



REVIEW OF THE ALTERNATIVE UNIVERSE

HIGHLIGHTS

- Hedge funds outperformed the equity market in 2018
- Systematic macro strategies were best in class mainly thanks to short oil positions
- Equity long/short suffered from the sell-off, sector rotation and deleveraging
- Fixed income and Volatility arbitrage strategies were resilient and finished the year positive
- Portfolio emphasis on Arbitrage managers, likely to capitalise on the new higher volatility regime

Strategies outlook

Macro



Equity Hedge



Event Driven



Relative Value



Cédric Vuignier
Head of Manager Research &
Alternative Investments



Christophe Campana
Senior Analyst

THE SITUATION SO FAR

2018 was a challenging year. Many conflicting forces collided, with the Fed hiking rates on the back of rising inflation, low unemployment and solid growth, while macro turmoil triggered sharp market reversals. Hedge fund performances in 2018 were down on average across most strategies, although they outperformed the MSCI World TR. It was difficult to find a profitable investment, but our uncorrelated strategy was the exception. It was robust in the last months of the year and finished in positive territory.

In terms of strategies, the worst performers were the managers with equity beta exposure, as the global deleveraging initiated from October until 21 December caught many off guard. The most resilient strategies were short-term quant and arbitrage strategies, which profited from the increase in equity volatility.

New challenges arose and managers had to adapt quickly to a new paradigm, characterised by the below.

- Donald Trump weighs on markets. His sometimes brutal tweets and decisions have a direct effect on hedge fund strategies, i.e. merger arbitrage. These are particularly sensitive to the US-China trade war, and Trump's actions are forcing these managers to review their investment processes.
- Impact of volatility constrained instruments such as risk parity, systematic and passive products, which gathered massive assets over last few years and became major market drivers.
- The liquidity gap has become a recurring theme and market driver. Following the Global Financial Crisis, new regulations forced proprietary desks to shut down, and with ongoing Fed tightening, the liquidity gap acted as a catalyst to the fundamental increase in volatility.

We have increased our allocation in favour of shorter-term players – both systematic and discretionary – and to volatility arbitrage, more likely to capitalise on the current end-of-cycle environment.

MACRO

Equity deleveraging, as well as the move to higher implied and realised volatility levels, were detrimental to macro managers over the review period. Entering September, allocations across discretionary macro managers were similar to those witnessed over the whole year, namely in the lows but still with some equity beta, which was rapidly trimmed to near-zero in October. Managers were in aggregate tetanised by the lack of clarity on markets, worsening liquidity conditions and tumultuous macro environment. They kept a light idiosyncratic and tactical positioning, tilted to US rates and long US dollar versus commodity currencies – the latter being the largest detractor over the period. Systematic, excluding macro, managers struggled once again, as most kept a long bias asset-wise. The frequent reversals and lack of sustained trends made 2018 a difficult year for trend followers – even if upward trends in US rates allowed them to capitalise on bonds – while short-term contrarian models were particularly resilient.

OUR OUTLOOK

We find this end-of-cycle environment, characterised by a lot of noise, appealing – hence the emphasis on a longer investment horizon and the reduced use of systematic managers (excluding macro systematic) as we enter uncharted territories. Discretionary macro managers can implement relative value trades using rates and FX and should therefore be able to capitalise on the rising divergences across central bank policies. Another argument in favour of macro managers is their heavy use of futures to implement trades. This means they have large amounts of unencumbered cash, invested in treasury bills earning over 2.5% risk free per annum.

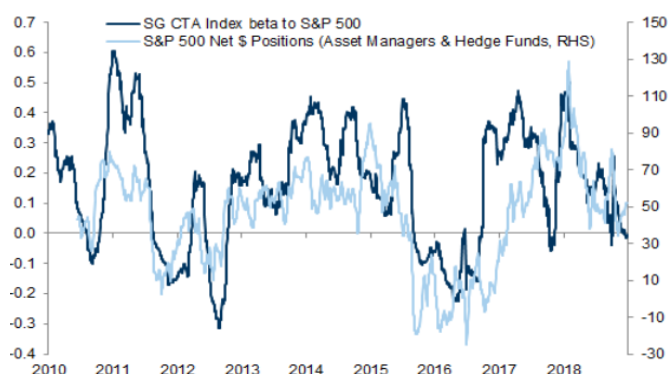
EQUITY HEDGE

The September to December period was detrimental to equity markets, with no safe havens and most indices posting double-digit negative returns. In the US, the most resilient sectors were defensive sectors, such as utilities, telecoms and consumer staples, whereas crowded growth stocks and cyclical sectors, such as IT, consumer discretionary and industrials, struggled the most. The most perverse effect for long/short managers was global deleveraging. The overall risk reduction of hedge fund managers during the market meltdown had an immediate impact, increasing downside selling pressure on long trades, as well as short coverage upside pressure. This hostile environment was particularly complex for managers with a net long bias and those with significant sector bets, as they were caught on both sides. Notably, we witnessed a rotation into defensive sectors in the second half of 2018, with healthcare, consumer staples, telecoms, and utilities making up four of the top five most net bought sectors. US market neutral managers were also hit by this dual impact of leadership reversal and global deleveraging, finishing the year in negative territory.

OUR OUTLOOK

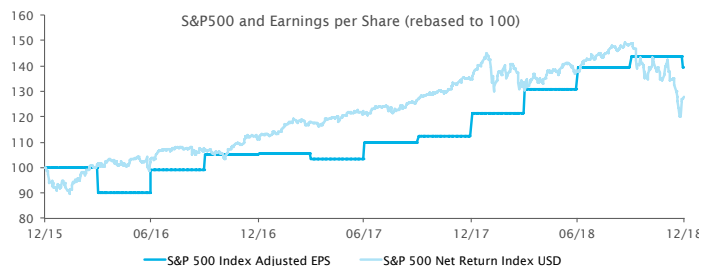
Almost all long/short managers reduced their gross and net exposures in the last months of 2018. We expect them to increase portfolio risk again during the coming earnings season, as soon as there is evidence fundamentals are stronger than analysts' recent sharp downgrade.

CTAs were very long equities at the beginning of the year but positioning now seems more neutral, in line with CFTC net long equity positioning



Source: Bloomberg, CFTC, Goldman Sachs Global Investment Research
Data from January 2010 to December 2018

The recent decrease in Earnings does not justify the correction of the S&P 500



Source: Bloomberg
Data from December 2015 to December 2018

EVENT DRIVEN

Over the review period, Event-Driven hedge funds posted negative performance in a complex environment which was driven, among other things, by political concerns and subsequent market conditions. Managers with higher beta exposure were particularly impacted in this bearish environment.

Merger arbitrage spreads did not move significantly throughout the period except in November when they tightened and once again the strategy was resilient. The sub-strategy benefited from tightening wide spreads on M&A deals related to China because of rejection fears after the Chinese regulator did not approve the NXP/Qualcomm deal.

Deal breaks portrayed returns in the merger arbitrage space over the period, and our managers were impacted by the aftermath of the Akorn deal break, which happened on the first day of October. The judge decided that Fresenius had legitimate grounds to terminate its acquisition agreement. It was the first time ever that a Delaware court allowed a Material Adverse Clause, allowing the buyer to pull out of its acquisition obligation.

OUR OUTLOOK

In a context where CEO confidence keeps decreasing and it becomes more difficult to complete large merger and acquisition deals or activism campaigns, we would advise remaining cautious on the strategy by avoiding positions linked to cross-border concerns. Regarding distressed credit - excluding oil, gas & energy - loan and default volumes are at historic lows. Nonetheless, similarly to prior cycles, lower-rated issuances have increased dramatically in recent years. In the past, large levels of issuance have been a leading indicator of a spike in defaults.

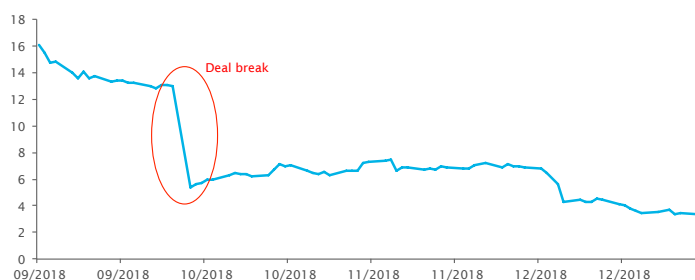
RELATIVE VALUE

Higher rates and wider spreads made 2018 the third worst year on record for investment grade total returns, just after the 1994 Great Bond Massacre and the 2008 Global Financial Crisis, while high yield fared only slightly better. Credit long/short managers were quite resilient over the review period. Risk budgets were still in the lows, on the back of tight spreads - with US high yield credit spreads near historical ten year lows - issuances were at record levels, particularly in the US and Europe, and underwritings were loose. Arbitrage managers went on to deliver, with fixed income arbitrage managers still in full speed mode with a bias to futures. They were positive every month over the period, reallocating some risk away from the long-standing play on bonds to Japan and the US. In regards to volatility arbitrage, even if the opportunity set was supportive, we witnessed a lot of dispersion across managers. Volatility premium arbitrageurs were impacted by a flattish US curve and sharp switch to backwardation, as well as a daily S&P 500 rally, while US-centric dispersion managers performed well.

OUR OUTLOOK

As mentioned since now a couple of months there are many pending issues in regards to credit but we keep a moderate optimism on capital arbitrage while we cut all credit beta. Higher volatility levels represent the ideal background for yield curve arbitrage and swap spreads. Volatility arbitrage should come back as a prime source of return, hence our steady positive outlook here.

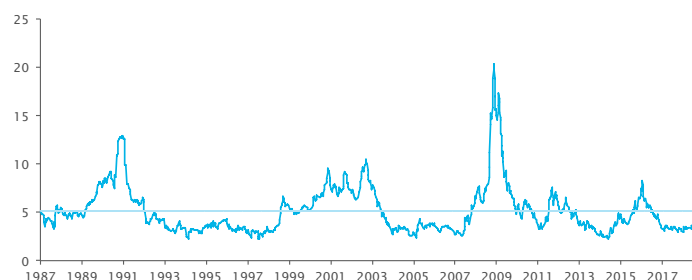
Akorn 2018 Stock Price Evolution (USD)



Source: Bloomberg

Data from September 2018 to December 2018

U.S. High Yield Credit Spreads: Near historical lows



Source: Bloomberg

Data as of: December 2018

➤ MIFID II AS A SOURCE OF INCREASED OPPORTUNITY FOR SMALL AND MID-CAP EQUITIES

One of the goals of MiFID II was to separate research from trade execution and improve overall transparency, including for how managers spend investors' money. Today, twelve months after coming into force, the first impacts of MiFID II are starting to show.

The impacts on the buy-side and sell-side communities are quite different, as MiFID II states the former cannot receive research without paying for it, since this would be considered an inducement. This means sell-side actors have to provide top-quality research for which clients are willing to pay. In order to adjust their offer, due to decreasing investment house research budgets, sell-side firms are narrowing their focus, in particular on certain sectors. According to McKinsey, fees collected by investments banks have dropped by 30-35% in 2018 and this downtrend will extend into 2019. As sell-side houses must cut costs and reduce coverage, they will naturally decrease or abandon research on small and mid-caps, due to less demand from mainstream investment houses.

The main consequence for small and mid-cap investors is the reduction in stock coverage will trigger market inefficiencies, creating opportunities for investors using their own research. The buy-side can grow its competitive edge, taking advantage of publicly available information that is simply not researched by the sell-side community. Nonetheless, less broker research means a reduction in trading liquidity provided to smaller companies, hence a higher probability for undiscovered stocks to remain under the radar.

Hedge fund managers active in micro, small or mid-caps, especially in Europe, benefit from this trend, as they usually conduct all their research internally and have seldom relied on secondary research. Fund liquidity terms allow them to absorb the potential illiquidity premium of smaller companies. New trading channels such as dark pools – private securities trading forums/exchanges – also create additional liquidity.

