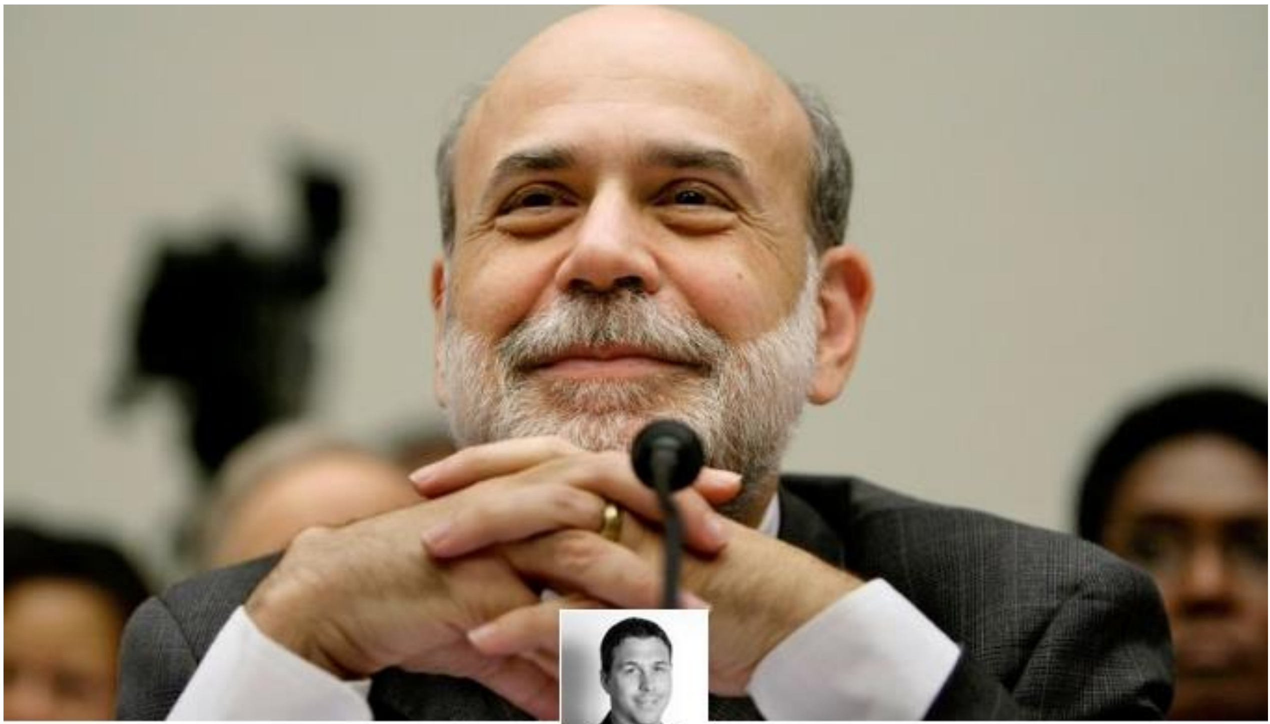
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If You Can't Beat Them, Hire Them

Emblematic of the state of the financial world, former Federal Reserve Chairman Ben Bernanke is taking an advisory role with Citadel, the $25 billion hedge fund based in Chicago. Making less of a splash but certainly worth pointing out, Bernanke follows the footsteps of Jeremy Stein, who recently departed his post as a voting member of the Federal Open Market Committee prior to joining BlueMountain Capital Management as a consultant.

On the surface, these moves likely appear to be the simple case of a few public servants seeking the opportunity to make a little money in their post-servant lives. In reality however, there is a more likely root cause.

For years, hedge fund returns have suffered relative to traditional market returns. Central bankers around the world have worked in earnest to thwart volatility and to keep markets calm. Hedge funds by comparison, revel in unbalanced markets where volatility creates opportunity. The addition of two significant Federal Reservists to the hedge fund world underscores one key investing tenet, "Don't fight the Fed."

Many hedge funds were able to generate eye-poppingly good returns in 2008 and 2009 when, thanks to the Great Recession, volatility was abundant. Since that time, many hedge funds have been largely vexed by the overall tranquility of capital markets and the lack of any meaningful market sell-off in the S&P 500 for over 1,000 days, and counting.

The last real spike in volatility came back in 2011 when the markets were forced to deal with oil prices spiking from $75/bbl to over $100/bbl, the U.S. debt downgrade and the tsunami in Japan. Since then markets have dealt with innumerable potential pitfalls, taking them all in stride. The debt ceiling and government shutdown, the significantly negative polar vortex effect on GDP, corporate earnings forecasts missing expectations, Greece parts 1, 2 and infinity, the rapidly rising dollar, Vladimir Putin vs. the Ukraine, the Ebola scare and ISIS have all had the potential to cause the markets to pause or retreat, though none managed to do so.

How can so many potential negatives all be so unceremoniously dismissed by the markets? With a touch of irony, the market has been responding just the way former hedge fund manager Martin Zweig predicted it would. His famous saying, "Don't

fight the Fed," expressed his belief that when interest rates are going down, markets go up. And interest rates have certainly been going down.

In addition to falling rates, central bankers around the world have locked arms in their fight against volatility through various quantitative easing ("QE") programs. QE is the policy playbook central bankers go to when standard monetary policy fails, in order to stimulate economic growth and to quell financial market instability. Simply put, central bankers print money to buy financial assets, increasing asset prices and lowering asset yields. And as stated above, when interest rates are going down, markets typically are going up.

What has ultimately been so frustrating to hedge fund managers, and consequently their investors, is the magnitude and duration of these coordinated QE measures. The first round of U.S. QE ended in 2010. The prevailing thought was that as QE ended, interest rates would normalize or in this case, move higher. This was not the case however, as QE 2, QE 2.1 and QE 3 were subsequently needed to simply keep markets stable and create some modest economic growth. The normalization of interest rates, which was once widely expected to occur at the end of the first round of QE, has still failed to materialize-trillions of dollars and five years later.

Hedge funds thrive in volatile markets for many reasons. They are obviously hedged, have the resources to understand extremely complex assets, and have more sticky capital than other structures, allowing them to work through more challenging investment opportunities than managers of other products such as mutual funds or ETF's. However, with the collective efforts of central bankers focused on eliminating instability, keeping asset prices high, and keeping interest rates low, the benefits hedge funds provide have been of little use.

This brings hedge fund managers to their current state of mind wondering when, or perhaps even if, interest rates will rise and volatility will reenter the markets? This is a question best answered by the central bankers making these collective decisions. The markets in January of this year were handicapping an increase in interest rates being announced by the Fed at the June Federal Open Market Committee meeting, but these expectations have already begun to shift to September, and it's only April.

While it has obviously been, and continues to be, difficult to predict when the tides will change, they will change. When this happens, the Fed will be increasing interest rates instead of lowering them, and asset prices will no longer be supported by central banks. "Don't fight the Fed" will take on a new meaning, where normal price exploration will occur in markets, volatility will increase, and some asset prices will fall, some precipitously. The vast majority of hedge fund managers will benefit from being hedged and, certainly, the better managers will find opportunities in the markets to create shareholder value. Just as they have done in the past.

Citadel and BlueMountain likely feel the changing tides are stirring but, as with many investors, remain unsure of the timing. When the tide shifts, opportunities will be plentiful for hedge funds. As to when that occurs, who better to ask than the central bankers themselves?

Sincerely,

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