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OPINION

OTHER VIEWS BRANDON SMITH

Long/short equity — unconventional inflation hedge whose time has come

After a decade-plus in which investors haven't had to consider downside scenarios, emerging questions about the prospects for inflation have many considering hedging strategies to help offset the risk. The caveat, however, is that thanks to historically low interest rates, what worked in the past won't necessarily have the same effect going forward.

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Consider, for instance, the correlations evident across equities and bonds. The S&P 500 index shed 19.96% in the first half of the year, marking its worst performance since 1970. Bonds provided little to no relief, as the Bloomberg U.S. Aggregate Bond index of investment-grade securities fell by 10.35% in the first half. This, too, marked the worst start on record based on data dating back to 1975. Industry observers for years have been saying that the 60/40 portfolio is becoming obsolete; the markets in 2022 are now echoing this same sentiment.

As inflation becomes more acute and as the Federal Reserve embraces a hawkish stance, the question on the mind of allocators is where they can find an adequate hedge against inflation. At this point in the cycle, it can feel like trying to book brunch reservations on Mother's Day morning. While most liquid alternative funds are designed as a diversifying exposure for longer-term strategic allocations — vs. tactical exposures to react to a shifting market — value-oriented, long/short equity strategies can be well suited for the current backdrop.

Consider, for instance, the shortcomings of bonds today. Many fixed-income portfolios reflect a tilt toward long-duration exposures, a response to the historically low interest rates. As a result, these allocations — rather than providing their traditional ballast function — are susceptible to any move higher in interest rates. This would likely be true in both a more pronounced inflationary scenario as well as a Fed reaction to improving economic growth.

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Not to try to predict the future, but the former seems more likely in the near term.

Inflation reports released during June 2022 were quite daunting. Consumer prices surprised to the upside in May with the headline CPI up by 8.6% year-over-year vs. a consensus estimate of 8.3%. Meanwhile, the core PCE, the Fed's preferred inflation measure, increased by 4.7%.

Given the economic news, the Federal Open Market Committee hiked the federal funds rate by 50 basis points in its May meeting and by 75 basis points at both the June and July meetings. The Fed also telegraphed future rate hikes would be needed to quell inflation. This would likely create headwinds for long-duration fixed income for the foreseeable future.

As the cost of capital escalates, equities too

are most likely going to be affected. And the most expensive areas of the market — which anecdotally make up a large proportion of short books today — are also segments disproportionately impacted in a rising-rate environment. Growth stocks, in particular, have also been hurt by the increase in interest rates, given the "long-duration" nature of their future expected profit streams.

Perhaps more than any other group of names, the FAANG stocks — Facebook Inc. (now Meta Platforms Inc.), Apple Inc., Amazon.com Inc., Netflix Inc. and Google (Alphabet Inc.) — have come to define the extended rally over the past decade.

More recently, this group has symbolized the volatility among growth stocks. As of July 15, the group was down by over 40% year-to-date.

On the other hand, the undervalued corners of the market, likely representing the long exposures of most value strategies, could continue to benefit as investors rotate into high-quality segments of the market and scrutinize fundamentals to better assess business momentum and manage risk.

In terms of style, the value cycle continues to surge ahead. In the first half of the year, the Russell Value benchmarks — the Russell 1000 Value, the Russell Mid Cap Value, and the Russell 2000 Value indexes — beat their Russell Growth counterparts by an average of 14.04%. This was the largest performance gap between value and growth since the bursting of the "dot-com" tech bubble in 2000.

To be sure, there is no shortage of variables that can influence performance in an inflationary environment. If the economy continues to grow, for instance, traditional hedges such as gold or Treasury inflation-protected securities have historically underperformed, according to research from consulting firm Meketa Investment Group. However, in more extreme scenarios, in which there's an acute inflationary spike over an extended period, these categories have provided the counter-cyclicality for which they're generally associated.

An active, value-oriented approach in executing a long/short strategy can help allocators take the guesswork out of trying to predict how the inflationary cycle will ultimately take shape. This is particularly the case in a market that has a new appreciation for fundamental analysis and risk.

The outperformance of value last year and in the first half of 2022 shouldn't be unexpected. Looking at the top quintile of stocks whose price appreciation has been most correlated with the downward trajectory of Treasury yields, the names in this cohort traded as high as a 70% premium to the overall market over the past six months, based on analysis from Empirical Research Partners LLC. The top industries in this grouping consist of software and internet services, medical technology, and biotech.

Conversely, analysis from Empirical Research Partners also shows that the bottom quintile of equities showing the strongest anti-correlation to downward moving Treasury yields revolve around cyclical industries, including banking names and companies in the consumer finance, insurance, industrial equipment and machinery sectors. This grouping, over the same time period, traded at its all-time largest discount compared with its long-term average.

Again, there's no telling what the future holds for the markets, the economy or even how policymakers may react to whatever unfolds. It may not be a conventional hedge, but an actively managed, value-oriented long/short equity strategy is uniquely positioned to potentially provide investors with counter-cyclicality amid the uncertainty. It may sound like a hedge, but a short book targeting the most overvalued names may also represent an additional lever to capture alpha amid a correction. At the same time, these strategies can allow managers to calibrate their approach based on the evolving opportunity set in front of them. This is what makes value-oriented long/short an unconventional, but potentially effective hedge today. ■

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