Forecasting Beyond the Credit Crisis – Part 4: Conclusion

In the conclusion to his fascinating four-part series, Philip Niles suggests that now, perhaps more than ever, is the time for hedge funds to truly show their worth.

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Over the past several issues of **Canadian Hedge Watch**, it has been argued that the United States' equity markets are currently embroiled in a secular bear market which could continue for some years to come. Following closely from this conclusion, it is important that recommendations are made for investors for both the short term and the long term. Indeed, while it is certainly useful to identify and categorize current market conditions for academic and empirical reasons, a practical application of these findings has always been the end goal.

Stock market returns are an important factor to a number of interested parties for a wide variety of reasons. For individual investors, the vast majority of retirement ideas and financial planning tools are based on a certain return for an equity portfolio. Without sufficient returns on invested capital, a great number of people will not be able to meet their financial goals, whether they are financing retirement, college tuition, a second home, or any number of other costly items. For pension plans, an inability to generate sufficient investment returns could result in a situation where the plan itself is underfunded, leading to decreased benefits for plan members. Such a situation would be even more devastating in the case of national pension plans where citizens are absolutely dependent upon these benefits to finance their lives.

Based on the experiences of past secular bear markets, very low, perhaps even negative, real returns on investment can be expected in the U.S. equity markets over the coming years. Nominal returns during secular bear markets are just slightly more than one percent, meaning real returns are perhaps zero, if not negative. Table 1 (below) presents the last six secular market cycles, their duration, and the average yearly return on equities over that time span.

Secular Bear Markets	Duration (Years)	Average Yearly Return	Secular Bull Markets	Duration (Years)	Average Yearly Return
1906-1921	16	1.58%	1922-1928	7	17.20%
1929-1949	21	1.69%	1950-1965	16	10.60%
1966-1982	17	1.59%	1983-1999	17	15.30%

Table 1: Dow Performance During Secular Bull and Bear Markets Source: The Author (2009)

The picture that is painted for current equity markets is not favourable. The past three secular bear markets, presented on the left half of the table, show that returns have been downright terrible during such periods. But our original question remains: if low or negative real returns on investment are to be expected for the equity markets, what are the other alternatives for investors seeking to maximize their real investment return? Now, perhaps more than ever, is the time for hedge funds to truly show their worth, as they present the best alternative to maximize returns to investors in any type of market environment.

Table 2 (below) outlines the expected return, the standard deviation of returns, and the risk-to-reward ratio for a variety of broad-based investments covering the latter portion of the most recent secular bull market and the beginning of the current secular bear market (that is, covering the years 1990-2005). The assets covered are the S&P 500 index, the 10-year U.S. Treasury Bill, the NASDAQ index; the European, Australasia, and Far East (EAFE) index, the Hedge Fund Return Index (HFRI) Composite and Fund of Funds (FOF) indices, and cash.

Asset Class	Standard Devion (Risk)	Expected Return	Risk / Return
S&P 500	18.42%	12.43%	1.482
10 Year US Treasury	8.13%	8.48%	0.959
NASDAQ	35.08%	16.38%	2.142
EAFE	19.91%	4.87%	4.088
HFRI Composite	11.42%	14.94%	0.764
HFRI FOF	9.51%	10.43%	0.912
Cash	1.93%	4.49%	0.430

Table 2: Return, Standard Deviation, and Risk/Reward: 1990-2005
Source: Anson (2006, pp. 75)

A few interesting points can be derived from the above presentation. First, we note that (not unexpectedly) the lowest return comes from investments in cash. In these uncertain times, investors, both individual and institutional, have hoarded cash in their savings accounts rather than putting these funds to work in any number of investment vehicles. Common sense and the above figures show that, over the long term, this will generate nothing but lackluster returns. Certainly, with a cash investment, the likelihood of losing money is essentially nil, but an investor in cash is paying a high price for such safety.

Perhaps the most telling and interesting point comes when the risk/return profile of the investments are studied with some depth. In effect, the chart above presents a computation of how much risk an investor must incur in a particular asset in order to gain 1% additional return; as such, the lowest possible ratio is favoured, assuming a rational investor. It can be seen that, on a risk-adjusted basis, the hedge fund investments beat every investment class other than cash, even the 10-year US Treasury. More to the point, an investment in the HFRI Composite Index produced higher annual returns with far less risk (as measured by the standard deviation) than a similar investment in the S&P 500. The HFRI Composite not only outperformed the S&P 500 in terms of absolute returns, but also on a risk-adjusted basis.

In the end, an investment in an alternative asset of some variety, whether a hedge fund, private equity fund, or a similar derivation, will likely outperform an investment in the Dow Jones Industrial Average index. There are a few reasons why this should be the case. First, hedge fund portfolio management is a skill-based profession and these investment companies are infamous for attracting top investment managers. It is reasonable to assume that a talented investor at the helm of a given hedge fund will beat the market average and the results presented in Table 2 support this notion, especially on a risk-adjusted basis. Second, the flexibility available to hedge fund managers is unparalleled in regards to risk management. For example, as the name suggests, hedge funds are able to hedge their positions at their discretion. Through the use of options or swaps, a money manager at a hedge fund has tools at their disposal for controlling risk in a given position, limiting the potential downside on a particular investment position.

Additionally, there are far more investment choices other than the traditional long/short equity hedge funds that normally come to mind when alternative investments are considered. The selection is endless: distressed debt, global macro, short only, real estate, commodities, etc. The sky is truly the limit when it comes to the focus and strategies of hedge funds, and this simple fact would allow an investor to craft an appropriate investment mix to achieve the necessary risk/reward scenario as well as to achieve sufficient diversification.

U.S. stock markets have experienced a great deal of turbulence in recent memory. The deteriorating housing market in the United States has only compounded the difficulties faced by the stock market, and the general slowing of the American economy has proven to be too much for equities. Since 2000, the Dow Jones Industrial Average has fallen, presenting negative nominal returns on investment and even darker real returns. While some pundits and speculators have claimed that the difficulties are temporary in nature and will correct themselves in the very near future, others claim that this is not the case, pointing rather towards an underlying market trend as the culprit.

While it would be fortunate if the underlying difficulties were merely temporary, the current examination has come to the conclusion that the Dow Jones Industrial Average is currently experiencing a secular bear market, which features low, if not negative, real rates of return on investment. This conclusion is drawn from a study of the Dow/Gold ratio, the market Price/Earnings ratio, and the change in the level of the money supply. Specifically, all three variables reached key inflection points around the turn of the 21st century. Each of these moments point towards the onset of a secular bear market similar to like trends witnessed over the course of the history of stock market measurement and observation. Given past experiences with secular market trends, and secular bear markets specifically, the current market conditions can be expected to continue until sometime between 2015 and 2020 and realize investment returns of approximately 1.5% per annum over that time frame.

Given the less than appealing returns on investment which can be expected over the coming years, investors would be wise to turn towards substitute investments outside equities. Perhaps the most compelling option is alternative investments, most notably hedge funds. A number of alternative investment strategies should provide an investor with a robust return on investment which will outpace the equity markets over the remainder of the secular bear market as well as keep risk to a minimum at a given level of return.

However, despite all of the negativity, we will finish with a ray of light that can be taken from the above analysis. The past three secular bear markets have featured a nominal rate of return just slightly higher than 1%. Note, however, that this number, though pathetically low, is still positive. Thus far in the current secular bear market, nominal returns are massively negative. By extension, if past market conditions are an indication, the current secular bear market should finish with a positive nominal return on investment. This means that, since returns have already been so largely negative, there appears to be some upside potential over the short-to-medium term, even while markets continue to work out this secular downturn. *

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