Hedge Funds in 2023

2022 began with the everything-rally turning into an everything-sell-off as macroeconomic and geopolitical events sparked a concerted sell-off in stocks and bonds, leading to net outflows for the hedge fund industry. Many felt this was the year we would come to know who has been skinny-dipping in the ocean. There were moments of extreme shock with situations such as the LDI crisis in the UK and then the FTX bankruptcy, but thankfully we didn't have a Lehman-like moment. Investment professionals believe there are certainly pockets of hidden leverage, but no system-wide concern, at least as of now.

In the ensuing volatility, hedge funds were able to outperform the broader market, supporting the case for active investments. It has been over a dozen years since the last crisis. That means investment professionals with even a decade of experience have not witnessed a major bear market (the Covid sell-off would have given them a glimpse of it). Will 2023 be that year or has the Fed perfected its landing?

2023 will be a challenging year for hedge funds, especially the smaller fund managers. Below are my thoughts on emerging and new fund managers for the upcoming year.

1. **Small fund managers will face difficulty in raising funds:**

   Fundraising will be difficult for smaller hedge funds in the coming year as central banks continue to tighten liquidity. Given the uncertain macroeconomic environment, the rising count of layoff announcements, and the sell-off in markets in 2022, LPs are holding back from making investments in smaller fund managers. The larger managers would get a bigger portion of the pie, as allocators are more comfortable with the risk protocols built into the bigger names. For fundraising, prime brokerage cap intro events and independent events help to get in front of the right people, but it will be on the fund manager to build those relationships. New fund managers should understand that the allocation decision will happen when the LPs are ready, and not when the fund managers want it. Therefore, they need to continue to be in touch and build relationships.

   Developing good professional marketing material also goes a long way in LP meetings and helps stand out in a crowded market environment. At TresVista, we have seen clients reach out to us to develop new brochures and marketing materials or even jazz up their previous material ahead of big conferences like the Context Summit. We are also seeing requests to help implement and manage client CRMs to keep track of and have information at hand about various conversations.

2. **Communication with existing LPs is important in the current scenario:**

   While new fundraising is a continuous process, it is also important to keep the current investments and limit outflows, especially in the current economic scenario. In this context, it is important for fund managers to communicate with their LPs. LPs will have questions about the market, the outlook, and the fund manager's thoughts. In addition to the quarterly letters, we suggest increased communication between the fund managers and LPs. During a bull cycle a quarterly letter suffices, in the current scenario, I will suggest the same thing to fund managers that I did when working remotely during Covid – increase communication frequency and be proactive. Initiating one-on-one calls with every LP will be helpful. A call in a six-month time frame in this economic scenario should suffice. Discussions should be held with all LPs, and all LPs should be treated equally. I came to know of a scenario where a hedge fund held an annual meeting, but only called some selected LPs. As one would expect, it did not go down well with the other LPs who felt left out. We are in a service industry at the end of the day. Several funds with average performance continue to grow AUM because they treat LPs very well.

3. **Move toward value will continue in 2023:**

Growth stocks have outperformed Value stocks since the Great Financial Crisis, till late 2020. This led to a large movement of funds to Growth during these years of outperformance. The outperformance of Growth was exacerbated by Covid, as central banks pushed in more liquidity and the trend of digitalization accelerated. Investors took the growth due to this and extrapolated it to long-term growth rates. However, since 2021, Value stocks have made a comeback, sparked by tightening monetary policy, which reduced the present value of the cash flows expected in the distant future of Growth stocks. Growth expectations were also normalized as countries lifted Covid restrictions, and the world (excluding China) moved back to normalcy. Value stocks are back from slumber, outperforming in 2021 and 2022. Investors have started to move back to Value stocks and the trend will continue in 2023.

4. **Opportunities from volatility and macro environment:**

The increase in volatility due to tightening liquidity, and the turn in the economic cycle would create opportunities for hedge fund managers to outperform the benchmark. In such a scenario it is good to have an increased watchlist of potential opportunities. Small and emerging fund managers have limited resources, and they could look to utilize offshore service providers like TresVista to augment their research desks. We are seeing client requests to run different screeners to look for new ideas, build models, and conduct initial research on new shortlisted ideas. Fund managers have also asked us to run scenario analyses on the impact of rising interest rates and lower spending on portfolio companies. Further, we are seeing fund managers look at previously ignored sectors as they have fallen out of favor or would be impacted by the turn in the cycle.

5. **The worst may not be over:**

The latest US inflation numbers have come in below expectations, resulting in the S&P500 rallying in October and November. This led to calls of a bottom being made and a new bull rally. However, risks persist as the Fed continues to raise interest rates in a slowing economy. The yield curve remains inverted, suggesting a recession, and the count of layoff announcements continues to rise while earning expectations are being downgraded. Though there don't seem to be any systematic risks like those seen during the Great Financial Crisis in 2008, there is a risk from hidden pockets of leverage. We got a glimpse of how quickly things can fall apart with the

LDI crisis in the UK. Fund managers should continue to be careful about leverage, consumer spending, and their impact on valuations and earnings.

6. **Digital transformation:**

   It is important that small and emerging fund managers look at technology to improve the firm's efficiency, especially in the current high inflationary scenario. The use of technology to ease client onboarding, improve client experience, and automate the resource-intensive back office and compliance processes will help maintain long-term competitiveness. It does not make sense for small fund managers to hire a technology stack at their scale. So, they can either hire an offshoring partner like TresVista for customized solutions or go for an off-the-shelf software solution, with the only drawback being limited customization with the latter.

7. **Move back from digital to more traditional assets:**

   The FOMO which caused an increasing interest in new digital assets like cryptocurrencies and NFTs has ended with a sharp drop in digital asset prices and trouble at many crypto businesses (FTX being the biggest). Though believers blame the businesses and not the asset itself, the fact remains that investors are hurt and wondering where decentralization is. For contrarians, it might be a good time to buy, but the fallout of the implosion of the second-largest exchange will continue to reverberate and push investors back to more traditional assets.

8. **Secular trends of ESG, data, and shareholder activism to continue:**

   Structural themes around ESG and data that we have seen over the past few years would continue in 2023. Sustainability will continue to get more important and become a more regular part of investment criteria. The recent step by the EU to tax imports based on emissions would accelerate the inclusion of ESG in investment decisions. Non-quant fund managers also continue to look for ways to include more data in their investment decisions.