

January to April 2018

Monday, 06/11/2018

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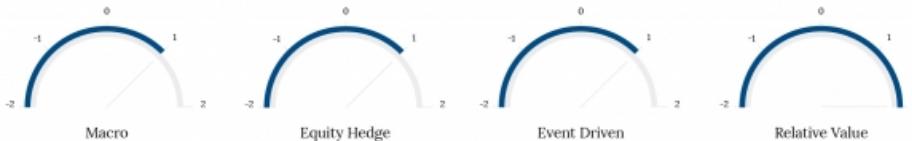


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- Volatility is back and creating opportunities.
- Increasing dispersion of returns.
- Widening merger spreads.
- Low net exposure strategies favoured for equities.



THE SITUATION SO FAR

In the first four months of 2018 we have seen the return of volatility to the equity market. We expected a rise from last year's abnormally low levels of volatility. The increase of the portfolios' arbitrage allocation during 2017 was beneficial, mainly to Fixed Income and Volatility Arbitrage. Both were positive during the February and March sell off.

The "trade war" between China and the US, the rising US interest rate and huge trend reversals have created significant performance dispersions among hedge funds. We have seen some managers taking more risk (e.g. higher concentration) due to 2017's low volatility and some of these were damaged by idiosyncratic events over the period. Nevertheless, generally hedge funds finished the period slightly down but still positive, depending on the indices.

We are convinced that the current environment is favourable to hedge funds. Investors struggle to allocate capital, and this asset class can provide returns with useful downside protection for the uncertainty expected in the next few years. We expect normalisation to continue, but Federal Reserve tightening and tapering in Europe should profit rates trading and increase opportunities in the equity market. It will also help maintain the increased volatility and dispersion that favour most of strategies.

At the end of this insight, you can read our view on blockchain and cryptocurrencies.

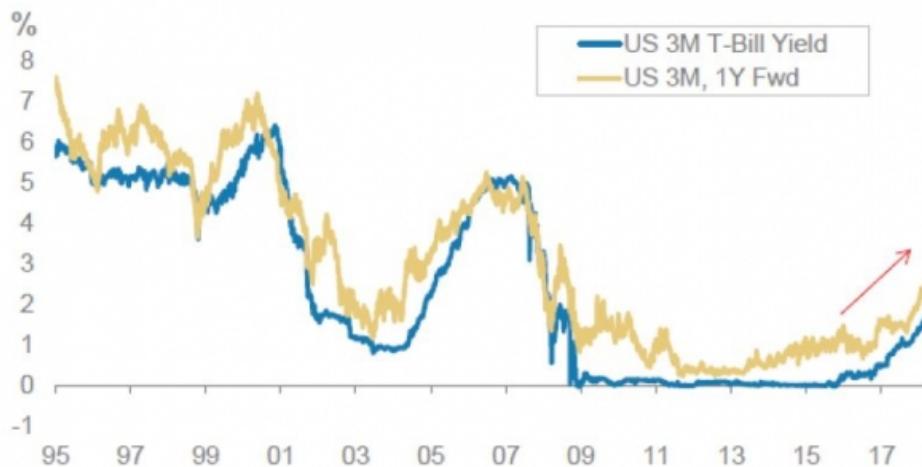
MACRO

As in the final third of 2017, most discretionary macro managers struggled to deliver performance in the first four months of this year. The year began well as risk-on allocations were benefitted by markets reaching 20-year highs. Indeed, even if some risk budgets were relatively low, most managers had kept a synchronised global growth tilt, mainly played out through short fixed income and long equities. An additional theme, short US Dollars, benefitted systematic managers. The party stopped in early February when volatility roused from years of lows, triggering mixed results for discretionary managers. Rates trended higher, offsetting the massive equity sell-off that was detrimental to most systematic managers. As a result, equity exposure was trimmed down, with most managers finishing the review period in a defensive mood.

Our outlook

There is no change on our positive outlook for the macro bucket, with markets becoming more fundamentally driven and rates finally beginning to weigh on emerging markets. Managers are balancing an optimistic growth outlook against an undetermined consolidation period, with the looming «trade war» between China and the US acting as a potential negative catalyst.

3M rates have risen dramatically in recent years



Source

Morgan Stanley Research, Bloomberg, SYZ Asset Management. Data as of: 30 April 2018

EQUITY HEDGE

Markets have been hectic as of late: the US 10y yield has risen by +100 bps between its lowest level in September 2017 and its recent high at 3.03% in April 2018. Meanwhile, equity markets have had a bumpy ride. Higher rates increase the cost of capital for companies and have a mechanical effect on their valuations in discounted cash-flow models. Nevertheless, a higher cost of financing has much more impact on capital intensive or bond proxy industries, like utilities, telecoms or consumer staples, than on growth sectors like technology or consumer cyclicals. This can be seen in the performance of global sectors YTD to end of April. In dollar terms, consumer discretionary are up +4.4%, IT and energy +3.5%, whereas consumer staples (-7.2%), real estate (-5.1%) and telecoms (-3.9%) were lagging in an overall flat market. Despite negative months in February and March, the HFRI Equity Hedge index is up +0.8% over the period principally thanks to a good month of January (+2.9%). The HFRI Equity Market Neutral sub-strategy is up +0.5% in the first four months of the year.

Our outlook

As intra-stock correlations and the cost of capital have increased substantially so far in 2018, the environment has become more selective for Equity Long/Short managers. On the other hand, higher volatility has opened new opportunities. Therefore, we favour sector or multi-sectors funds with low net exposure in order to mitigate sudden sector rotations and market drawdowns.

Consumer defensives were hit by recent yield increase, consumer cyclicals resilient



Source

Bloomberg, SYZ Asset Management. Data as of : 30 June 2017 - 30 April 2018

EVENT DRIVEN

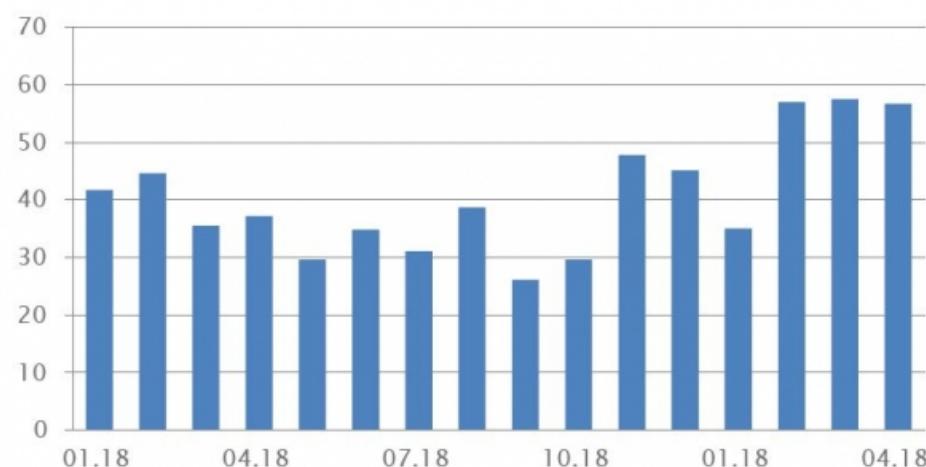
During the period under review, dispersion in returns of Event Driven hedge funds increased meaningfully. Volatility in equity markets spiked in February and impacted Special Situations funds with high beta exposures. Merger Arbitrage spreads widened in February and April to levels rarely seen in recent years. Some transactions, certainly more than anticipated, were rejected by US authorities such as the Department of Justice and the Committee on Foreign Investment, which surprised the investing community. Usually, the US offers a predictable process for mergers and acquisitions, but this has changed under Trump's administration. Also, following Trump's announcement of potential trade tariffs for China, the Chinese Ministry of Commerce's approval for Qualcomm's acquisition of NXP was delayed - eight other countries had previously approved the transaction. US chipmaker Qualcomm now has to unexpectedly refile in China. NXP shares plummeted and drove heavy losses to merger arbitrageurs. Widening spreads hurt investors initially, but we believe they offer opportunity for more nimble funds. Credit opportunities continued to be relatively limited, although these should increase if and when the economic cycle turns.



Our outlook

With an increase in equity volatility and in merger arbitrage spreads, the outlook has become darker for Special Situations strategies and brighter for Merger Arbitrage funds. It probably makes sense to be over-exposed in Europe, where rules are more stable, and under-exposed to the U.S. and emerging markets, due to an unpredictable US government and its relationship with China.

Event driven hedge funds proprietary return dispersion index



Source

SYZ Asset Management. Data as of : 30 April 2018

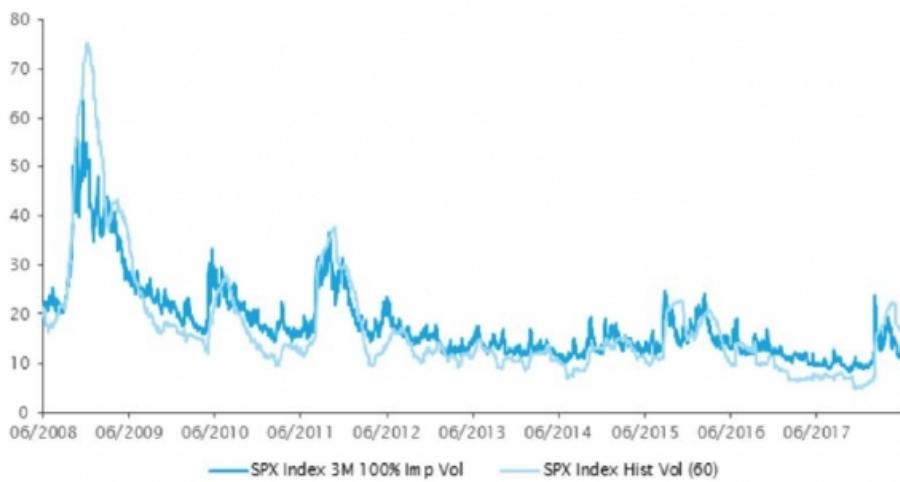
RELATIVE VALUE

The long-awaited fundamental change in volatility, after years of lows in realised/implied volatility, occurred on February 5th, after an irrational January. Credit managers had difficulty navigating the higher equity volatility and lower yields in government bonds, with high yield bonds seeing some outflows as a result of investors looking for floating rates. Notably, Long/Short managers outperformed distressed managers as allocation to stubs was negatively impacted. Positioning has remained fairly idiosyncratic, with most managers at the lower end of their risk budget. To the contrary, strategies focused on rates and Volatility Arbitrage posted strong performance and took advantage of the change in the volatility paradigm to reallocate more capital to Equity Volatility Arbitrage and Swap Rates books.

Our outlook

The opportunity set is ever-increasing for rates and volatility arbitrageurs, with yields and swaps spreads widening and, more importantly, equity volatility normalising. As mentioned previously, in regards to Credit Long/Short we remain more cautious as most managers are in a defensive mood, expecting the volatility to spread from equity to credit. However, we like Capital Structure Arbitrage, which is likely to benefit from increasing dispersion.

S&P 500 realised vol is finally rising



Source

Morgan Stanley Research, Bloomberg, SYZ Asset Management. Data as of : 30 April 2018

OUR CONVICTIONS

Blockchain and Cryptocurrencies: Revolution or Illusion?

The blockchain, even if still an emerging technology, is revolutionary and innovative. It is likely to change industry standards in many economic sectors.

In the financial sector for instance, real applications can and will probably be seen in the international payments space: as banking access in remote areas as a stable form of currency; in B2B payments as a threat to the SWIFT system; in securities trading and settlement; to manage bank guarantees and many more.

Getting exposure to the blockchain technology itself is not easy and one of the best ways is probably to invest in companies that develop or provide blockchain-based solutions. Those companies are most likely start-ups and venture capital-type investments and would require a private equity approach with a long-term investment horizon.

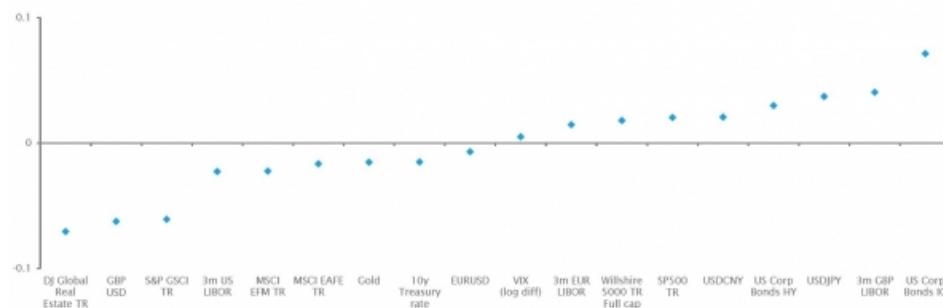
Investing directly in cryptocurrencies is another way to get exposure to the growth of the blockchain technology and indirectly to its underlying infrastructure. The bitcoin is the first visible application of the blockchain, but trying to value it proves to be very difficult, so investing in bitcoin or any cryptocurrency is, at this stage, an uncertain bet on the future.

The technology is likely to see many applications in the next years, but the use of a wider range of cryptocurrencies and especially bitcoin is more questionable due to its scalability limits. However, if one cryptocurrency becomes a new global standard and a "reserve currency" adopted by all market participants, then its price is likely to rise further. We are still very far from this assumption and it is questionable whether the bitcoin will be that currency.

Despite these uncertainties, the good news for people willing to invest in one or a basket of cryptocurrencies in a global portfolio is that they offer diversification benefits thanks to very low correlation with traditional assets, without requiring much allocation due to high volatility and high expected return.

Among the available investment alternatives, a diversified multi-cryptocurrency fund is probably the less risky way to invest in this area. Nevertheless, selecting such a fund requires particular skills in terms of technological understanding and, even more importantly, careful assessment of the operational setup and security risk. The due diligence exercise is made even more challenging as very few cryptocurrency managers have long and proven track-records

Correlations of Bitcoin with traditional asset classes is low



Source

Bloomberg, SYZ Asset Management. Data as of : 31 October 2012 - 30 April 2018

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