

September to December 2017

Friday, 02/09/2018

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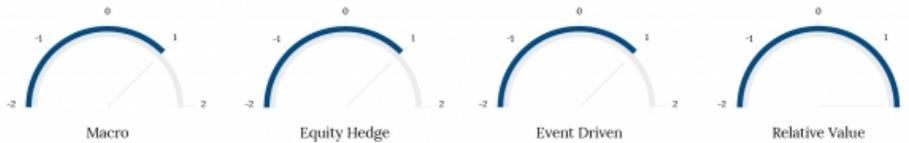
Cédric Vuignier
Head of Manager Research



José Sanchez
Product Specialist

- Great year for Equity Hedge, and positive expectations for 2018 with current conditions.
- Positive period for Event-Driven marked by a few idiosyncratic events, and great hopes for the new year following the U.S. tax reform.
- Relative Value managers on a favorable trend, with good prospects for the future thanks to the normalization.
- Difficult year for Macro managers, but strong conviction into our allocation.

Strategies outlook



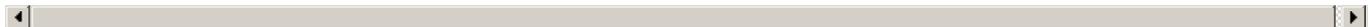
THE SITUATION SO FAR

2017 was finally a good year for the hedge fund industry after three difficult ones. Our two strategies performed above target in 2017. The uncorrelated strategy, which has zero beta with the equity market, was up more than 4.5%, while the multi-strategy was up more than 6% with a beta below 0.30.

The main difference with previous years is an improvement in the environment for alpha generation. Whether it be Equity Market Neutral or Arbitrage strategies, most managed to make good money. While the first style profited from a decrease of the intra-stock correlation not seen since pre-2008, the second gained from volatility in the bond market. We expected it should help Macro Discretionary managers, too. Unfortunately, those who stayed away from equities and emerging markets struggled as they were on the wrong side of the trade all year, e.g. long USD and short US government bonds. The improvement of the other economies and a weak inflation outlook completely subverted the great expectations for these trades.

Thanks to the rally of risky assets, it was not a surprise the biggest winners were the beta bias strategies like Technology Equity Long/Short and Emerging Market strategies. The largest gains came from China Equity Long/Short managers.

In 2018, we should expect to see an improvement for the hedge fund industry as market normalisation will continue. Federal Reserve tightening and tapering in Europe should profit rates trading and increase opportunities in the equity markets. In addition to equity dispersion, US tax cuts, which will increase corporate activity and give opportunities to stock pickers, should benefit the equity strategies, namely Long/Short Equity and Event-Driven. At the end of this document, you can read our conviction on machine learning.



MACRO

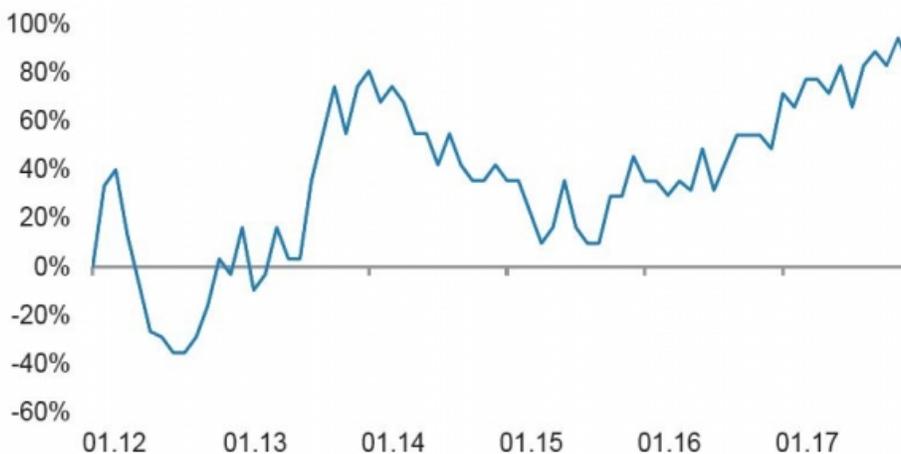
The review period was again quite complicated for Discretionary Macro managers unable to implement risk and extract alpha. Indeed, the risk budget was back to lows and except for the reflation trade post-Trump's election, which was short lived, there were no sustainable fundamental trends to capitalise on outside of equities. The last two months of the year were particularly detrimental for short US rates on the back of dovish Fed comments, the ECB's rhetoric and weaker inflation outlooks. Positioning was fairly idiosyncratic including being long European risk, quite agnostic on rates and sovereign credit allocation, with no specific consensus on FX. Currencies were the largest detractors over the period and year-to-date, while those with a bias to Emerging Markets and European peripherals outperformed. Systematic managers were more resilient for those with a larger long equity allocation, especially in September, as all other asset classes were detrimental, impacted by larger swings intra-month.

Our outlook

Our outlook might sound like an nth reiteration of our previous letters, but timing markets is a complicated exercise. Indeed since the taper tantrum in 2013, many, including ourselves, have seen a rapid normalisation of the rates environment with a return to fundamentally-driven markets and sustainable trends as likely to benefit their funds. We reiterate our positive view and this time we hope it will materialise.

Global Growth is Unusually Synchronised

Share of Global PMIs > 50



Source
Morgan Stanley Research, Haver Analytics. Data as of : January 2018

EQUITY HEDGE

All-in-all it was another positive period for Equity Hedge strategies thanks to strong and supportive equity markets around the world. However, the on-average +4.7% performance for the asset class (HFRI Equity Hedge) from September to December was not created without some market turmoil. First in September, the market saw a change in leadership when value stocks (such as energy, materials and industrials) suddenly recovered on the back of strong growth numbers, whereas market darlings technology companies underperformed. An even more severe sector rotation - and style rotation from growth to value - happened at the end of November when telecom companies in the US recovered from nowhere and tech companies posted negative returns in a rising market. The growth momentum trade suddenly underperformed and some managers were caught in the short term rotation. Nevertheless, the full year strong momentum led on average to double-digit positive performances for L/S managers and around +5% for market neutral strategies, illustrating the alpha opportunities that were available in the market in 2017.

Our outlook

We expect equity markets to be mostly driven by fundamental factors rather than macro events in 2018 with the US Fed's monetary policy normalisation. On top of this, wide equity dispersion and low intra-sector and intra-stocks correlations are a great playground for alpha creation. Bottom-up strategies are therefore to be favoured.

US market : Wide sector returns dispersion in 2017, dominated by IT



Source
Morgan Stanley Research, Bloomberg. Data as of : December 2017

EVENT DRIVEN

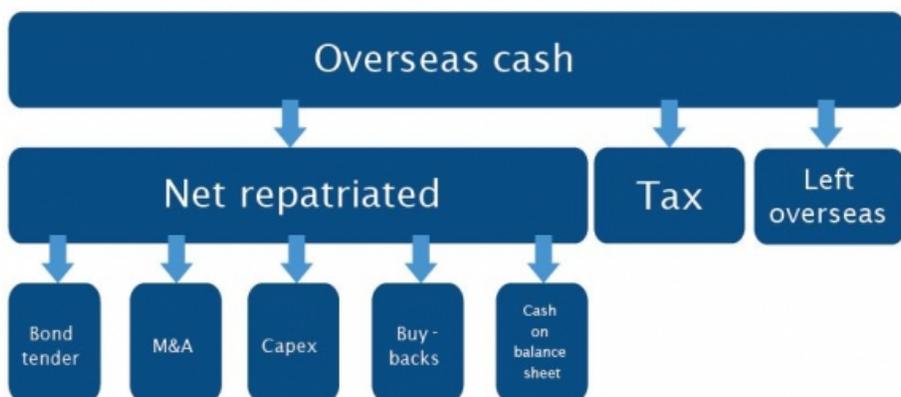
The third part of the year continued to offer a favourable environment for Event-Driven strategies. Interestingly, return dispersion between hedge funds increased significantly. The most important systematic event was the US tax reform, which has already impacted equities and will change the Event-Driven opportunity set once enacted. Our outlook below focuses on cash repatriation. The most important idiosyncratic event reminded investors that the returns in Event-Driven depend on specific catalyst-driven situations, for better and worse. That is generally good and limits correlations between the returns of Event-Driven hedge funds and the main market indices. The US Department of Justice (DoJ) decided in November to block the USD 100 billion+ friendly acquisition of Time Warner by AT&T, which caught the Merger Arbitrage community by surprise. The deal presented a large spread for technical reasons, a short time to completion and a limited downside. The DoJ had not blocked a vertical merger in recent decades. The parties decided to go to court so the story is not over yet. Hedge fund managers focused on trading spreads might be rewarded.



Our outlook

The opportunity set is likely to increase. Cash repatriation should lead to a number of corporate actions. Surveys indicate that U.S. companies have an estimated 2.5 trillion overseas. Some of it will be repatriated and then used to pay down debt, buyback stocks, proceed to acquisitions, spend it as expenditures or increase dividends.

US Cash repatriation - our assumptions



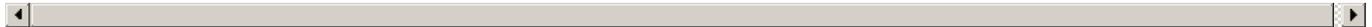
Source
SYZ Asset Management. Data as of : January 2018

RELATIVE VALUE

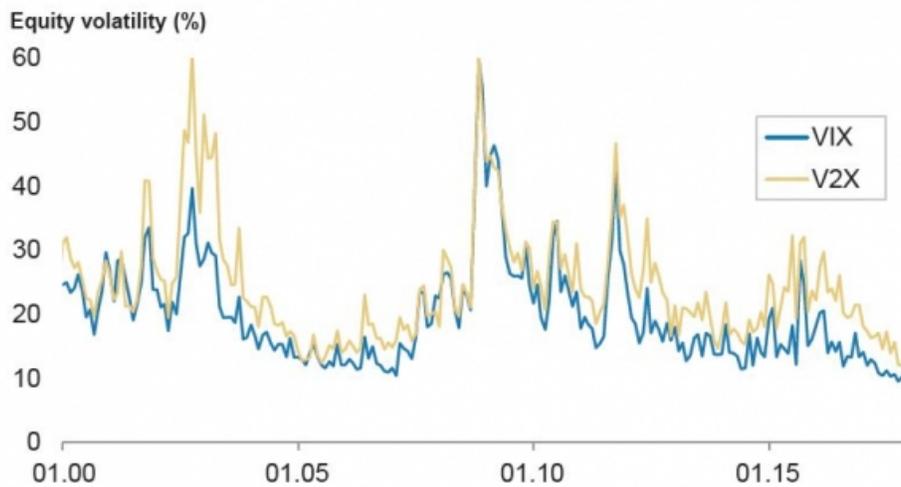
To the exception of November, where spreads widened, the whole period was again quite supportive for Credit managers, which continued to benefit from the up-trend in US equities and risk-on markets. Drivers were similar to previous months with the bulk of risk allocated to High Yield Commodity-related securities and stubs with additional risk allocated to Convertible Arbitrage trades. Detractors were idiosyncratic including Puerto Rican municipal bonds due to Hurricane Maria in September and Altice in November. There was no real trade consensus among managers, each capitalising on various issues, tranches and events but all keeping a long bias. In regards to both Interest Rates and Volatility arbitrageurs, the positive trend continued too, most posting strong performance, with risk budgets in the upper range, with a tilt to respectively bunds basis and sovereign rates volatility trades.

Our outlook

We have considerably increased our risk in favour of Relative Value managers as we are optimistic on the bucket having trimmed down most of our beta allocation. Indeed, the opportunity set is ever increasing with several hikes expected in 2018. Volatility, both implied and realised, is at historical lows, short-enc US rates have begun to re-price and many expect inflation to finally pick up. Finally, US tax reform was formally approved and should represent a strong catalyst for credit.



Equity Vol Remains Low



Source
Bloomberg, SYZ Asset Management. Data as of : January 2018

OUR CONVICTIONS

Artificial intelligence and machine learning as a new paradigm in the Asset Management industry:

Artificial intelligence (AI) and machine learning (ML) have been among the hot and recurring topics of 2017, sharing the stage with passive equity investments, risk premiums and the madness surrounding Bitcoin. All share, at different levels, a common DNA and have triggered the same fears and introspection around the rise of the machine.

Both terms are confusing and overlapped as ML is a direct application of AI. Starting with the latter, AI is a 50 year-old concept aimed at replicating human intelligence using machines able to carry out tasks by themselves. It has come to the fore recently due to the availability of big data, high-powered computing and advanced algorithms, all allowing cheaper and faster applications of AI. It is interesting to note that 90% of all data in existence today were created in the last two years (source: Man AHL).

More specifically, ML, as a direct application of AI, is designed to identify repeatable structures and relationships in data without needing explicit instructions. Some techniques might include deep learning (i.e. a rebranding of neural network) and natural language processing. The former refers to algorithms using artificial neural networks, trained on large data sets to recognise a range of stimuli. The latter is focused on interpreting written or spoken language using techniques such as assigned numerical scores measuring the positive or negative sentiment of company financial reports in a repeatable and unbiased manner.

Broad industry applications are abundant today, ranging from driverless cars to virtual assistants and delivery drones - even to victory in games of chess.

The financial services world is not immune to this (r)-evolution. Insurance firms and investment banks are using ML-based tools to automate areas such as contract validation and data processing. Similarly, asset managers are no exception with the massive flows to passive instruments, pressure on fees and ever-increasing transparency regulation encouraging further cuts to operational costs and investment in technology.

Specifically to the fund industry, many already use ML systems either in predicative analytics to generate investment ideas or as an early warning system for assets at risk. Notably, quantitative shops use ML to help uncover non-linear relationship between inputs using alternative sources of data, away from the classical ones (i.e. price, volume and fundamentals), using instead social media, satellite cartography or web search information.

The number of managers using this approach exclusively is rising, but it requires a sound network and the deep knowledge that an alternative investment team can provide.

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