ALTERNATIVE INVESTMENTS INSIGHTS

September to December 2016

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The central theme of 2017 will be the continuation of the reflation trade and its impact on asset pricing.

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- 2016 challenging for hedge funds.
- 2017 more uncertainty and volatility should be supportive for hedge funds.
- Expectations of rate normalizations should provide opportunities in Relative Value.
- Event-Driven strategies could benefit from fiscal stimulus.
- We remain positive on volatility strategies.
- Special feature: a look at opportunities in Asia capital markets.

THE SITUATION SO FAR

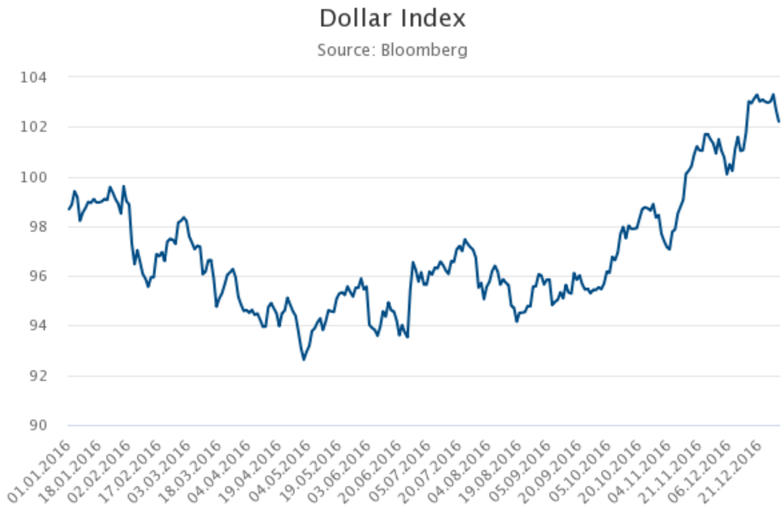
2016 was another challenging year for hedge funds and active management. Political surprises coupled with more Central Bank easing earlier in the year put a lot of pressure on manager's returns. From a business standpoint we saw managers lowering their fees significantly in response to the lack of inflows and tough performance. As we write those lines: it appears that last year's winners were credit funds followed by energy and commodity focused managers as well as Emerging Markets specialists. Event Driven strategies performed well on the back of strong corporate activity. Macro and equity focused funds printed disappointing numbers for the year as lack of market trends and sector rotations were detrimental to performance across the board. The central theme of 2017 will be the continuation of the reflation trade and its impact on asset pricing. While we cannot be sure of the economic outcomes, we are confident that higher interest rates will be beneficial for active managers across all asset classes. For instance we expect macro managers to take advantage of the policy divergence across Central Banks. Additionally, if President Trump allows US companies to repatriate earnings from overseas this could be a strong tailwind for M&A focused funds. Following a strong year, credit managers will be facing tighter spreads but potentially more dispersion across names as late-cycle dynamics kick in. We still favor managers that can take advantage of higher volatility and lower liquidity such as fixed income arbitrage and capital markets arbitrage.

MACRO

Most discretionary managers ended 2016 in positive territory with the bulk of the gains generated in the last quarter after months of low returns accompanied by low risk taking. The risk-on market environment following Trump's victory saw the US Dollars rally and other reflation theme rewarded (i.e. long equity, short rates,...). Managers entered the New Year full of confidence with the same trades/themes deployed with very little room for alternative trades to a few exceptions within sovereign credit (short Mexico, Turkey and South Korea while long Russia and Brazil). Systematic managers' performances lagged across all models. They were negatively impacted by the bond sell-off of November and more broadly since July where they lost traction due to their exposure to the energy complex. Essentially , macro systematic models were aligned with discretionary traders, posting strong gains from fixed income relative value bets. Currently, the bulk of the risk is allocated to equities and FX.

Our outlook

We remain positive on macro managers with directionality supported by the Fed's clear plan on its continuation of US rate hikes. US rates normalization is waking up classical macro managers, that had difficulties generating strong gains over the last four years due to compressed bond spreads and flat yield curves. Directionality and sustainable trends might be challenged depending on the effectiveness of Trump's plan when implemented and conflict with the Fed.

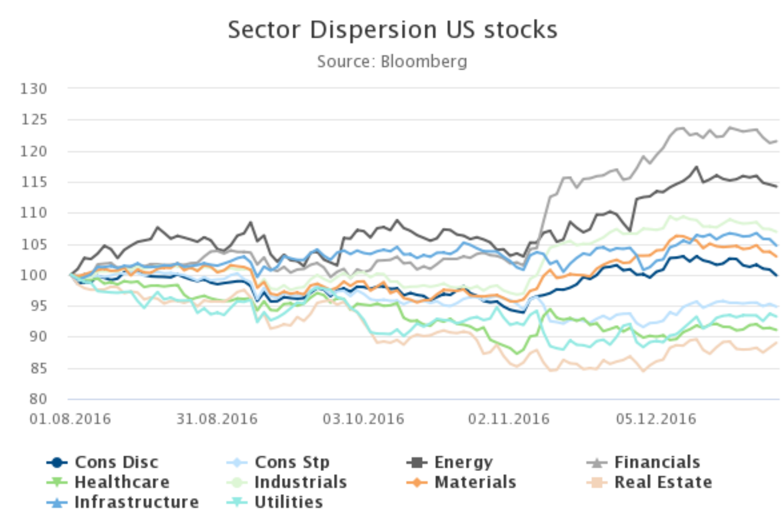


EQUITY HEDGE

Equity Hedge managers performed well over the last part of the year making back most of the losses suffered in the first half. Meanwhile, 2016 proved to be very challenging as aggressive market and style rotations out of quality and growth stocks into value cyclicals caused significant dispersion in manager's performance. From a geographical perspective, alpha generation in Asia was strong despite heightened volatility. European managers underperformed significantly mostly due to strong outflows from European markets: obviously Brexit and the Italian referendum added to managers difficulties. US based managers fared relatively better on the back of inflationary expectations brought by the new US administration but not all managers were exposed to the cyclical stocks that rallied. Generally, performances were disappointing because managers were unable to generate positive performance from their short books while their long books generally outperformed the market. Looking forward it's hard to determine the full consequences of the new US administration's agenda, and while the macro landscape has changed considerably the year-end rally has already discounted a lot of good news.

Our outlook

Given the uncertainties around the health of the global economy, we expect more volatility and higher dispersion. Both factors should provide good tailwinds for uncorrelated strategies and low net managers. We also like the environment for Japanese managers as structural changes will provide opportunities for stock pickers in the region.



EVENT DRIVEN

Corporate event activity was strong in 2016, which provided a fertile ground for event driven managers. More in details, USD 5 trillion of merger and acquisitions were announced, which is very high. The most successful merger arbitragers avoided the high profile breaks and managed to post double digit returns for the year. Generating a strong performance in special situations was generally harder as the number of activist campaigns decreased and the volume of share buybacks was similar to 2015. Still, funds exhibiting a long bias benefitted from the bullish U.S. equity markets. Some managers navigated away from catalysts and were generally penalized by factor and sector rotations. Liquid event driven credit strategies predominantly depended on the refinancing of levered and stressed companies. The opened high yield markets and strong credit issuance were positive factors, which helped managers deliver outsized returns.

Our outlook

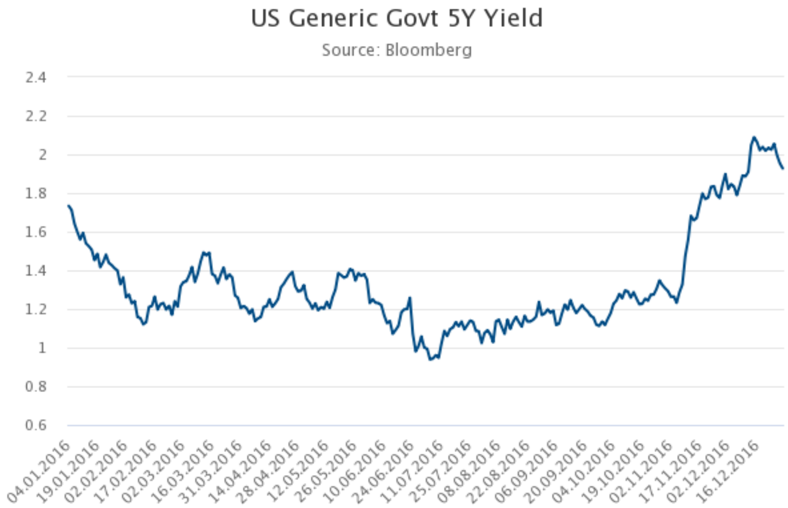
The outlook for 2017 is bright. Trump's election is likely to favor a sustained level of corporate activity : less regulation in general, nominations of business friendly regulators, repatriation of large amounts of cash held abroad by corporations (estimated at USD 2.5 trillion, part of which will be used or returned to investors) and a longer credit cycle.

RELATIVE VALUE

Despite rising policy uncertainty, volatility and dispersion have dramatically declined and 2016 ended with IG and HY spreads to the end of their post-2008 range. It allows most managers to deliver double digits across the whole liquidity spectrum with HY leading gains. Nevertheless, the overall risk deployed by managers is still in the lower ranges as evidences of uncertainties on the Fed's initial plan and Trumps' "reflationary" plan. Positioning is agnostic and highly idiosyncratic, with some US high yield positions trimmed down and profits taken with risk deployed instead in capital structure and balance sheet arbitrage trades, more sensitive to interest rates. In regards to rates and volatility arbitrageurs, the whole period was supportive to the exception of November and the Trump's victory induced bond rally and rates spike. Both strategies have seen additional capital allocated as the set of opportunities is increasing with looming rates normalization and, as mentioned above, from expected wider dispersion and increasing volatility, especially on rates.

Our outlook

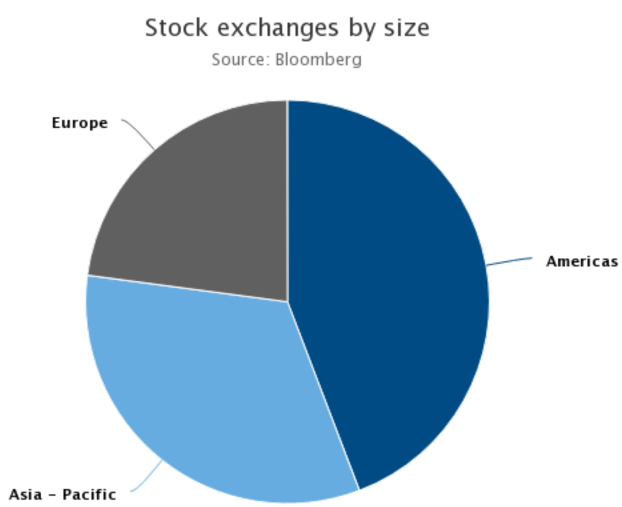
Following the rally in credit mainly pushed by the energy sector we currently favor alpha generating strategies such as fixed income arbitrage and capital structure arbitrage. Both strategies should benefit from an interest rate normalization. Volatility strategies should also benefit from the dislocations generated by the new US administration.



OUR CONVICTIONS

Following a recent trip to Asia we wanted to share our insights on the local hedge fund industry. Our key takeaway would be that historically, managers in the region were long-biased and often only managed to capture the beta of the market, while today we see more and more hedge funds that disintermediate local investment banks in capital markets. Essentially these managers take risks that investment banks do not want to keep on their balance sheets for regulatory reasons. This creates a plethora of trading opportunities for managers that are completely uncorrelated from global market moves. For instance, Asian markets typically display a low skew coupled with faster volatility moves as markets move. The popularity of structured products that are usually short volatility is the main factor behind this inefficiency. This means that savvy hedge fund managers can take advantage of buying cheap options from investment banks with much more upside than in other markets. There are also arbitrage opportunities in the interest rate curves of countries with onshore/offshore markets like Korea : where managers exploit inefficiencies in the NDF curve particularly as the big exporters repatriate capital at certain key points in the year.

Finally, we believe hedge funds face fewer competitors in Asia than in the US and Europe and operate in markets that appear much more inefficient. Obviously less participants also means less crowded trades. This provides for further de-correlation from other hedge funds. Asian managers stayed clear of the issues that plagued US hedge funds' returns in periods of market stress. Additionally the talent pool in Asia seems to be stronger and stronger as we see "third generation managers" spinning out of large established hedge funds or foreign investment banks. As hedge funds struggle to find idiosyncratic returns in the West, we found the opportunity set in Asia extremely rich as macro, credit long/short and arbitrage managers are starting to provide greater diversification opportunities for investors.



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