins to approach maturity. According to data compiled by Bloomberg as of September 2024, approximately 40% of dollar-denominated convertible bonds are coming due by the end of 2026.[18] Convertible bond managers can benefit from this refinancing activity as outstanding bonds are often repurchased at a premium, and existing bondholders may receive favorable allocations to any associated new issues.

We continue to search for alpha sources in smaller RV managers or more niche strategies. RV strategies sometimes risk commoditization as capital piles in and arbitrage opportunities dissipate. For this reason, we try to identify RV managers that we believe can differentiate by trafficking in more niche areas of the market. Today, we see such opportunities in catastrophe reinsurance, where supply/demand dynamics and another year of significant losses for the insurance industry translated into reinsurance premiums that have eroded some year over year but remain high relative to history. We also believe smaller managers in RV strategies such

[17] Source: Barclays Bank PLC
[18] https://www.bnnbloomberg.ca/investing/2024/09/13/hedge-fund-arb-trade-surfs-140-billion-wave-of-debt-coming-due/

as volatility arbitrage, mortgage trading, and systematic strategies may have an advantage if they can trade more quickly with less market impact, if they can invest with greater tolerance for mark-to-market volatility, or if they can correctly anticipate the flows of larger peers. In particular, we believe that AI may help level the playing field for smaller quantitative managers, as it can dramatically reduce the time and labor involved in coding and software development, and if trained correctly, generative AI can augment or replace certain research resources. Both should enable smaller teams to do more R&D than ever before.

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