

## January to April 2017

Thursday, 06/01/2017

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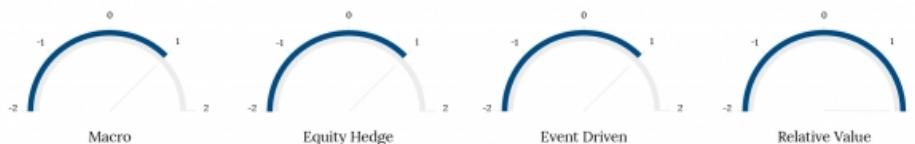


**Cédric Vuignier**

Head of Manager Research

- Positive performance for hedge funds so far in 2017
- Macro: Mixed returns, CTA's stumble on commodities
- Equity: Good performance across the board, big push from small caps and tech giants
- Event Driven: CEO confidence is high as macro worries wane
- Relative Value: low VIX is good for non-directional strategies
- Big data, machine learning: what does it mean?

### Strategies outlook



### THE SITUATION SO FAR

Hedge funds have started the year with positive performance across all strategies, global markets delivered robust gains as business and consumer confidence levels broadly improved. Indeed, it's the first time since the crisis that we have witnessed healthy growth across the US, Europe and Asia simultaneously. Undoubtedly, President Trump's pledge to cut taxes and invest in infrastructure has provided a lot of steam for equity markets to rally. The Federal Reserve also hiked interest rates echoing the numbers that confirm an improving economic environment.

Obviously despite the good numbers risk remains central to our discussions with hedge fund managers, and while they may have a constructive outlook, many believe that the Fed could derail the current momentum by raising rates too quickly. Political risk remains high as President Trump has to deliver on his promises to keep markets happy.

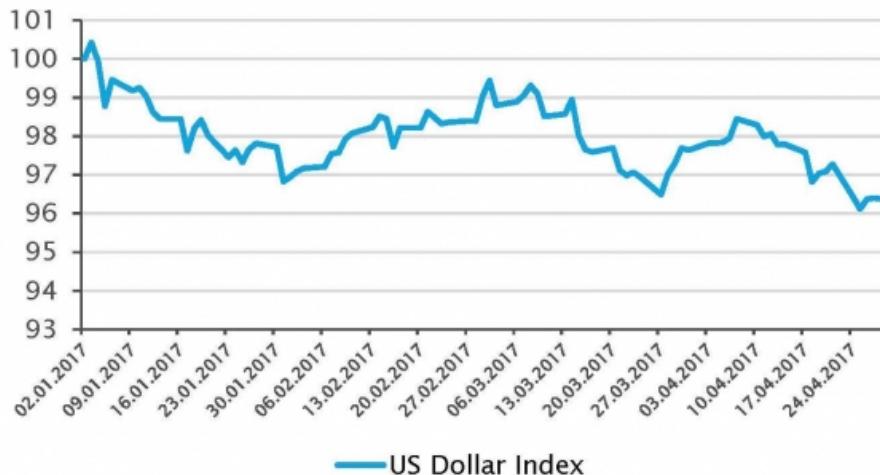
While hedge fund managers were able to extend their positive run since Q4 2016, the lack of volatility remained an overhang on performance and so far, remains the last hurdle for active managers to fully take advantage of their opportunity set. Interestingly, this is where we believe hedge fund managers – and all active managers – will make a difference. It is our belief that the reduction of AUM among active managers, coupled with the normalization of interest rates, will potentially increase the prospects to a return for a market environment that rewards hedge fund's investment styles.

## MACRO

Macro managers have posted mixed performance over the first four months of the year. Performance was primarily driven by the reflation theme, essentially expressing a view of higher equities, higher rates and a higher US dollar. While equity trades were successful, the brunt of the pain came from forex and energy positions especially for CTA's who lost money in long USD positions as well as long Natural Gas and Oil. With regards to positioning, discretionary managers have reduced their exposure to the reflation theme but remain constructive on the USD and have taken a more exotic approach to structure the trade. Meanwhile, systematic funds suffered through the period, with the bulk of the losses incurred from medium-term trend following models on currencies and energy. Choppy markets and rotations in and out of the reflation trade were the main headwinds for the strategy. Similarly to discretionary managers, the majority of risk was allocated to equities.

### Our outlook

From a macro perspective the tailwinds for the strategy remain intact. The US is expected to continue to raise interest rates while the EU and Japan remain in QE mode. This should create dispersion across various asset classes and currencies. The biggest catalyst will come from the US administration's ability to pass the tax reform. Meanwhile, we remain concerned about choppy markets and reiterate our preference toward macro systematic strategies.



Source  
Bloomberg

## EQUITY HEDGE

Following a difficult year in 2016, most managers rebounded sharply this year but are still underperforming major indices as short books detracted from performance across the board. There were two distinct periods: initially it was the Trump "reflation rally" with markets then becoming more fundamentally driven. While volatility remained muted, factor rotations were frequent: small, value and high beta stocks outperformed early in the year and then underperformed large, liquid growth stocks. Most of the alpha generation came from long positions in IT, financials and consumer stocks as managers took advantage of the sector rotation following Trump's election to reposition their books, or buy into stocks that had dropped to attractive valuation levels, especially in the tech sector. Short books detracted from performance as markets rose indiscriminately but dispersion across stocks rose towards the end of the period and provided long/short managers with a more positive backdrop. The manager's constructive view on equity markets means that they are running high levels of gross exposure as they find compelling ideas on both sides of their portfolios.

### Our outlook

Equity managers are still constructive on the backdrop for stock picking. We remain cautious as markets reach peak valuations and in this environment we prefer managers that carry a low net exposure and sector specialists. We also subscribe to the idea that shorting will be more successful in a rising rate environment.



Source  
Bloomberg

### EVENT DRIVEN

Corporate event activity was strong again during the first part of the year and CEO confidence reached levels not seen since the global financial crisis. Merger arbitrage volumes were in line with the previous period and volumes in Europe reached levels not seen since early 2007. The acquisition of Rite Aid by Walgreen, a USD15 billion transaction, expired in January with the antitrust approval still pending. It was then repriced and suffered from a large speculative news flow. Special situations funds generally kept or increased their long bias and their gross exposures. They benefitted from the continued bull market in the US and Europe, which was probably partially led by low volatility. It is hard to differentiate between the funds that ride the beta and those which truly stay focused on catalysts in equities. As a reminder, credit event driven funds generally have minimal interest rate exposure, as they tend to invest predominantly in high yield levered companies going through refinancing exercises. They benefited from the extended cycle and the open-ended primary markets for high yield issuers.

### Our outlook

The outlook is bright. The new French president is clearly pro-Europe, which brings more clarity in policies going forward - at least until the Italian elections. The European Union gives some sign that they want to fight populism by implementing social policies. Trump's election is likely to favor a sustained level of corporate activity including less regulation and repatriation of large amounts of cash held abroad by corporations.



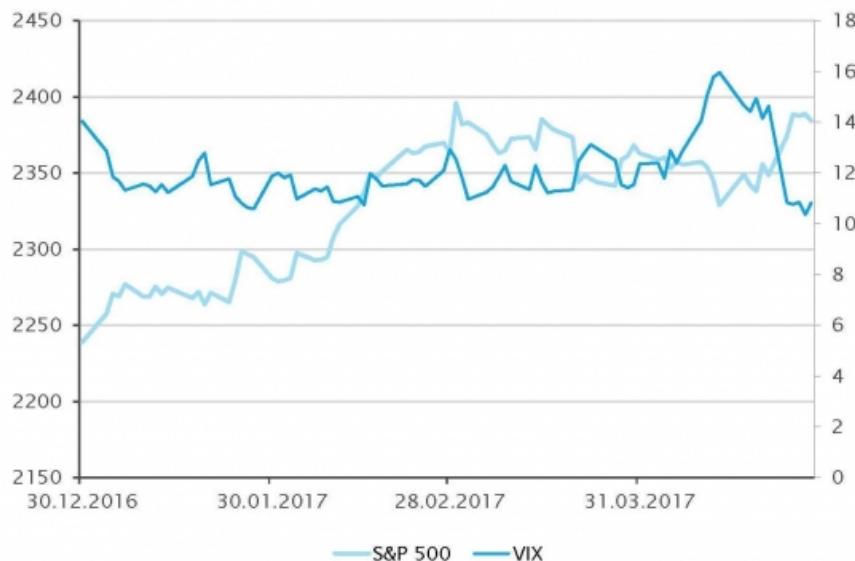
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## RELATIVE VALUE

Within Relative Value, all the strategies performed modestly for the period as equity volatility remained low which was beneficial to mean reversion strategies. While markets looked stable on the surface as indicated by very low VIX readings, the trading environment for non-directional strategies was marked by substantial style and sector rotations that weighed on performance especially in February. Interestingly, February was also a difficult month for volatility traders as the VIX and the S&P correlation spiked but these managers recouped their losses the following month. Elsewhere, fixed income markets remained solid as the global search for yield pushed spreads to tighten dramatically, managers made money on the lower rated paper in their books. Following the strong move in credit, managers remain cautious as valuations seem rich and supply and demand shift in high yield could lead to volatility. The higher volatility in rates was supportive for fixed income arbitrage managers with gains driven by European bond basis trades and swap spread basis.

## Our outlook

We are positive on the Relative Value space overall. With regards to fixed income arbitrage we remain positive and expect higher volatility in rates. We remain cautious and focus mainly on capital structure arbitrage within credit. The environment remains good for volatility arbitrage. Multi-strategy and market neutral funds should continue to benefit from a more fundamentally driven market.



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## OUR CONVICTIONS

Hedge funds have always been at the forefront of financial technology and sophistication. They were the first to use computers to generate trading signals as early as the 60's and the access to quicker or better information was always a part of their ability to generate alpha. Today, a lot of the information asymmetry that existed in the past is gone because of a wider access to information across the world. Subsequently, hedge fund manager's need to find another way to articulate a differentiated view from the consensus on the price of an asset or the next earnings of a company. And so it's no surprise that today hedge funds are spending big money on Big Data and hiring data scientists to make sense of all this data. Therefore, a new breed of traders has taken over Wall Street: Quantamentals! They combine classic trading skills of fundamental investors with the use of powerful computing and big data sets to confirm their view.

So how does this work? Obviously, buying the data is the easy part. Without proper cleaning this very expensive data is worthless. Once the data is clean it is fed into an algorithm that will detect patterns and suggest trading signals or price movement. Usage of machine learning is also growing currently, where hedge funds tap into large data sets to crunch through historical data to analyze global trends. Similarly, they use satellite imagery to track industrial development in China and monitor the parking lots of retailers to gain insight into store traffic. By doing so, they do not have to rely on unreliable official data released by governments and they can have a better idea of what a retailer's earnings will be before quarterly earnings are released. With renowned hedge fund firms expanding their quant teams, this trend is set to go on for a while and will potentially change the face of the hedge fund industry forever. From our perspective, the access to this new alternative data will provide new opportunities for new entrants to come in alongside the quant powerhouses that we have been working with for a long time.

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