

JANUARY 2025

Absolute Return: The Party Is Just Getting Started

KEY TAKEAWAYS

- After a period of low rates post the Global Financial Crisis (GFC) to March 2022, we have entered a new market regime characterized by higher rates, inflation and deglobalization. This has resulted in elevated idiosyncratic risk and, in turn, an improved opportunity set for absolute return strategies—commonly referred to as hedge funds.¹
- Our analysis of absolute return performance across different rate environments since 1990 shows that these strategies generated on average 52% higher *excess* returns above the risk-free rate² during periods of higher interest rates. Since the last rate increase in July 2023, absolute return performance has been on an upward trajectory towards levels previously seen in the early 2000s, a period when many investors relied on their absolute return allocations to drive their overall portfolio returns.
- While challenging for the global economy, higher interest rates can act as a tailwind for absolute return strategies by creating winners and losers—thus increasing return dispersion and alpha opportunities. As capital allocated to absolute return strategies has contracted in relative size within the broader alternative investments universe, we believe the current environment has become even more supportive for absolute return and, in particular, event-driven strategies.
- Given elevated valuations, near-record equity market concentration and narrow spreads across most of the credit spectrum, we expect returns from traditional assets like equities and bonds to revert to their long-term, risk-adjusted historical averages. We believe higher performance dispersion across and within asset classes, industries, countries and themes, and a likely resurgence of M&A activity, can create an improved opportunity set for absolute return strategies to deliver attractive risk-adjusted returns.
- Against this backdrop, we believe investors should consider increasing their allocations to absolute return strategies, which, in our view, can serve not only as a diversifying, lower-volatility ballast in a portfolio but also as a reliable source of outright return and liquidity.

FUNDAMENTALS STRIKE BACK

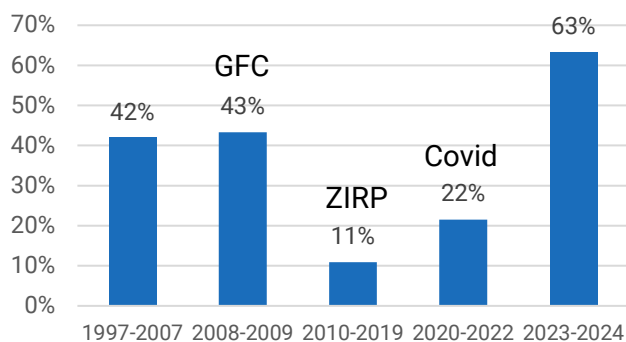
Many refer to the era after the GFC through 2021 as “ZIRP”—short for “zero interest rate policy”—because nominal rates hovered near zero and real rates veered into negative territory. During this time, the U.S. Federal Reserve’s quantitative easing (QE) programs had an outsized impact on markets. An analysis by Bank of America found that changes in the size of the Fed’s balance sheet explained the majority of the movement of the S&P 500 index not explained by changes in forward-looking earnings.³

“...using excess returns above the 3-month Treasury bill as a performance spread benchmark, we found that absolute return strategies outperformed in higher rate environments, on average, by 52% compared to other periods.”

Expanding on this finding, we observe a very low correlation between S&P 500 Index performance and earnings growth during ZIRP. Exhibit 1 shows that from 2010 through 2019, the R-squared (proportion of variance) between the S&P 500 index performance and the year-over-year growth in forward earnings per share (EPS) was only 11%. During the Covid-19 pandemic (2020-2022), the R-squared was 22%. The relationship between S&P performance and earnings growth was much higher before and after the ZIRP and Covid periods.

Exhibit 1: Earnings Drove Far Less of S&P 500 Performance During ZIRP

Relationship Between Forward Earnings Changes and Market Moves (R-squared)



Source: Bloomberg L.P., DKCM Research

The ZIRP period also corresponded with lower levels of price dispersion in both equity and credit markets. And the low correlation between price performance and earnings created a difficult environment for absolute return strategies. It is perhaps unsurprising that absolute return strategies during ZIRP had lower relative returns compared to the periods before and after ZIRP.

Higher rates have since returned, along with the greater importance of fundamentals on returns. As a result, equity and credit markets have had noticeably higher price dispersion. Dispersion in earnings performance and valuation multiples can become more pronounced during periods of structural transitions in the economy. Currently we are facing a number of factors including labor inflation, supply chain disruptions, advancements in artificial intelligence (AI), trends towards deglobalization and potentially significant changes in tariff policies and immigration. Companies that can adapt quickly tend to get a premium multiple for a period of time until others catch up, resulting in elevated valuation dispersion in markets. As of December 2024, the P/E multiple dispersion in the S&P 500 was in the 82nd percentile (based on data from 1990 through 2024), reflecting the complexity of the current environment.

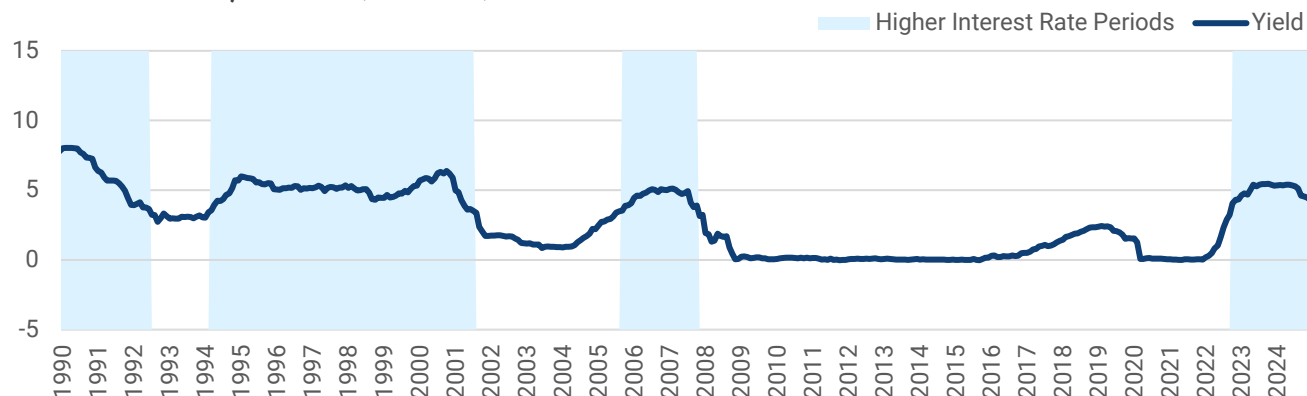
Over the next several years, we believe that fundamentals—and, in turn, alpha—will become a much more critical source of returns.

HIGHER RATES, HIGHER EXCESS RETURNS: THE ABSOLUTE ADVANTAGE

We analyzed the performance of absolute return strategies since 1990 across different interest rate environments, which we categorized as “higher” or “lower” using 3.5% yield on the 3-month U.S. Treasury bill as the point of divide.⁴

Exhibit 2: Higher Rate Periods Since 1990

3M Generic Treasury Bill Yield (1990-2024)



Source: Bloomberg L.P.

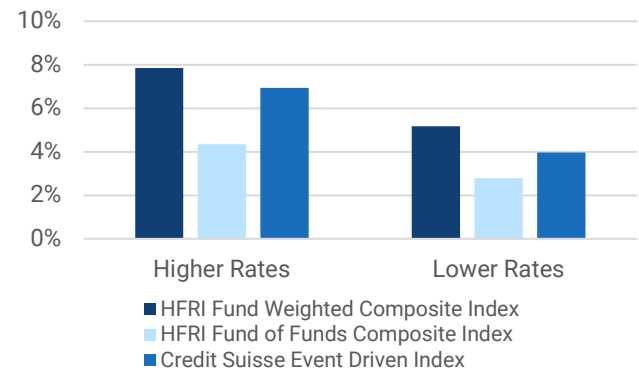
Using three indices that many investors consider to be benchmarks for their absolute return portfolios—HFRI Hedge Fund Composite Index, HFRI Fund of Funds Composite Index and Credit Suisse Event-Driven Hedge Fund Index⁵—we categorized the annualized monthly net returns of each index into either the “higher” or “lower” interest rate categories and then calculated the respective averages for each category. Then, using *excess* returns above the 3-month Treasury bill as a performance spread benchmark, we found that absolute return strategies outperformed in higher rate environments, on average, by 52% compared to other periods. Exhibit 3 shows the annualized net-of-fees excess returns, or spread, above the risk-free rate for each of the three indices we examined.

Our analysis shows that absolute return strategies have outperformed in higher rate environments, which we believe can be explained by elevated idiosyncratic risk and price dispersion. Interestingly, event-driven strategies get a bigger uplift from the change in the rate environment.

Simply put, these higher rate periods correspond with more alpha opportunities for absolute return strategies. This, in our view, suggests that absolute return can outperform given comparable conditions.

Exhibit 3: Absolute Return Strategies Outperform in Higher Rate Environments

Excess Returns Above the Risk-Free Rate (1990-2024)



Source: HFR, Inc. www.HFR.com, Credit Suisse, Bloomberg L.P., DKCM Research

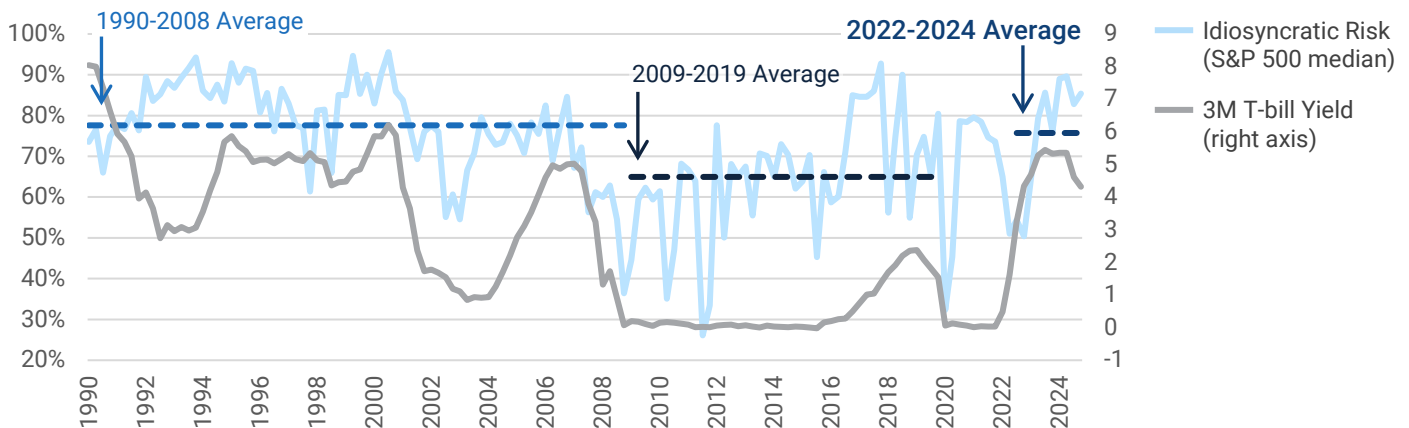
“Our analysis shows that absolute return strategies have outperformed in higher rate environments, which we believe can be explained by elevated idiosyncratic risk and price dispersion.”

ABSOLUTE OUTPERFORMANCE IN A CHANGED ENVIRONMENT

In many ways, the current environment is similar to the period prior to the GFC. Mirroring an analysis by Bank of America, we analyzed idiosyncratic risk in the equity market by measuring the percentage of the stock performance of the individual components in the S&P 500 Index that is not explained by co-movement with the overall index. Using the median of the S&P 500 Index as proxy, Exhibit 4 shows idiosyncratic risk levels from 1990 through 2024. Its correlation with rates becomes evident when mapped against the yield on the 3-month Treasury bill.

Exhibit 4: Idiosyncratic Risk Has Become More Elevated with Higher Rates

Idiosyncratic Risk (S&P 500 median) (1990-2024)



Source: Bloomberg L.P., DKCM Research

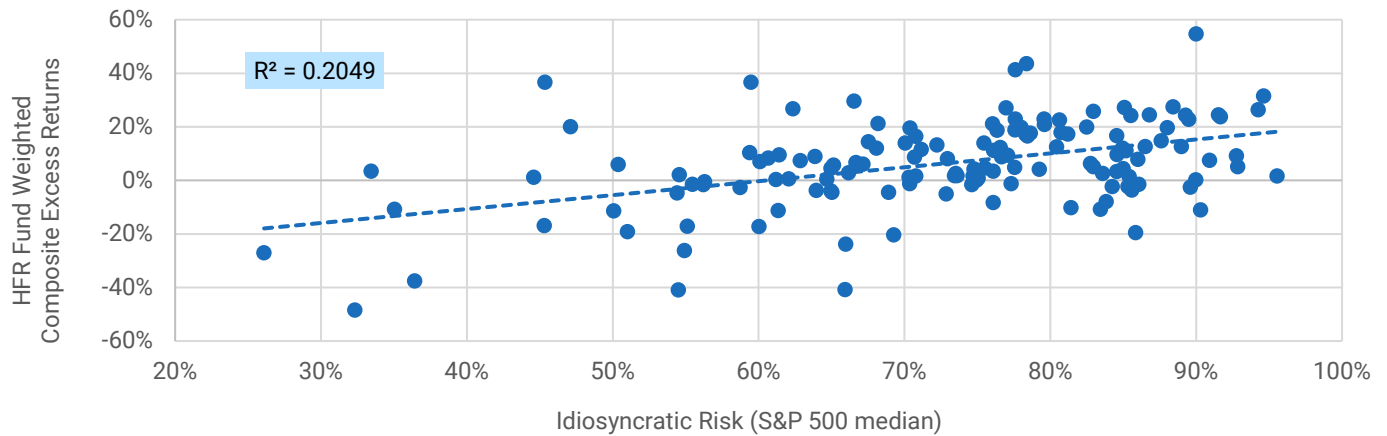
Idiosyncratic risk in the equity market rose significantly over the last three years as rates rose. The average level of idiosyncratic risk from 2022 through 2024 is meaningfully higher than the average from 2009 through 2019—and is near the average levels pre-GFC. (We have excluded 2020 through 2022 from this analysis due to the unique circumstances of the Covid-19 pandemic.) As of December 2024, the current level of idiosyncratic risk in

the S&P 500 is at the 82nd percentile (based on data from 1990 through 2024).

Moreover, we found there is a positive correlation between idiosyncratic risk (using the S&P 500 Index median as proxy) and absolute return performance (using HFRI Fund Weighted Composite excess returns as proxy) from 1990 through 2024.

Exhibit 5: Absolute Return Performance Is Correlated with Idiosyncratic Risk

HFRI Fund Weighted Composite Excess Returns vs. Idiosyncratic Risk (S&P 500 median) (1990-2024)

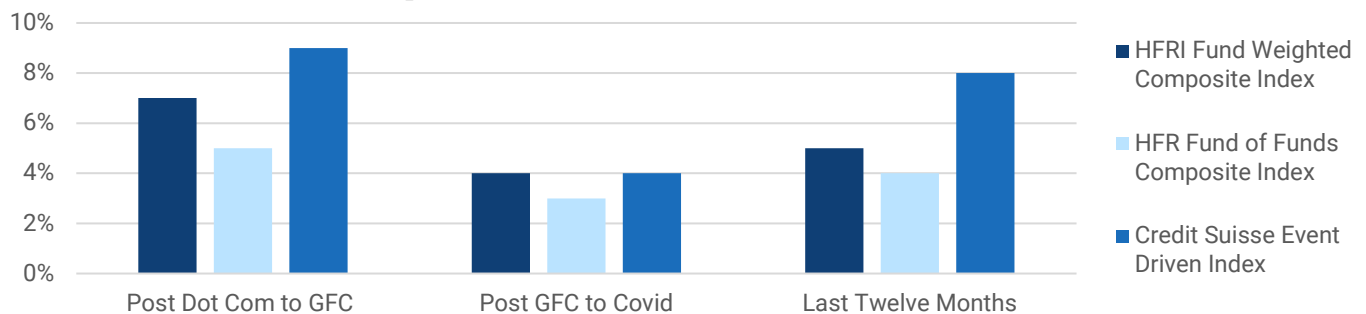


Source: HFR, Inc. www.HFR.com, Bloomberg L.P., DKCM Research

As rates rose, and as idiosyncratic risk became more elevated, so has the outperformance of absolute return strategies. Exhibit 6 compares absolute return performance (using excess spread above the risk-free rate as benchmark) across three periods: (i) post-dotcom bubble to the GFC (December 2001–November 2007), (ii) post-GFC to Covid (July 2009–January 2020), and (iii) the last twelve months (January–December 2024).

Exhibit 6: Absolute Return Performance Across Three Different Periods

Annualized Excess Returns Have Improved Since ZIRP



Source: HFR, Inc. www.HFR.com, Credit Suisse, Bloomberg L.P., DKCM Research

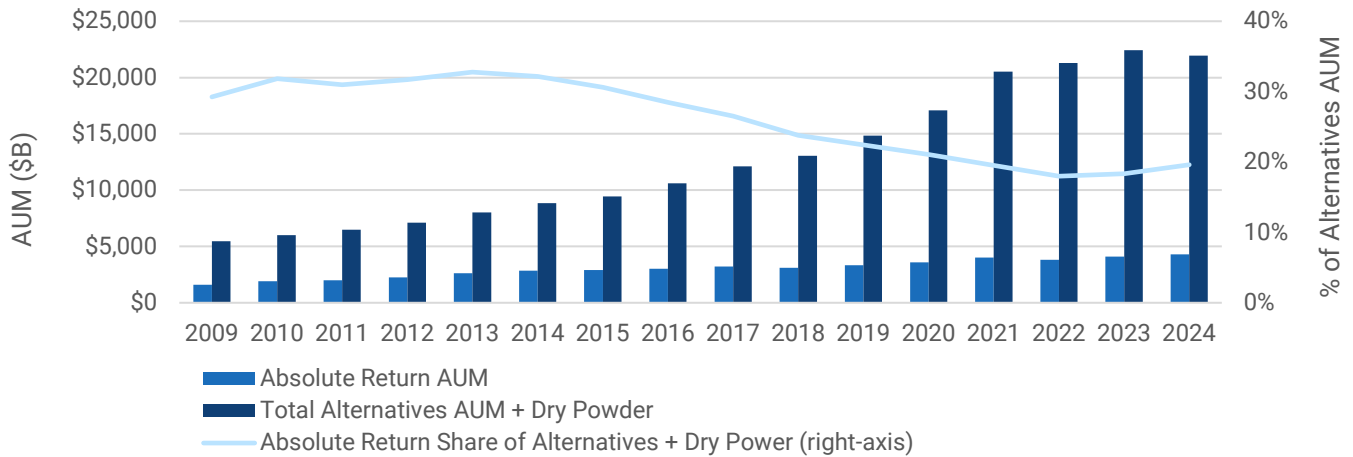
Absolute return outperformance—the annualized excess spread above the risk-free rate—over the last twelve months exceeds the levels during ZIRP. Interestingly, the outperformance by event-driven strategies is more pronounced than for absolute return strategies overall and could, in our view, be a function of the fact that the strategy is not “crowded.”

DRIVEN AWAY: ZIRP PUSHED ACTIVE CAPITAL TOWARDS PRIVATE EQUITY

Since ZIRP, capital allocated to absolute return strategies has contracted in relative size within the broader alternative investments universe. With \$4.5 trillion⁶ of assets under management in 2024, absolute return capital was just under 20% of the overall alternatives AUM.⁷ In 2009, absolute return strategies made up one-third of the overall alternatives AUM.

Exhibit 7: Absolute Return AUM Growth Has Trailed Private Alternatives Overall

Absolute Return AUM vs. all Alternatives + Dry Power (2009-2024)



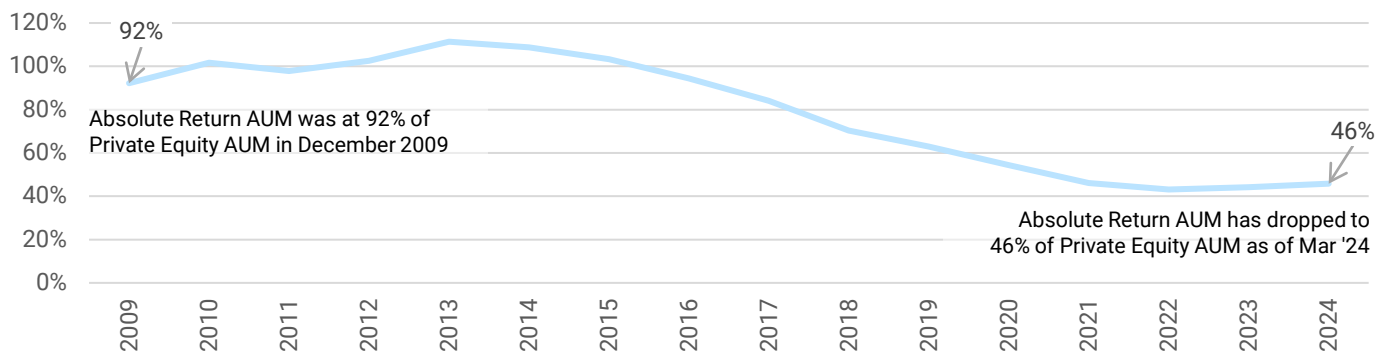
Source: HFR, Inc. www.HFR.com, Preqin Ltd.

While ZIRP was less favorable for absolute return strategies, it was a golden age for private equity, which benefitted from extremely low financing costs and rising valuations. During this time, a significant amount of “active” capital moved from the public markets—and absolute return strategies—into private equity. Absolute

return assets as a percentage of private equity assets declined by almost 50% as private equity grew at nearly twice the rate. In 2009, absolute return assets were nearly at parity with private equity assets; today, absolute return capital is less than half of total private equity assets under management.

Exhibit 8: Private Equity AUM Growth During ZIRP Far Outpaced Absolute Return

Absolute Return vs. Private Equity AUM (2009-2024)



Source: HFR, Inc. www.HFR.com, Preqin Ltd.

Within absolute return, event-driven strategies contracted even more dramatically. In 2009, event-driven strategies made up approximately 16% of total absolute return capital; in 2024, event-driven was less than 4%.⁸ As we’ve noted earlier, and shown in Exhibits 3 and 6, event-driven outperformance in higher rate environments is even more pronounced than overall absolute return.

A REVERSAL OF FORTUNES?

In the higher rate environment, many private equity sponsors have had more difficulty monetizing investments and private equity “distributions to paid-in capital” (DPI) multiples have dropped materially in the last few years. To make up for this DPI shortfall, some investors have tapped their absolute return allocations to shore up their portfolio liquidity and meet ongoing commitments.

We believe these investors are leaving just as the party is getting started!

With the return to more “normal” interest rates and the structurally higher inflation that we expect to remain as a result of deglobalization trends, we believe the current environment is likely to resemble the “higher rate” environment from before the GFC. Using a similar rate threshold as Exhibit 2, we analyzed the returns of the Cambridge Associates Private

Equity Fund Index since 1983 and found that, during higher rate periods, private equity underperformed its average across all lower rate environments by approximately 28%. This is perhaps unsurprising given that during higher rate periods it is more expensive for private equity sponsors to finance new deals and at the same time their portfolio companies must contend with higher interest expense and, in turn, less attractive exits.

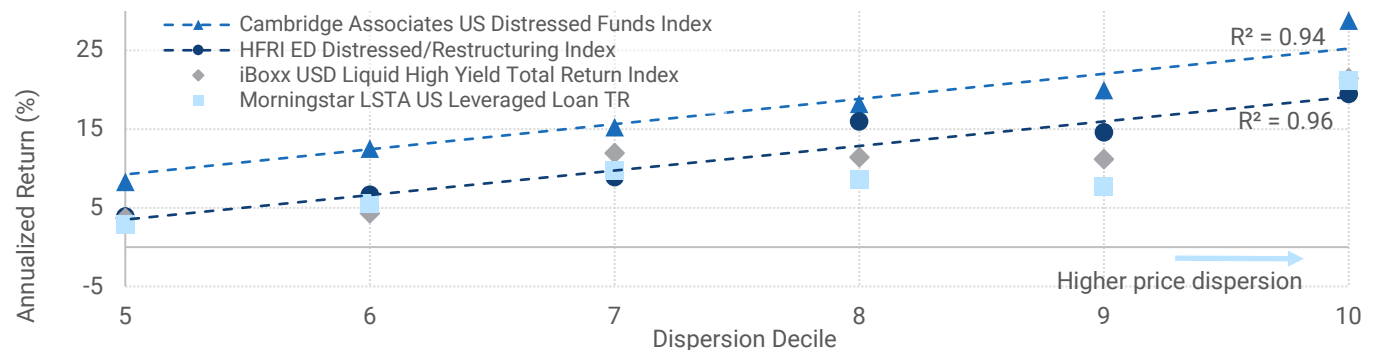
With higher-for-longer rates, elevated price dispersion and idiosyncratic risk, and an uncertain global economic outlook, there is a renewed focus on business fundamentals without the ability to ride equity market beta. At a time when capital allocated to absolute return strategies has been on the downswing, we believe the current environment has in fact become more supportive for absolute return (and perhaps less favorable for private equity).

CREDIT WHERE CREDIT’S DUE: WHEN ACTIVE MANAGERS SHINE

Since rates started to rise in 2022, there has also been elevated price dispersion in the credit markets. By analyzing dispersion levels of CCC-rated leveraged loans, we found that the higher the dispersion, the greater the outperformance by active managers of credit strategies. Exhibit 9 compares active manager outperformance (using the HFRI ED Distressed/Restructuring Index and the Cambridge Distressed Funds Index¹⁰ as proxies) with passive indices from 2007 through 2024. The data shows a strong relationship between elevated CCC-rated leveraged loan dispersion and subsequent year outperformance by the HFRI ED Distressed/Restructuring Index and the Cambridge Distressed Funds Index relative to passive indices.⁹ In fact, the R-squared between higher dispersion and higher subsequent returns over the next year is 0.96 and 0.94 for the HFRI ED Distressed/Restructuring Index and the Cambridge Distressed Funds Index, respectively.

Exhibit 9: Active Managers of Opportunistic Credit Strategies Outperform Passive Indices When Dispersion is Elevated...

CCC-rated Leveraged Loan Dispersion Deciles vs 1-year Forward Returns of Various Credit Indices (2007-2024)



Source: HFR, Inc. www.HFR.com, PitchBook Data Inc., Cambridge Associates¹⁰, Bloomberg L.P., Intex Solutions, Inc., DKCM Research

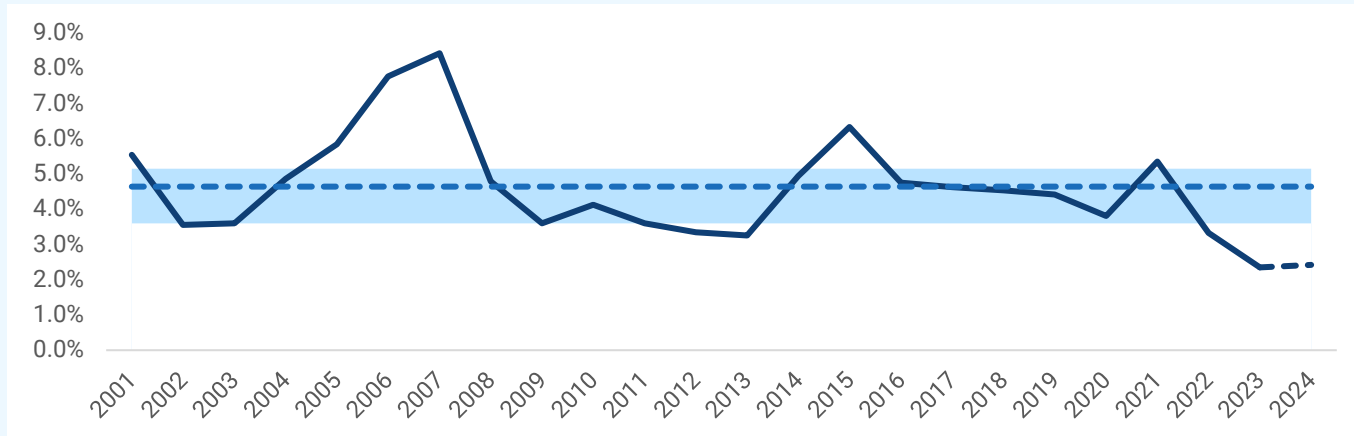
Over the 2007-2024 period, price dispersion for CCC-rated loans was lower during ZIRP. We calculate dispersion as the range of the 10th and 90th percentile normalized by the median. The current dispersion level for CCC-rated loans is 69 (as of December 2024), which corresponds to the 79th percentile for the 2007-2024 period. Based on our analysis, the CCC-rated dispersion portends well for active opportunistic credit managers to outperform passive indices by an even a greater margin than during periods of lower dispersion.

LET'S MAKE A DEAL: CONDITIONS FOR AN M&A REVIVAL

We believe there will be a bounce back for global M&A activity, which has hovered at its lowest levels since 1994. At just 2.4% of global GDP, global deal volumes have fallen to nearly 50% below the average of 4.6% of global GDP since 2001. Exhibit 10 shows that current global M&A activity is way below the 25th to 75th percentile range (in blue) since 2001.

Exhibit 10: Global M&A Levels Have Been Depressed Post '22 Rate Hikes

Volume of Announced Global M&A Transactions vs. Global GDP (2001-2024*)



* World Bank Global GDP for 2024 is an estimate based on extending 2023 with an expected growth rate.

Source: Institute for Mergers, Acquisitions and Alliances (IMAA), "Value of mergers and acquisition (M&A) transactions worldwide (in billion U.S. dollars)", Statista, Bloomberg L.P.



Given the backdrop of solid economic growth and healthy corporate cash balances in the U.S., combined with what we expect will be friendlier antitrust regulatory environments in both the U.S. and Europe, we believe that conditions are primed for an M&A revival.

In Europe, the desire to create pan-European corporate champions that can compete with peers in the U.S. and Asia could be a tailwind for activity. The appointment of Teresa Ribera as the European Commission's new competition chief is expected to result in a friendlier deal environment. On the back of Mario Draghi's September 2024 EU competitiveness report, which calls for greater consolidation at the European level to allow European companies to compete on a global scale, Ribera has a mandate to adopt a policy that is more supportive of companies scaling up in order to compete in global markets. European companies may also explore acquisitions in the U.S. to mitigate the potential impact of tariffs. Additionally, valuations for European public companies are substantially lower than those of U.S. peers, which may attract international strategic and financial buyers.

In the U.S., we believe there is meaningful pent-up demand for deals that were shelved due to the regulatory regime under the Biden administration and expect the Trump administration's stance towards antitrust enforcement and merger reviews to be significantly less onerous. After the U.S. Presidential election, feedback from deal practitioners has indicated that conversations about larger, transformational mergers have resumed. The Trump administration's pledges to reduce regulation and lower tax rates could also boost deal activity. Moreover, credit markets are robust, and the strong equity markets offer public corporate acquirers another currency for funding transactions.

It's worth noting that while the overall backdrop is positive, we expect dispersion in performance. Rhetoric from new administration officials implies that scrutiny will continue for technology sector deals, especially for those involving the largest players. Additionally, with inflation proving persistent and potentially increasing on the back of tariffs, financing costs may rise.

FROM ZIRP TO HERO: ABSOLUTE RETURN'S COMEBACK

We believe the exceptional beta-driven returns in credit and equities during ZIRP are not likely to be sustainable over the medium to long term under the new post-ZIRP market regime. With the end of the lower rate environment—and of markets being overwhelmed by QE-driven beta—we are seeing higher levels of price dispersion and idiosyncratic risk. Our analysis shows that these characteristics are positively correlated with outperformance by absolute return strategies.

“Absolute return managers that can flexibly allocate capital across the most promising investment opportunities and regions worldwide, in our view, are well-positioned to capitalize on a volatile environment characterized by more elevated dispersion across and within asset classes, industries, countries, and themes.”

Absolute return managers that can flexibly allocate capital across the most promising investment opportunities and regions worldwide, in our view, are well-positioned to capitalize on a volatile environment characterized by more elevated dispersion across and within asset classes, industries, countries, and themes. Merger arbitrage strategies can serve as a diversifying, low-duration fixed income alternative and, in this environment, the combination of merger arbitrage and credit strategies can benefit from the dual effects of higher interest rates and the anticipated revival in M&A activity. Convertible arbitrage strategies are also likely to benefit in this environment from an increase in convertible bond issuance given the attractiveness of the lower coupon profile and its potential as a source of funding for M&A.

Given elevated valuations, near-record equity market concentration and narrow spreads across most of the credit spectrum, we expect returns from traditional assets like equities and bonds to revert to their long-term, risk-adjusted historical averages. With a renewed focus on fundamentals, and markets freer to play a more significant role in setting asset prices, the opportunity is robust for absolute return investing—whether employing multi-strategy, event-driven and/or credit-oriented strategies.

For investors charged with generating returns to satisfy any number of objectives—from supporting the missions of endowments and foundations to meeting the payout requirements of pension plans and retirees—we believe absolute return can serve not only as a diversifying, lower-volatility ballast in their portfolio but also as a reliable source of outright return and liquidity. And to offset the anticipated compression in the returns of traditional assets, as well as increases in volatility, we believe that investors should consider increasing their allocations to absolute return strategies.

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ABOUT DAVIDSON KEMPNER

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¹ Hedge Fund Research (HFR) Inc. defines “absolute return” as a type of investment vehicle that attempts to generate steady, positive returns in all market environments by using a variety of investment strategies. The absolute return approach to fund investing is also commonly referred to as a hedge fund. For the purposes of this paper, we use the term “absolute return” synonymously with “hedge fund” unless noted otherwise.

² For purpose of this paper, “risk-free rate” refers to the return on the 3-month U.S. Treasury bill.

³ Bank of America U.S. Equity & Quantitative Strategy Research. This analysis is based on comparing the year-over-year change in the size of the Fed’s balance sheet to the year-over-year change of the S&P 500 index, after controlling for changes in forward-looking earnings using a fixed long-term P/E multiple, in order to determine how much of the residual move in the S&P500 is explained by quantitative easing.

⁴ From 1990 through 2024, the average yield of the 3-month U.S. Treasury bill was 2.7% but going back further to 1980 and 1970, the average yield through 2024 increases to 4.0% and 4.8%, respectively. Since 1980, the 3-month U.S. Treasury bill exceeded 3.5% in 53% of quarters. As such, we believe 3.5% would be an appropriate cut-off over a longer time horizon for determining “higher” versus “lower” rate environments.

⁵ We used the HFRI Hedge Fund Composite Index and the HFRI Fund of Funds Composite Index since their inception in 1990. For event-driven strategies, we used the Credit Suisse Event-Driven Hedge Fund Index instead of the HFRI Event-Driven Special Situation Index because the former index’s inception is 1984 whereas the latter’s index is 2008. We found there was a high correlation between the two indices during the period in which they overlap.

⁶ HFR, Inc. www.HFR.com, as of September 30, 2024.

⁷ According to Preqin, alternative capital in private markets (e.g., private equity, credit, real estate and infrastructure), including capital deployed and dry powder, totaled \$17.6 trillion as of March 31, 2024.

⁸ HFR, Inc. www.HFR.com, as of September 30, 2024.

⁹ Our data source is Intex for loan ratings, with data beginning in 2007, and Markit LoanX for price data.

¹⁰ Cambridge Associates US Distressed Funds Index, by S&P Dow Jones Indices.