Hedge Funds

Risk reduction in uncertain markets

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In this note we summarise the performance of hedge funds in 2018 and make some comments on the prospects for 2019, following what has been a good start to the year for the asset class. We then report on the results of Preqin's latest annual survey of investors' attitudes to hedge funds – one outcome of this study was that 79% of respondents planned to either maintain or increase their exposure to these types of funds during 2019, the highest such level since late 2014. Finally, we take a look at the listed hedge fund sector in terms of performance, rating and asset flows.

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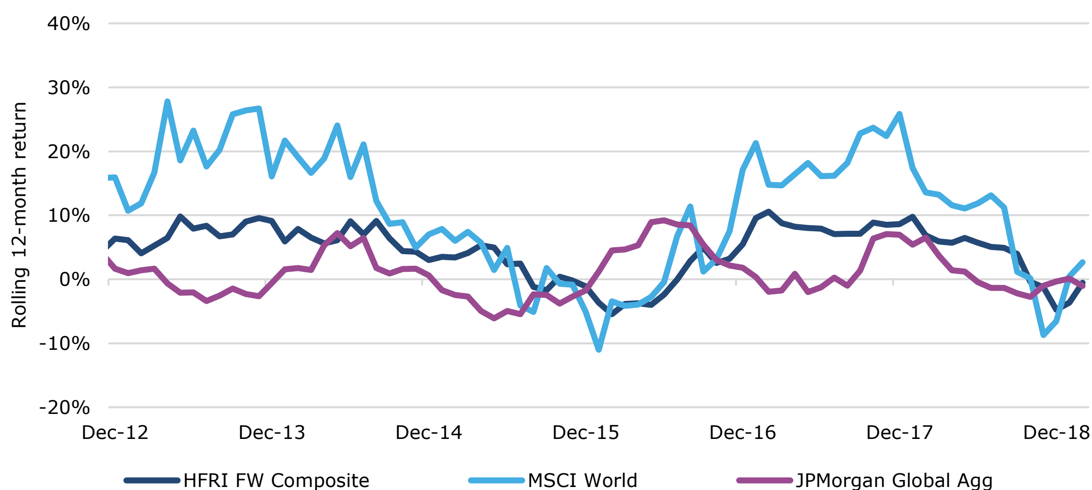
2018 performance

Hedge fund performance got off to a good start in January 2018 (the HFRI Fund-Weighted Composite index was up 2.3% that month) but gave back those gains over the next couple of months, stemming from the large sell-off in equity markets following the emergence of inflationary fears. Hedge funds then delivered steady, generally positive performance over the two quarters up until the end of Q3 2018 as stock markets rallied, helped by, for example, increasing consumer confidence and low unemployment in the US. However, large hedge fund losses were seen in the fourth quarter as a risk-averse sentiment gripped the markets, due to a wide range of factors including concerns over rising rates in the US and the ongoing US/China trade war. Overall, 2018 was a difficult year for hedge funds, with the HFRI Fund-Weighted Composite index down 4.7% during the period, the worst annual return since 2011. Furthermore, the trailing 12-month return had reached the lowest level since early 2016 by the end of the year.

Fig 1: Hedge fund, equity and bond rolling 12-month returns

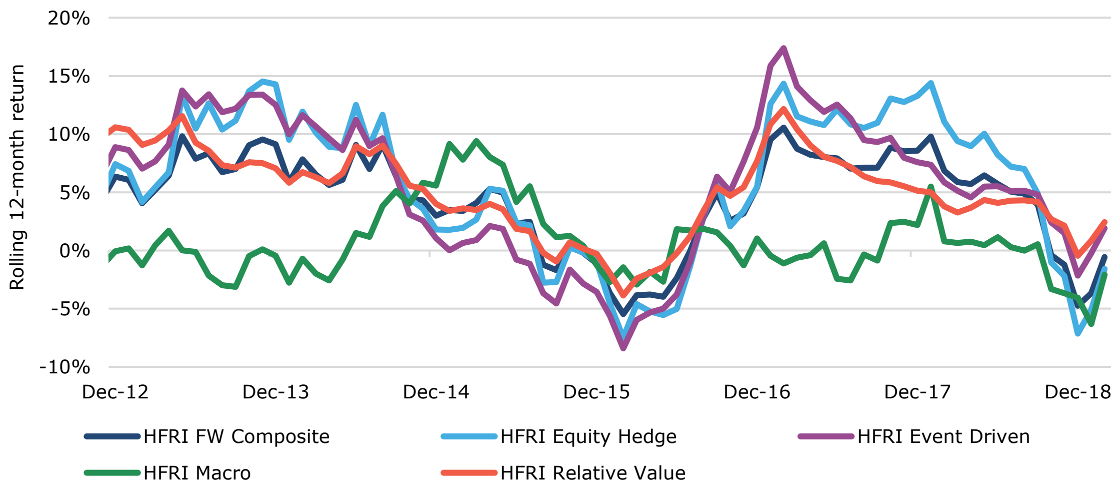


Source: Fidante Capital, HFR, Bloomberg. From 31 December 2012 to 28 February 2019. Past performance is not a reliable indicator of future results.

Drilling down further, none of the four main hedge fund strategies were able to make money in 2018, with the annual returns ranging from down 7.1% (for the HFRI Equity Hedge index) to down 0.4% (for the HFRI Relative Value index). The performance for the hedged equity sector should not be a surprise, given the generally positive beta to equity markets adopted by the managers of these funds and the performance of stock markets, which ended the year in negative territory. The more market neutral, relative value types of funds were better able to protect their valuations but were still negative (the HFRI Equity Hedge: Market Neutral Index was down 1.0%). Macro managers generally found the markets difficult (many of the markets traded were characterised by reversals and/or range-bound price movements) with the result that the HFRI Macro index was down 4.0%. The deal flow which underpins merger strategies

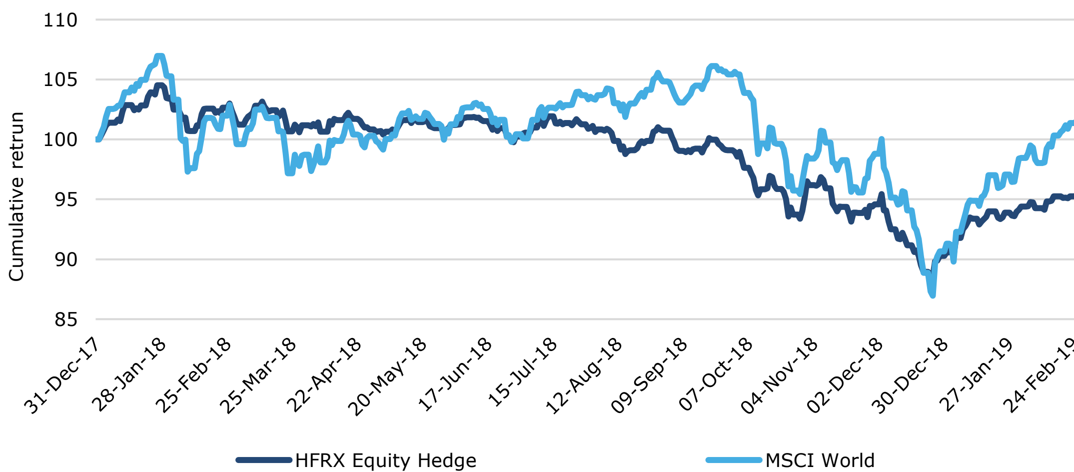
was strong through the year, helping the HFRI Event Driven: Merger Arbitrage Index to a gain of 3.3% in 2018, but was not able to completely offset the negative contributions arising from the elevated and at times "spiky" market volatility, and other factors, with the result that the overall HFRI Event Driven index was down 2.2% over the 12 months.

Fig 2: Hedge fund rolling 12-month returns



Source: Fidante Capital, HFR, Bloomberg. From 31 December 2012 to 28 February 2019. Past performance is not a reliable indicator of future results.

Fig 3: Equity hedge and equity market rolling 12-month returns



Source: Fidante Capital, HFR, Bloomberg. From 31 December 2017 to 28 February 2019. Correlation over the period was 0.87. Past performance is not a reliable indicator of future results.

2019 performance and outlook

Following the disappointing end to 2018 for hedge funds, 2019 has got off to a good start, with the average hedge fund (as represented by the HFRI Fund-Weighted Composite index) being up 4.9% over the first two months. Again, we can look at the breakdown of performance by strategy – average returns over the period ranged from up 1.0% (for the HFRI Macro Index) to up 7.0% (for the HFRI Equity Hedge Index). The only average negative year-to-date sub-strategy performance came from those funds represented by the HFRI Macro: Systematic Diversified Index (which includes CTAs).

One significant contributor to the decent performance so far this year has been the re-establishment of the risk-on market environment, as the market shrugged off the late 2018 concerns and focused instead on the prevailing (and perhaps wavering) signs of ongoing economic growth. In addition, the sell-off towards the end of 2018 led to a situation whereby many assets became "over-sold", with prices out of line with fundamental underlying valuations, and many funds have been able to benefit from these types of opportunities.

Can this state of affairs continue for an extended period into 2019? We expect that as prices normalise, the short-term opportunities created by the end of 2018 market volatility will become fewer in number, and less attractive in terms of their ability to generate good returns. There are many reasons to believe that heightened market volatility, with occasional volatility spikes (not generally helpful for hedge fund strategies), could re-emerge, not least due to the uncertainty surrounding the Brexit discussions. On the other hand, if a favourable Brexit outcome is ultimately reached (which admittedly does not look likely right now), there could be strong gains across risky assets in the UK, which could contribute positively to hedge fund returns.

Last week we published our latest quarterly market outlook note, which considered the likelihood of the US and European economies entering a recession over the next one to two years.[1] Much uncertainty remained, but based on the modelling presented in that note, it looked likely that both those economies would enter a recession sometime in 2020. And towards the end of last week, the ECB made clear its subdued outlook for the Eurozone economy, based on the economic indicators. Furthermore, global equity markets, which had rallied so far in 2019, started to look like they were running out of steam. All this points to the possibility that we are entering the latter stages of this economic cycle.

Back in August 2018 we published a note that outlined how different hedge fund strategies could be expected to perform in the latter stages of an economic cycle, based on historical hedge fund index analysis.[2] This note showed that certain strategies performed better in an economic slowdown (for example, short-biased equity strategies), or worse (for example, hedged equity and event driven), or were largely unchanged (for example, statistical arbitrage, merger arbitrage and equity market neutral). The analysis was extended to include those historical periods when stock markets were falling sharply, during economic slowdowns – in this case, the clear winners were short-biased and volatility trading strategies, for understandable reasons. However, in order to help ensure good performance through an entire economic cycle, the note also showed that it may be beneficial to maintain an exposure to multi-strategy hedge funds, with their diversified exposures across hedge fund strategies which can be weighted, by the manager, in accordance with prevailing conditions in order to optimise performance.

Putting all these considerations together, we believe that 2019 will be another "interesting" (for "interesting" read "challenging") year for hedge funds, with the eventual outcome dependent on a number of distinct, and unpredictable, economic, political and market developments. We do, nonetheless, believe that there will be opportunities for hedge funds to make money. Furthermore, given the uncertain backdrop, multi-strategy funds may be best placed to deliver relatively attractive risk-adjusted returns over the next year or two.

[1] https://www.fidante.com/resources/market-outlook-q2-2019

[2] https://www.fidante.com/resources/hedge-funds-in-the-late-stages-of-a-business-cycle

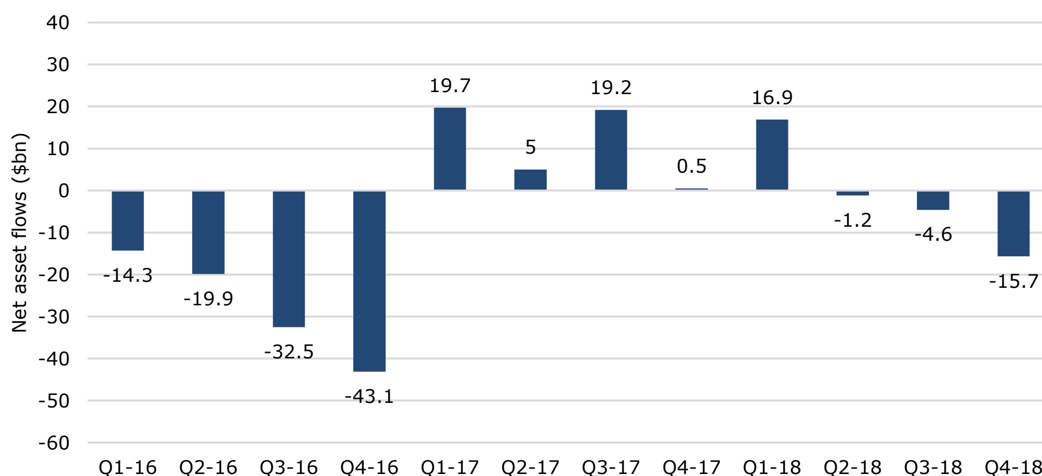
Hedge fund allocations

Net asset flows

This time last year, Preqin published their annual report on the hedge fund industry, which as usual included the results of a survey of investors' attitudes towards the sector based on polling that took place in November 2017. The results showed that just 27% of respondents were planning to decrease allocations to hedge funds in 2018, with the balance expecting either to increase or maintain their allocations. As revealed in this year's Preqin report, which was published recently, this translated into some positive momentum in terms of asset flows in Q1 2018, but this tailed off over subsequent quarters, perhaps initially due to the hedge fund performance reversal in February 2018, then in response to the positive market sentiment and the steadily increasing equity markets (which investors did not feel they needed to "hedge" against), and then finally due to the sell-off in Q4 2018. In the end, there were net outflows of $4.6bn during 2018, according to Preqin. However, total assets under management for the hedge fund industry did manage to reach a new peak at the end of Q3 2018 (£3.62tn), tailing off thereafter as performance worsened.

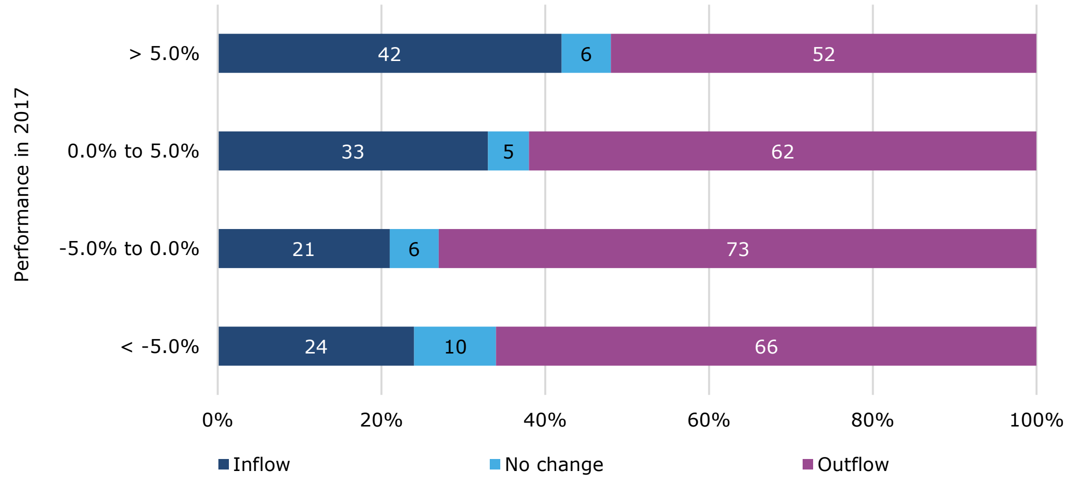
According to Preqin, credit strategies saw the largest inflows in 2018 ($22.1bn added, up 11.5% over the year) in response to rising interest rates. The largest outflows were experienced by equity and relative value strategies (-$14.2bn/-3.2% and -$24.3bn/-7.6%, respectively), most likely due to investors favouring higher beta exposures during the greater part of the year. And again, we can see the effect whereby the better performing funds in 2017 saw the more significant inflows in 2018, and vice versa.

Fig 4: Quarterly net asset flows for hedge funds



Source: Fidante Capital, Preqin.

Fig 5: Hedge fund net asset flows in 2018 by 2017 performance

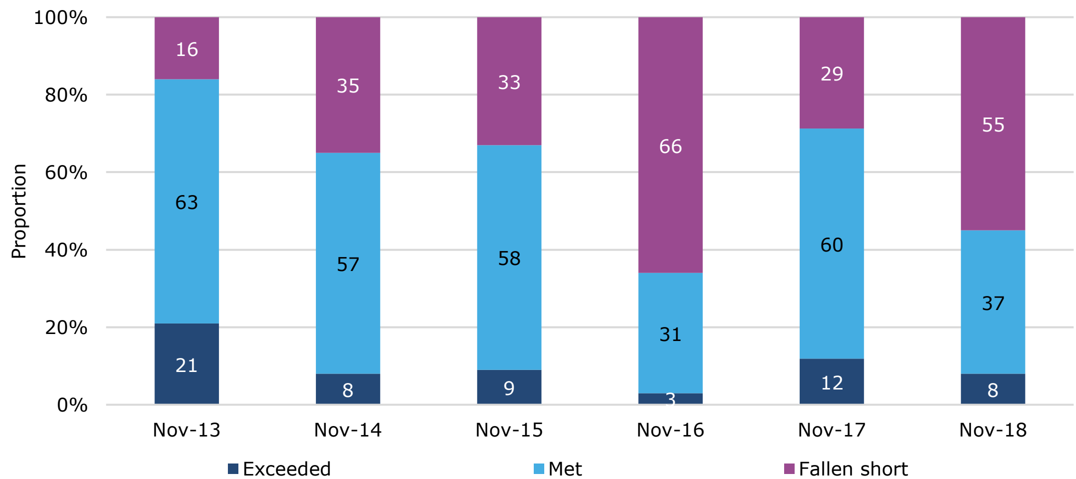


Source: Fidante Capital, Preqin.

Allocation plans for 2019

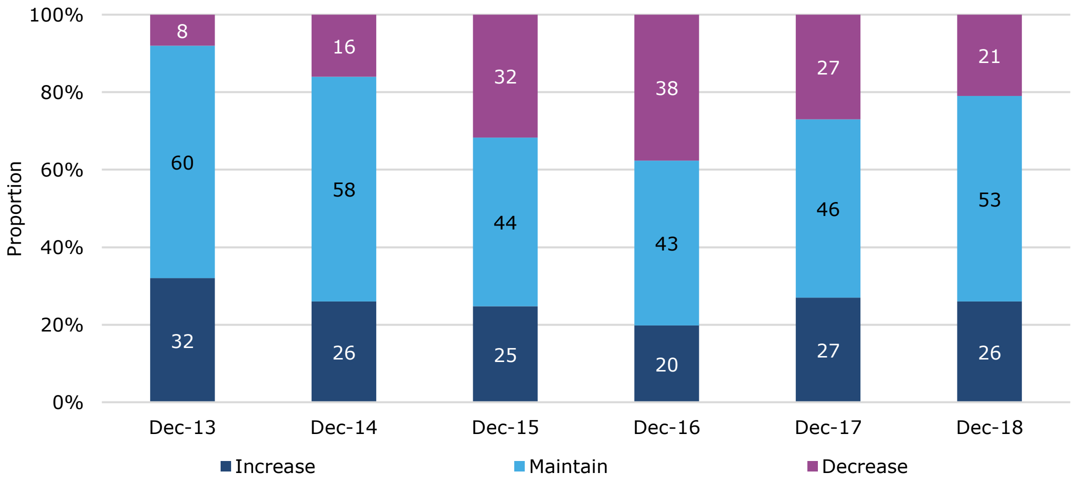
In the Preqin survey, investors recognised that hedge fund performance had been disappointing in 2018, with 55% saying that hedge funds had fallen short of expectations and only 8% believing that performance had exceeded expectations. Nonetheless, there is still an excess of investors saying that they will either maintain (53%) or increase (26%) the level of their investments in the sector in 2019 - this "positive attitude", by this measure, is at its highest level since Preqin's poll taken towards the end of 2014. This stems from the fact that hedge funds are seen as a necessary portfolio diversifier and a risk reducer in volatile markets – markets could be more volatile in 2019 than they were in 2018. Related to this point, the Preqin survey shows that 59% of investors believe that we are at, or close to, the peak of this equity market cycle and therefore close to a correction of some sort – given this, many are planning to make their portfolios more defensive (40%, up from 37% last year).

Fig 6: Hedge fund investor attitude to performance



Source: Fidante Capital, Preqin.

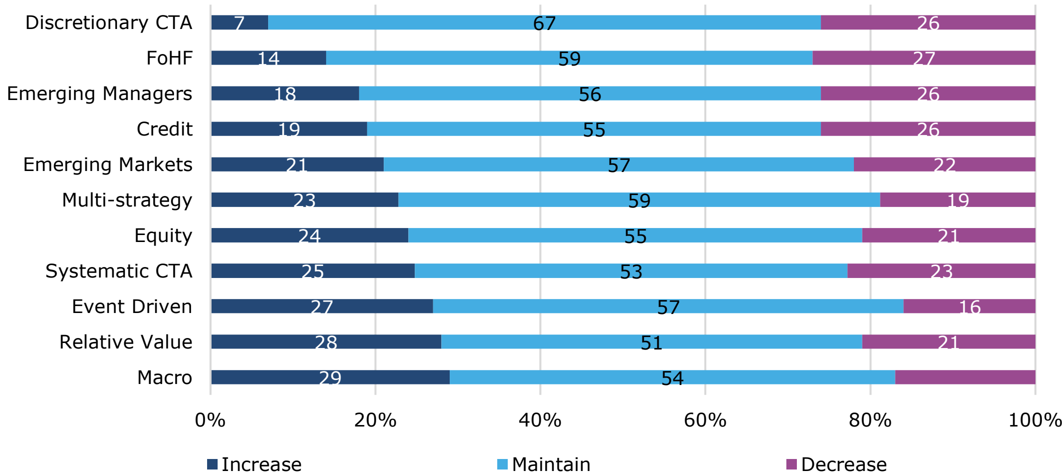
Fig 7: Hedge fund investor allocations over the next 12 months



Source: Fidante Capital, Preqin.

Looking at the hedge fund strategies favoured by the Preqin respondents for the coming year, it is apparent that those strategies which are traditionally better able to cope with volatile markets, and typically have less market beta, with lower correlations, are likely to receive the largest allocations - these include macro, relative value and event driven strategies.

Fig 8: Hedge fund investor allocations by strategy over the next 12 months



Source: Fidante Capital, Preqin

Listed hedge funds

Performance – NAV and rating

Half of the **single-strategy listed hedge funds** mimicked the return for the HFRI Fund-Weighted Composite index in 2018, by losing money over the course of the year. These loss-making companies were down in the range from -5.4% (NB Distressed Debt Extended) to -11.3% (Third Point Offshore). The positive performers were Gabelli Merger Plus (up 2.8%), Sanditon (up 1.5%), NB Distressed Debt Global (up 1.2%) and Pershing Square Holdings* (approximately flat, at -0.6%). Also apparent from the chart below is the volatility of monthly returns for this group of funds.

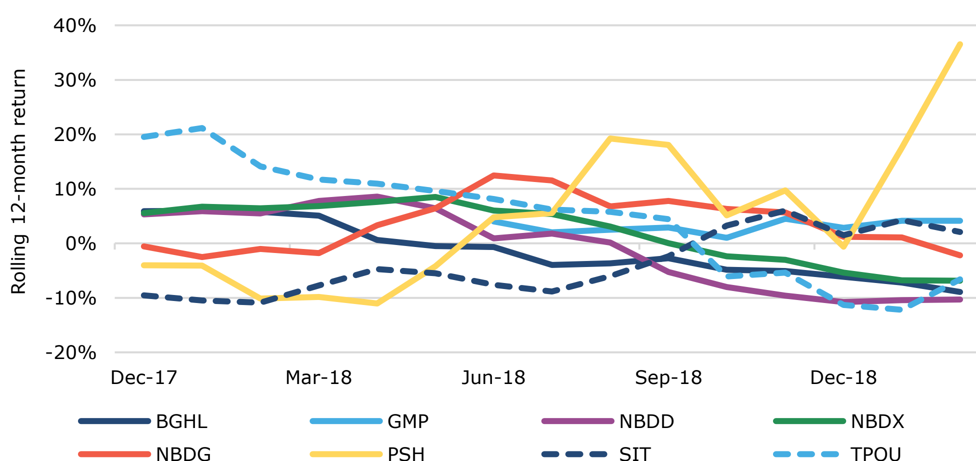
The **diversified listed hedge funds**, on the other hand, generated much smoother returns over the period. For BH Macro and BH Global, the NAV returns were up 12.4% and 5.4%, respectively. Both these companies generated unusually good performance in May 2018, largely from global rates and bond trading but also from FX and credit trading (BH Global was up 5.4% and BH Macro was up 8.2% in May 2018). Highbridge Multi-Strategy*, on the other hand, was down 2.0% in 2018, with the largest losing strategy (sector-focused long/short equity) contributing a loss of almost this amount.

The majority of the **single-strategy listed hedge funds** have generated positive NAV performance over the first two months of 2019, with the standout performances coming from Pershing Square Holdings* (up 29.4%) and Third Point Offshore (up 6.3%), both benefiting from their net long exposures to the rising equity markets.

Amongst the **diversified listed hedge funds**, Highbridge Multi-Strategy* was able to generate a positive return in January and February 2019 (up 2.2%), profiting from some of the dislocations that emerged in the market sell-off towards the end of 2018, for example in Japanese equities and in the relative value between the debt and equity of single companies.

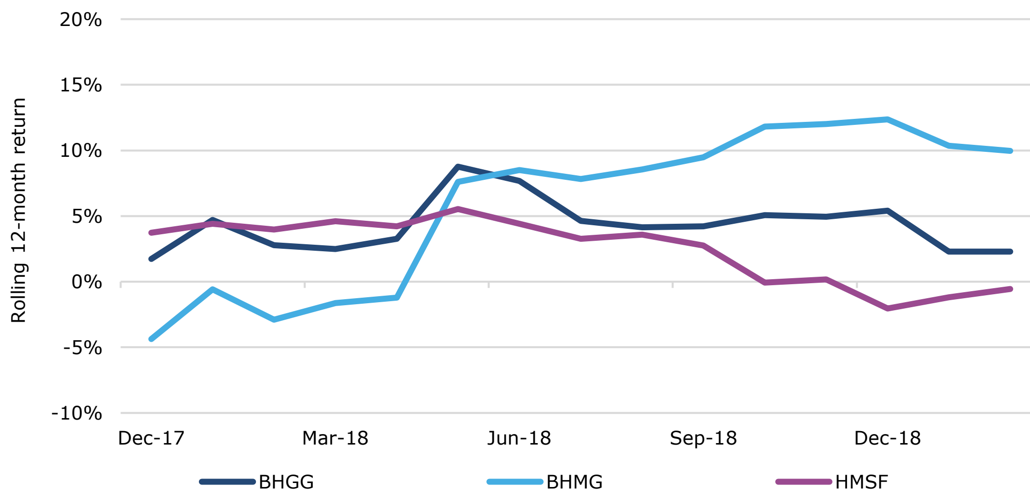
The good NAV returns for BH Macro and BH Global in 2018 have resulted in their narrowing share price discounts since the end of 2017 – both have narrowed from a discount of around 7% to just below par as at the end of February. There has been no similar re-rating of shares for the other listed hedge funds, be they single-strategy or diversified, over the same 14-month period.

Fig 9: Listed hedge fund rolling 12-month returns – single strategy



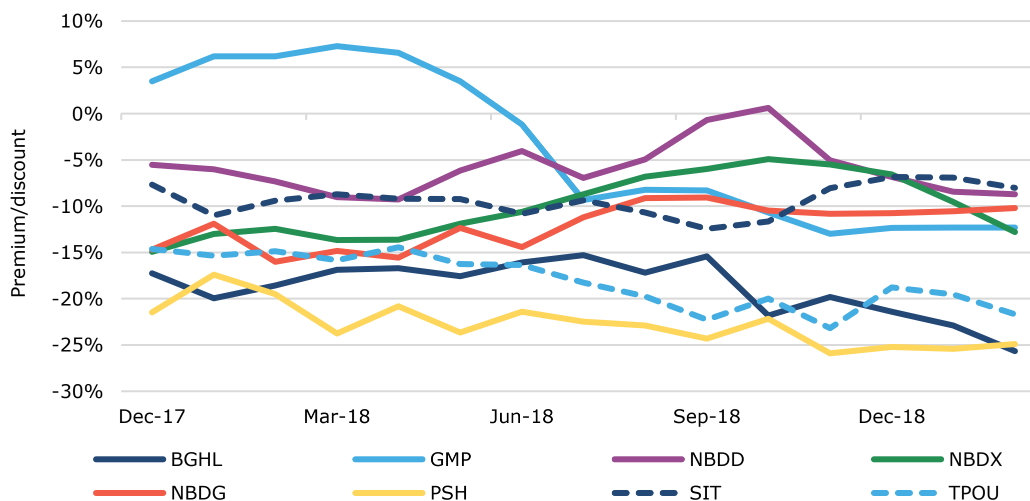
Source: Fidante Capital, companies. From 31 December 2017 to 28 February 2019. Companies are: Boussard & Gavaudan (BGHL), Gabelli Merger Plus (GMP), NB Distressed Debt Ordinary (NBDD), NB Distressed Debt Extended (NBDX), NB Distressed Debt Global (NBDG), Pershing Square Holdings* (PSH), Sanditon (SIT) and Third Point Offshore (TPOU). Track record reporting currencies: GMP, NBDD, NBDX, PSH and TPOU in US Dollar; NBDG and SIT in Sterling; BGHL in Euro. Past performance is not a reliable indicator of future results.

Fig 10: Listed hedge fund rolling 12-month returns - diversified



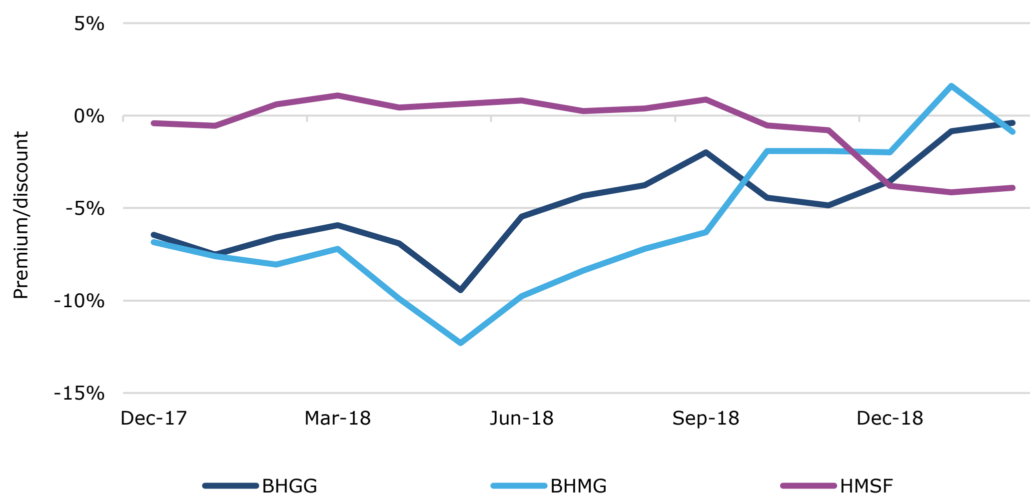
Source: Fidante Capital, companies. From 31 December 2017 to 28 February 2019. Companies are: BH Global (BHGG), BH Macro (BHMG) and Highbridge Multi-Strategy* (HMSF). All track records are in Sterling. Past performance is not a reliable indicator of future results.

Fig 11: Listed hedge fund premiums and discounts – single strategy



Source: Fidante Capital, companies. From 31 December 2017 to 28 February 2019. Companies are: Boussard & Gavaudan (BGHL), Gabelli Merger Plus (GMP), NB Distressed Debt Ordinary (NBDD), NB Distressed Debt Extended (NBDX), NB Distressed Debt Global (NBDG), Pershing Square Holdings* (PSH), Sanditon (SIT) and Third Point Offshore (TPOU). Past performance is not a reliable indicator of future results.

Fig 12: Listed hedge fund premiums and discounts – diversified



Source: Fidante Capital, companies. From 31 December 2017 to 28 February 2019. Companies are: BH Global (BHGG), BH Macro (BHMG) and Highbridge Multi-Strategy* (HMSF). Past performance is not a reliable indicator of future results.

Asset flows

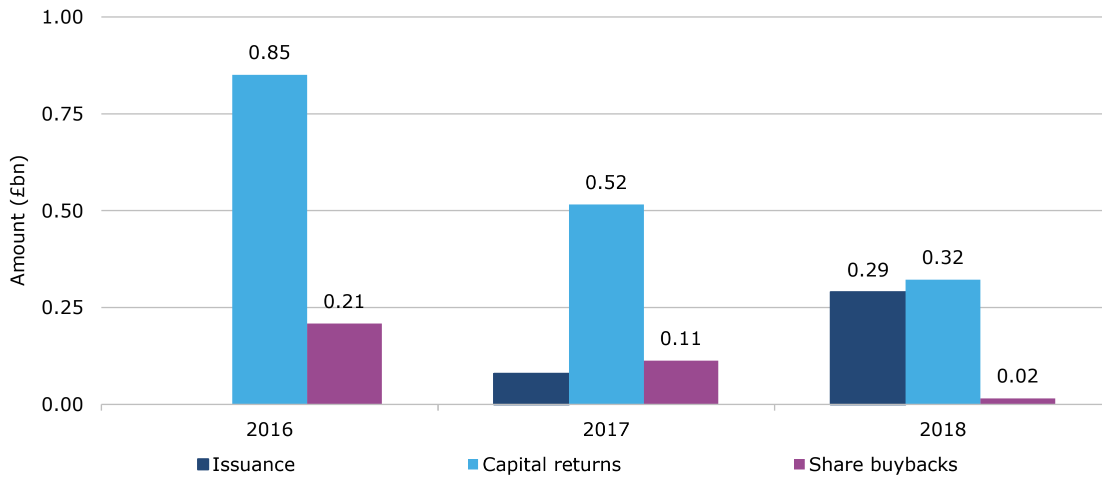
The Preqin reports show that asset flows into hedge funds were generally higher in 2017 and 2018 than they were in late 2015 and 2016. This generally increasing appetite for hedge funds over the last couple of years compared to previously has seemingly fed through to the listed hedge fund sector as well. Issuance has increased over the last three years, although the 2018 total was dominated by the £265m IPO of Trian Investors 1 in September 2018 (this is an activist fund, the first IPO in the sector since Gabelli Merger Plus in July 2017). Alongside this, capital returns and share buybacks have reduced over the same three-year period.

As seen above, most of the sector is trading at wide discounts to NAV and so it seems that the scope for further growth is limited, barring further IPOs (none of which have been announced to date). One company that has issued shares since the start of 2018 is Highbridge Multi-Strategy* (£18.9m in total) and this could continue in 2019, especially if that company's good performance continues and is reflected in share price appreciation. The only other companies that are trading close to par are BH Global and BH Macro, though new issuance by these two companies seems less likely.

Other than that, NB Distressed Debt will continue to return capital to investors across each of its three share classes, as per their investment mandates.

In short, it is not at all clear whether the trends in net asset flows that became evident in 2018 will continue into 2019.

Fig 13: Asset flows in listed hedge funds



Source: Fidante Capital, companies.

Summary[3]

2018 was a difficult year for hedge funds, with the average return being down 4.7% following a loss of 6.0% coming in the final quarter as markets sold off. Hedged equity funds were the largest losers, down 7.1% in 2018. Thanks to a re-establishment of a risk-on sentiment at the very end of 2018, which has continued for much of 2019 so far, hedge fund returns have rebounded and are up 4.9% on average in the first two months.

It's not at all clear that this good performance will continue for long, amidst the growing fears of slowing economic growth (notably in the Eurozone, but also in other regions) and the likely end of the current economic cycle, potentially leading to recessions in the US and the Eurozone sometime next year. In addition, the trade tensions between the US and China continue, as do the Brexit uncertainties. All these factors are likely to lead to increasingly volatile markets, which are likely to have a negative impact on some hedge fund strategies, while others will be relatively unaffected. Nonetheless, we believe that opportunities will emerge for certain strategies and managers, and that hedge funds will be able to deliver better risk-adjusted returns than traditional asset classes, with low correlations, thereby offering protection when included in investment portfolios.

Preqin has published the results of its latest annual survey of the hedge fund industry, having canvassed the opinions of investors in November 2018. The outcome of the survey shows several interesting findings, including the fact that the highest proportion of respondents since late 2014 plan to maintain (53%) or increase (26%) their investments in the sector, as part of efforts to make their portfolios more defensive. Furthermore, it is those strategies which are better able to cope with volatile markets that are forefront in those investors' minds – macro, relative value and event driven strategies.

Amongst the listed hedge fund sector, the single-strategy funds were generally split between those that lost money in 2018 and those that did not (though in no case could you call the return generated "spectacular", except when compared to traditional markets). Two of the listed hedge funds that are more diversified by strategy were able to buck this trend, with the best performance coming from BH Macro, which was up 12%. As with the HFRI indices used in this note, the majority of the funds in the listed sector have generated positive performance in 2019 so far, with Pershing Square Holdings* leading the way (up nearly 30% to the end of February). The comments made above regarding the likely future performance, and the benefits of investing in this sector, also apply to this set of funds.

[3] Source: Fidante Capital, HFR, Preqin, companies. Past performance is not a reliable indicator of future results.

Appendix

Fig 14: Returns for HFRI indices (by strategy and selected sub-strategy), equity and bond indices

	2016 (%)	2017 (%)	2018 (%)	2019 YTD (%)
HFRI Fund-Weighted Composite	5.4	8.6	-4.7	4.9
HFRI Equity Hedge	5.5	13.3	-7.1	7.0
HFRI EH: Market Neutral	2.2	4.9	-1.0	0.5
HFRI Event Driven	10.6	7.6	-2.2	4.8
HFRI ED: Activist	10.4	5.5	-10.6	8.4
HFRI ED: Distressed/Restructuring	15.1	6.3	-1.9	5.0
HFRI ED: Merger Arbitrage	3.6	4.3	3.3	2.3
HFRI Macro	1.0	2.2	-4.1	1.0
HFRI Macro: Discretionary Thematic	0.0	0.3	-0.7	2.2
HFRI Macro: Systematic Diversified	-1.4	2.1	-6.7	-0.4
HFRI Relative Value	7.7	5.1	-0.4	3.5
HFRI RV: Fixed Income Asset Backed	5.1	7.7	3.8	1.1
HFRI RV: Fixed Income Convertible Arbitrage	8.1	5.9	-3.1	4.8
MSCI World	7.5	22.4	-8.7	11.0
JPMorgan Global Aggregate	2.2	7.0	-1.0	0.9

Source: Fidante Capital, HFR, Bloomberg. The 2019 returns are to 28 February 2019. All track records are in US Dollar terms. Past performance is not a reliable indicator of future results.

Fig 15: Returns for listed single manager hedge funds

	2016 (%)	2017 (%)	2018 (%)	2019 YTD (%)
BH Global £	6.7	1.7	5.4	-0.9
BH Macro £	5.8	-4.4	12.4	-0.3
Boussard & Gavaudan €	7.2	5.9	-6.1	-1.0
Gabelli Merger Plus $	n/a	1.9	2.8	2.1
Highbridge Multi-Strategy £	5.4	3.7	-2.0	2.2
NB Distressed Debt Ordinary $	1.8	5.3	-10.8	1.5
NB Distressed Debt Extended $	3.6	5.5	-5.4	0.0
NB Distressed Debt Global £	29.7	-0.6	1.2	-3.8
Pershing Square Holdings $	-13.5	-4.0	-0.6	29.4
Sanditon £	5.1	-9.5	1.5	-1.3
Third Point Offshore $	6.1	19.5	-11.3	6.3

Source: Fidante Capital, companies. The 2019 returns are to 28 February 2019. The Gabelli Merger Plus track record starts in July 2017. Past performance is not a reliable indicator of future results.

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