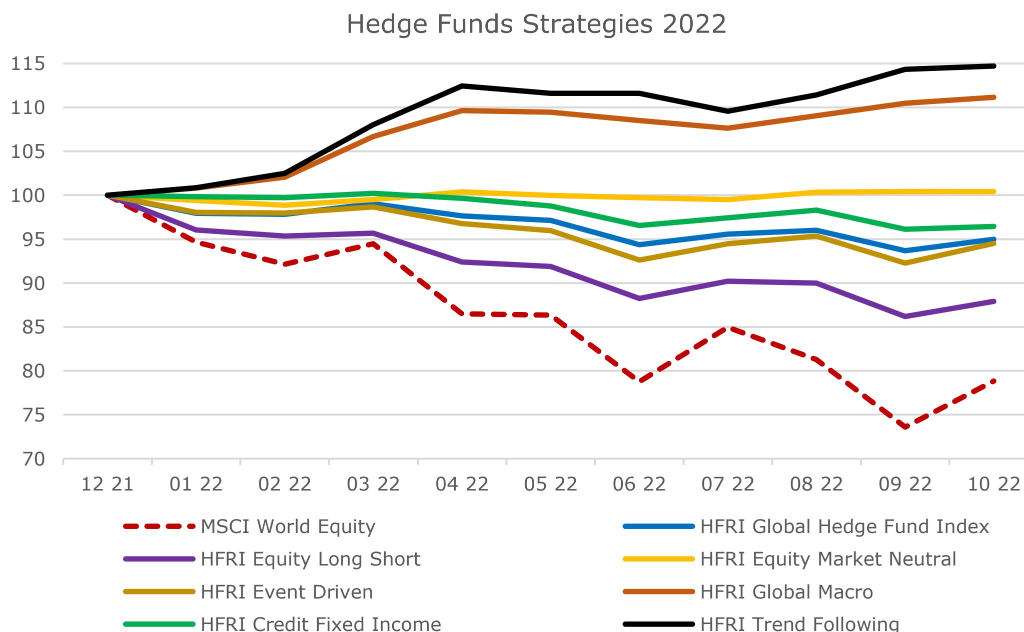
Hedge Funds Review & Outlook

Investment Insight | Series XI

1 Hedge Funds Review 2022

The year of 2022 was characterised by a turbulent market environment in which the predominantly technology stock-driven bull market faltered due to tighter central bank monetary policy, high inflation figures, slowing supply chains, Russia's invasion of Ukraine and fears about the global economy. Against this backdrop, hedge funds declined by -4.2% as measured by the HFRI Global Hedge Fund Index (to November 2022). Compared to other asset classes, this is a significant relative outperformance, as equities lost -19.5% (MSCI World) and bonds -16.3% (Bloomberg Global-Aggregate TR Index Value Unhedged).

Chart 1: Hedge Funds Strategies: Large dispersion among strategies

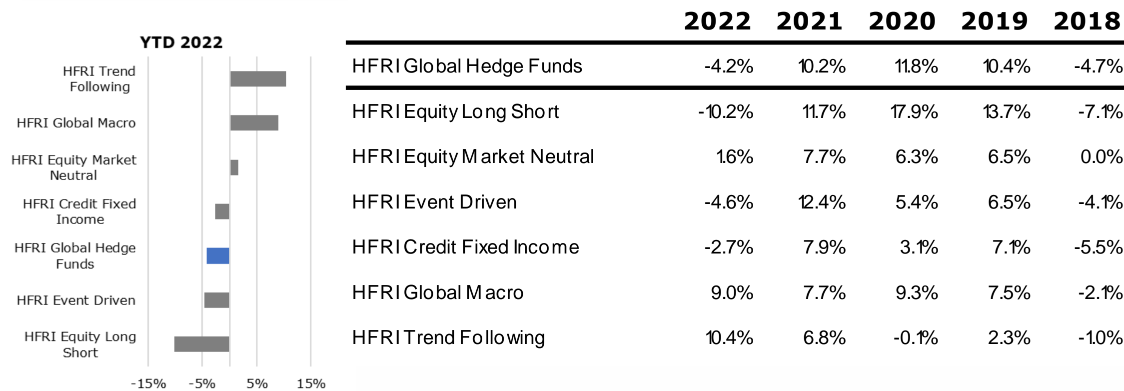


Source: Bloomberg Finance L.P. HFR

The hedge fund index thus had a relatively low downward participation and was able to stand out strikingly from the very negative environment. But the question is justified as to why the "hedge"

nevertheless only worked to a limited extent? In fact, the global hedge fund index does not quite live up to the absolute return promise, which is mainly due to its composition. It has a strong weighting of equity long short managers, which in turn have an average market beta of 0.50. This results in a relative "long bias" to the market of 0.35 beta on average for the entire hedge fund index.

Chart 2: Performance Main Strategies



	2022	2021	2020	2019	2018
HFRI Global Hedge Funds	-4.2%	10.2%	11.8%	10.4%	-4.7%
HFRI Equity Long Short	-10.2%	11.7%	17.9%	13.7%	-7.1%
HFRI Equity Market Neutral	1.6%	7.7%	6.3%	6.5%	0.0%
HFRI Event Driven	-4.6%	12.4%	5.4%	6.5%	-4.1%
HFRI Credit Fixed Income	-2.7%	7.9%	3.1%	7.1%	-5.5%
HFRI Global Macro	9.0%	7.7%	9.3%	7.5%	-2.1%
HFRI Trend Following	10.4%	6.8%	-0.1%	2.3%	-1.0%

Source: Bloomberg Finance L.P. HFR

As with all averages, the HFRI Global Hedge Fund Index is not representative of the sub-strategy constituents, which exhibited a very large performance dispersion in 2022. Not surprisingly, market-decorrelated strategies such as global macro or trend following performed very well. The withdrawal of liquidity from markets triggered movements in all asset classes, some of which have not been observed to such an extent for decades. An optimal environment for systematic trend followers, who were able to trade reliable signals on this basis. Global macro managers "played" discretionary with similar positions, such as opportunities on the interest rate side, which allowed them to profit from the upward shift of the yield curve (short duration) and were also able to turn the changes in the term structure into profitable trades. Global macro managers also successfully pursued strategies such as short equities, long volatility, long commodities and long US dollars. In general, managers with market-neutral market exposure delivered on their promise, on both the equity side as well as on the fixed income side. In these two asset classes, however, managers with a "long bias" suffered.

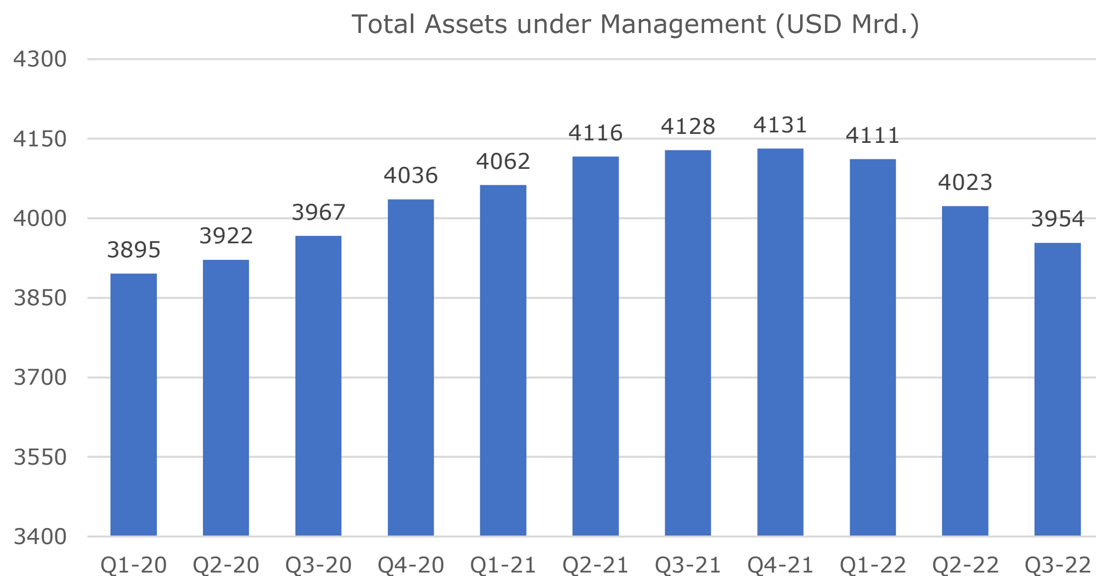
Valuable diversification through hedge funds in the portfolio

Even in 2022, hedge fund strategies were anything but static and homogeneous - yet many managers were able to deal with the challenging market environment adaptively and profitably. Recent market dislocations have actually demonstrated that hedge funds can act as a stabiliser and valuable diversifier in a portfolio. Portfolio resilience with hedge funds can be enhanced, especially when traditional stabilisers such as fixed income fail. The concept of "absolute return"

shows potential especially in phases of difficult market conditions. However, the wide dispersion of returns of the individual strategies and managers shows that active manager/strategy selection is all the more important - "buy & hold" does not work with hedge funds either, dedicated management of the investments is absolutely necessary. The Alpinum Alternative Strategy returned more than +5% in 2022, despite the extreme market conditions. The strategy thus underlines its competence to manage alternative funds in a difficult environment, decoupled from market trends.

2 Hedge Fund Industry 2022

Chart 3: Total Assets under Management

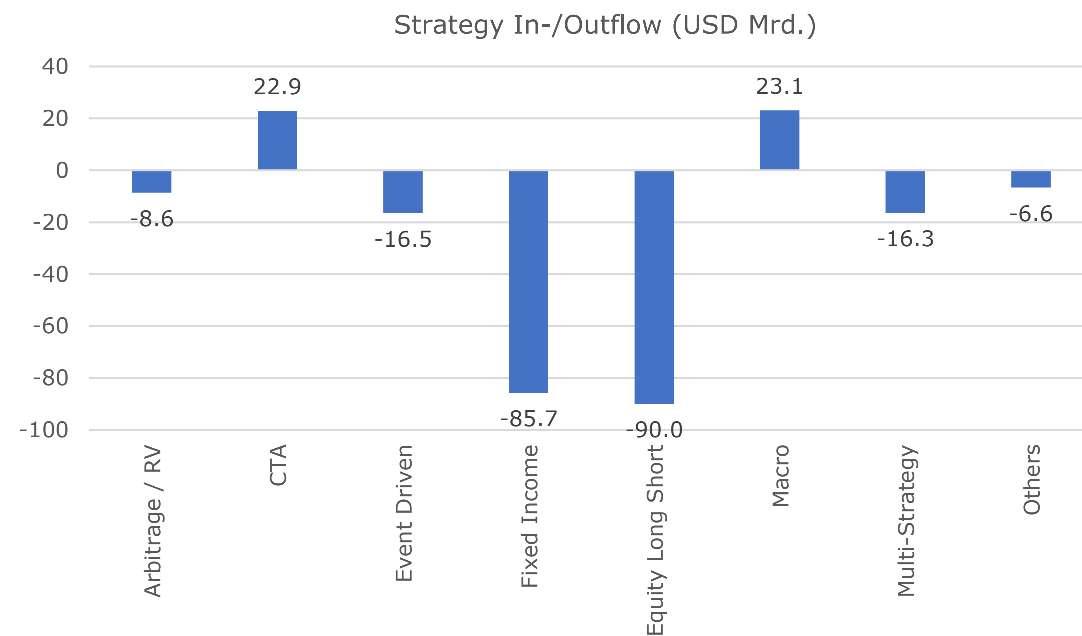


Source: Eurekahedge

The hedge funds industry recorded significant outflows totalling USD 178 billion in 2022 (up to September 2022). It now stands at USD 3.95 trillion, according to Eurekahedge data, having peaked at USD 4.13 trillion at the end of 2021. In Q3, USD 62 billion was withdrawn, the largest quarterly outflow since the pandemic in Q1 2020.

It is assumed that investors are "re-balancing" their portfolios. Some of the outflows are due to the "relative liquidity" of funds to other alternative asset classes such as private equity or private debt. Investors are withdrawing funds from available sources to prepare for tighter inflation and a possible recession.

Chart 4: Strategy In-/Outflow



Source: Eurekahedge

At strategy level, equity long short managers (USD -90.0 billion) and fixed income managers (USD -85.7 billion) saw the largest withdrawals, while global macro (USD +23.1 billion) and trend follower / CTA managers (USD 22.9 billion) were the only managers to see inflows over the year as a whole.

3 Hedge Funds Focus Topic: Convertible Arbitrage

Convertible Bonds: A convertible bond is a hybrid security that can be converted into equity of the issuing company. It usually has a lower yield than a comparable bond that does not have a conversion option. However, this is offset by the fact that the holder of the convertible can convert the security into equity at a discount to the market price of the share. If the share price is expected to rise, the bondholder will exercise his option to convert into equity; if not, the option will lapse and the bond (bond floor) will hold as a floor.

Convertible arbitrage: The arbitrage strategy for convertibles aims to hold a long position in a convertible and at the same time hedge it with a short position in the underlying stock. The arbitrageur tries to exploit inefficiencies in convertibles in a market-neutral way.

Convertible arbitrage managers found it particularly difficult to profitably implement their niche knowledge in 2022. While most managers reduced their risks early on, the market itself gave them little room to arbitrage inefficiencies: there were simply too few opportunities as new issues were too thin on the ground. In anticipation of higher interest rates, firms with capital-raising

needs had already started to raise cheap funding early in 2021. In 2022, with the materialisation of the higher interest rate environment, new issuance has fully collapsed - see table below. By the end of 2022, USD 39.5 billion of convertible bonds had been issued globally – in 2021 convertibles worth of 147.8 bn had been brought to the market, a drop of -73%.

Chart 5: Convertible bond issuance in USD billion:

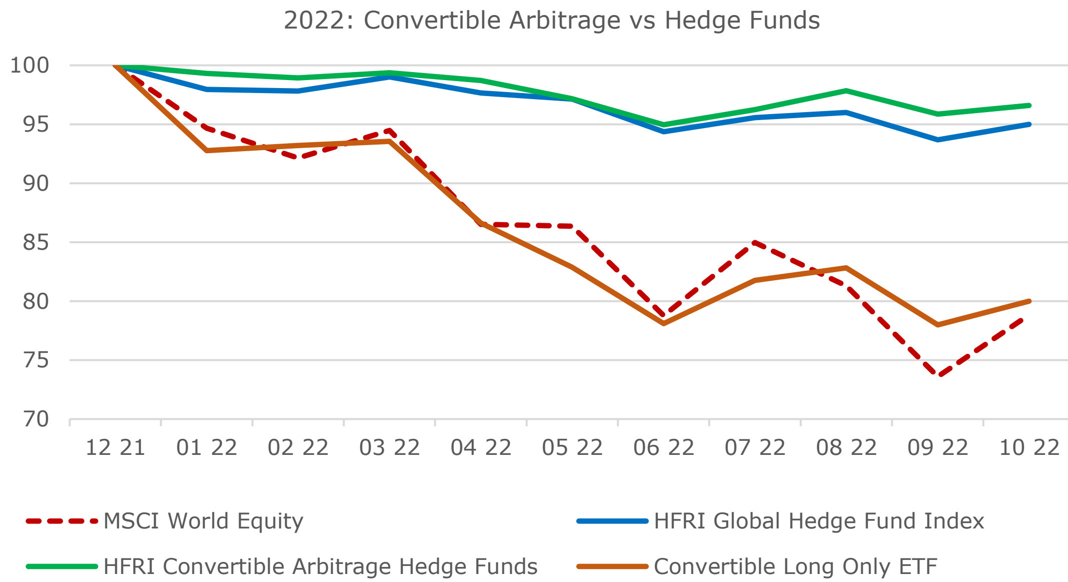
Global Convertible Bond Issuance					
	US	**Europe**	**Asia**	**Japan**	**Total**
2022	28.7	6.2	4.2	0.4	39.5
2021	84.3	22.9	33.2	7.4	147.8
2020	105.8	31.1	20.1	1.7	158.7
2019	53.1	18.8	12.1	1.0	85.0

Source: BofA Global Research

Many managers expect new issues to normalise towards the average in 2023. There is a pent-up demand for financing that should not be underestimated. Data suggests that this circumstance has already set in over the last quarter of the year.

Why might convertible arbitrage surprise positively in 2023? 1) Expected normalisation of new issuance as the main reason. 2) Convertible bonds trade close to the bond floor, which means better upside convexity. Additionally, the bond floor itself tends to be less vulnerable than in 2022 (pressure from the duration and credit quality side). 3) For years, zero-coupon convertibles were issued - the new interest rate environment changes this circumstance; convertibles with attractive coupons of 2-6% are now coming onto the market. 4) The relatively large correction in the convertibles market caused names with a very high delta (often in the tech sector) to stumble. Attractive risk-adjusted bottom fishing is now possible, opportunities arise to position in the growth sector without taking 1:1 directional risk. 5) Multiple opportunities allow managers to achieve attractive returns without increasing their leverage. 6) Convertible arbitrage is a niche market - not many managers are left in the market after difficult years. Managers, who are still in the market thanks to a stringent and considered strategy, are encountering a positive market environment with less competition at the same time.

Chart 6: Convertible Arbitrage vs Hedge Funds:



Source: Bloomberg Finance L.P. HFR

4 Outlook: Hedge Funds Strategies

	Underweight		Neutral	Overweight	
	heavily	slightly		slightly	heavily
HFRI Global Hedge Funds					
HFRI Equity Long Short					
HFRI Equity Market Neutral					
HFRI Event Driven					
HFRI Credit Fixed Income					
HFRI Global Macro					
HFRI Trend Following					

Source: Alpinum IM

The extremely difficult market environment of 2022 showed the merits of absolute return strategies and hedge funds. Key to this are very active management and diversification of return sources across asset classes, strategies and managers. The attractiveness of hedge funds is expected to continue in 2023 for the following reasons.

- Macro: Central banks will tend to continue to withdraw liquidity from the market, be it via interest rate hikes to fight inflation, or active tapering / phasing out of bond support programmes. Recession fears could drive sentiment.
- Rapidly rising interest rate environment spells trouble for companies with capital needs - expect to see losers and winners; ideal for talented equity or fixed income long short managers. Dispersion results in interesting trading opportunities.

- Some companies could get into extreme distress, which creates attractive opportunities for the stressed/distressed fixed income strategy.
- High interest rates, geopolitical tensions, energy crisis, fears of recession: the foundations for market volatility are sown - nevertheless, compared to 2022, we expect volatility to normalise and reduce slightly.
- Several indicators and indices are at extreme levels, up or down. The chance for normalisation is high, albeit accompanied by volatility - a good environment for relative value and arbitrage strategies, if a convergence to the average (mean reversion) takes place after periods of stress.
- Interest rate levels: higher interest rates are a tailwind for some hedge fund strategies and hedge funds in general. High interest rates fuel volatility (=opportunities), on the other hand hedge funds benefit 1:1 from attractive returns: Coupons for fixed income strategies; interest income on the cash account for derivative strategies (CTA, macro); interest income on the short account with the prime broker for the long short strategies.

The conclusion is that in such an environment, passive exposure to the market carries great risks. Very active management and hedge funds could provide effective solutions to successfully navigate through these opportunities. Again, we expect increased dispersion within hedge fund strategies - active management and maximum proximity to managers and their portfolios to be very important.

Equity Long Short: positive environment

The indices of equity long short managers often show weakness in phases of stress, which was evident at the end of 2018, in the early 2020s and also in 2022. The majority of funds have a "long bias" and are exposed accordingly. In this strategy, it is therefore eminently important to trust managers who can survive in a wide variety of environments, both positive and negative. The focus is on added value in an upward market and strict "drawdown management"; unfortunately, only a few managers combine these two virtues. When there are major trend changes in the market, fundamentally oriented managers are often too slow, too dogmatic, and trading-oriented traders are again at an advantage - this is where the right balance has to be found. Data from Morgan Stanley (the largest prime broker for hedge funds) shows that with the current market rally, many hedge funds covered their shorts globally and increased their net exposure. Some are lagging with performance, as it was costly to them to exit crowded short names. Large regional diversification, at sector, style or company level, offer many opportunities for the talented managers on the long as well as on the short side now.

«Long biased» Long Short Strategies

Long short strategies are clearly highly dependent on the performance of equity markets. Many managers were severely punished in 2022, as the majority of funds were too slow to position themselves conservatively in response to the rapidly deteriorating market environment. If market sentiment improves further in 2023, more directional strategies will benefit - but these are naturally subject to large fluctuations.

Equity Market Neutral: neutral outlook

As expected, the strategy was exposed to increased volatility in the second half of the year, as the period of "low hanging fruit" was over and increased short-squeezes hurt managers. The outlook remains neutral.

Event Driven (Merger Arbitrage): attractive environment for merger arbitrage and special situations strategies.

The current market uncertainty still manifests itself in relatively high merger arbitrage spreads. Deal volume has recovered slightly, with some large mergers taking place - the most prominent example in 2022 was Elon Musk's purchase of Twitter. With slightly lower market volatility in 2023, the strategy could show solid risk-adjusted returns, visibility for financing will tend to increase, cross-border deals reflect geopolitical tensions, but more mergers of companies from closely related countries will be agreed again. "Special situations" managers benefit from corporate restructurings and the increasing sales of assets to reduce debt on the balance sheet. Companies are feeling pressure from investors to merge in order to increase cost efficiency in a recessionary and inflationary environment.

Credit Fixed Income: very positive environment

The completely new interest rate environment, accompanied by a widening of credit spreads, led to large losses in this asset class. For hedge funds in the entire fixed income area, however, an opportunity window is now opening that has not been this large for a long time. On the long side, good quality bonds and loans at attractive levels are tempting, plus the coupon is now paying high percentages. On the short side, companies are coming under increasing pressure because they can no longer refinance themselves reasonably at such high interest rates. This creates great dispersion in the market, which can be exploited by active hedge funds. Apart from fixed income long short, opportunities in relative value or arbitrage are very attractive (see focus on convertible arbitrage). The paradigm shift on the interest rate side is completely reshuffling the fixed income market - a positive environment for hedge funds in this area.

Global Macro: slightly positive

Global Macro could continue to serve as a helpful portfolio diversifier. However, expectations will probably have to be scaled back compared to 2022. The ideal market environment with large movements in all asset classes may not be repeated to the same extent ("once in a decade short duration trade") and yet it is to be expected that certain markets will return to normal: Managers who have specific know-how on the currency side or a knowledge edge in emerging markets could benefit. However, the current rule for global macro is that managers with a flexible, opportunistic investment style and a quick reaction time are preferred to dogmatic and too fundamentally oriented managers. Clear preference for discretionary managers over systematic global macro models in the current environment.

Trend Following: slightly underweight

After years of lean times, trend followers have been able to profit thanks to clear and strong movements in the equity, bond, interest rate, commodity and currency markets. However, a difficult environment for trend followers are times when trends are in the process of reversing or flatten out into zigzag movements over time. Managers' models usually cannot hit the "turning points" and the risk of "whipsawing" trends is constant repositioning on the wrong side. This risk in 2023 consists in the assumption that, firstly, the very big trends do not materialise again to this extent (e.g. peaking interest rate hikes) and, secondly, the whole volatility complex comes down a notch compared to 2022.

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