ALPINUM INVESTMENT MANAGEMENT

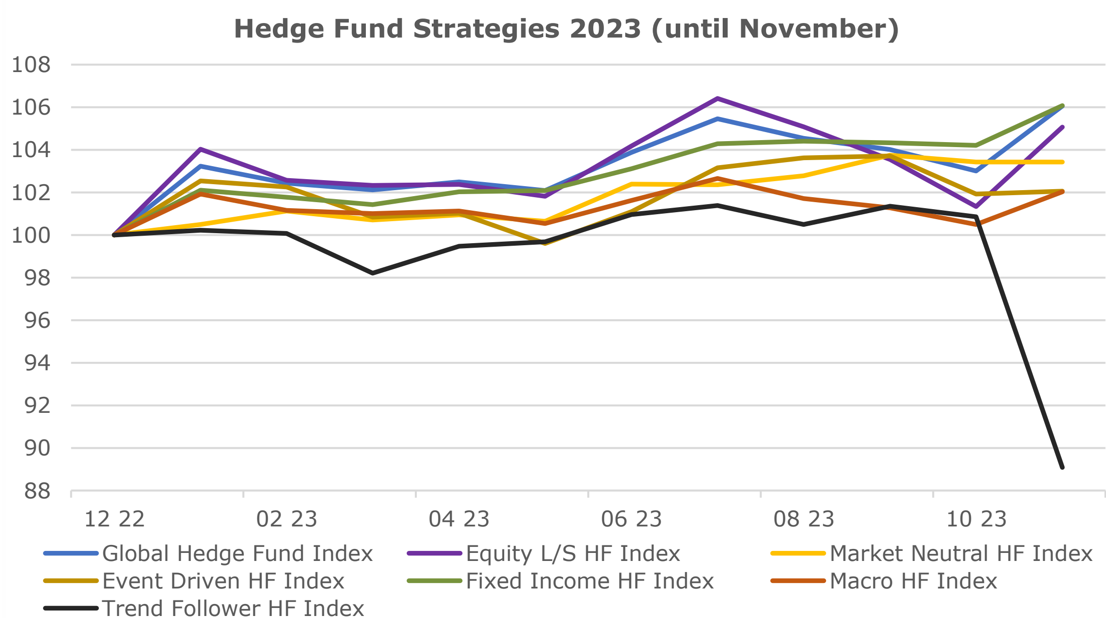
Hedge Funds Insight 01/2024

Hedge Funds Review & Outlook

1 Hedge Fund Review 2023

During November, after three difficult months with sharp price drops, signs of falling inflation led to a rally in both, equity and bond markets. The broad Eurekahedge Index recorded an increase of +3.0% in November, while traditional asset classes such as equities rose by +8.4% (MSCI World hedged), investment grade bonds by +1.5% (Bloomberg Global-Aggregate TR Index Value Unhedged) and high yield bonds by +4.9% (ICE BofA Global High Yield). Such strong market swings with short, rapid upward movements are often difficult for hedge funds to master. Nevertheless, the performance over the year was positive – evidence for the resilience of hedge funds during phases of market stress, as experienced from August to October. During these months, the MSCI World fell by -9.2%, bonds by -5.4% and high yield by -2.6%, whereas the hedge fund index only lost around -2.3%.

Chart I - Hedge Fund Strategies

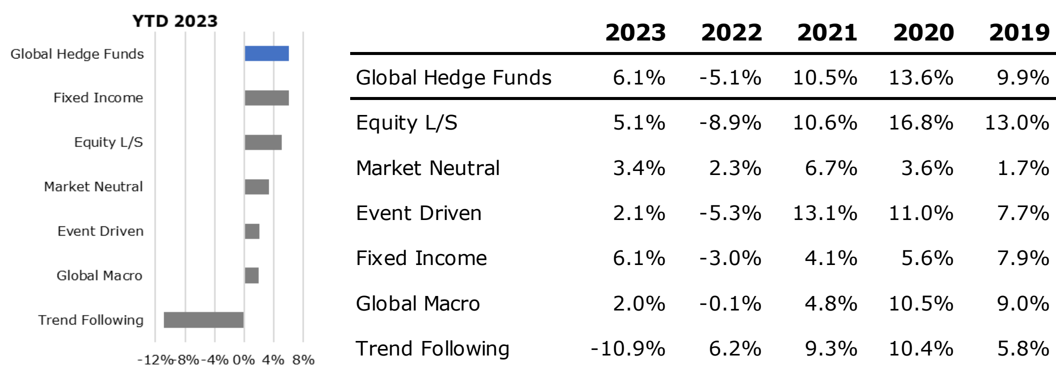


Source: Alpinum IM, Eurekahedge

In general, 2023 brought a sort of trend reversal: the stocks that were punished the most last year have so far delivered above-average returns. The "Magnificent Seven" should be mentioned here (the US tech stocks Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla), which have been the talk of the town this year, having gained a whopping 99.3% by the end of November (S&P 500 +20.8%). However, these stocks are subject to high volatility: in 2022, for example, the same seven stocks lost -45.3% (S&P 500 -18.1%).

By now, most companies have adapted to the new interest rate level and profit margins have stabilized. The tightening of monetary policy is likely to have reached its peak worldwide. The banks' restrictive lending measures represented an additional headwind for some companies in 2023. We expect that high equity valuations could be challenged next year due to increased interest rates and weak growth prospects, both will lead to higher dispersion at regional, sectoral and company-specific levels. An attractive environment for active and flexible hedge fund managers, both on the long and short side.

Chart II - Performance Main Strategies (until November 2023)



	2023	2022	2021	2020	2019
Global Hedge Funds	6.1%	-5.1%	10.5%	13.6%	9.9%
Equity L/S	5.1%	-8.9%	10.6%	16.8%	13.0%
Market Neutral	3.4%	2.3%	6.7%	3.6%	1.7%
Event Driven	2.1%	-5.3%	13.1%	11.0%	7.7%
Fixed Income	6.1%	-3.0%	4.1%	5.6%	7.9%
Global Macro	2.0%	-0.1%	4.8%	10.5%	9.0%
Trend Following	-10.9%	6.2%	9.3%	10.4%	5.8%

Quelle: Alpinum IM, Eurekahedge

The trend reversal on the markets was also reflected in the hedge fund strategies. Last year's winners (macro and trend following managers) are currently the losers and vice versa. Macro and trend following managers were unable to cope with the sharp changes in interest rates and the linked currency fluctuations. On the other hand, strategies with market beta (e.g. "long-biased" equities long short) performed well, as did strategies in the fixed income sector (fixed income long short, arbitrage, relative value) - these strategies experienced the strongest tailwind thanks to the sharp rise in interest rates.

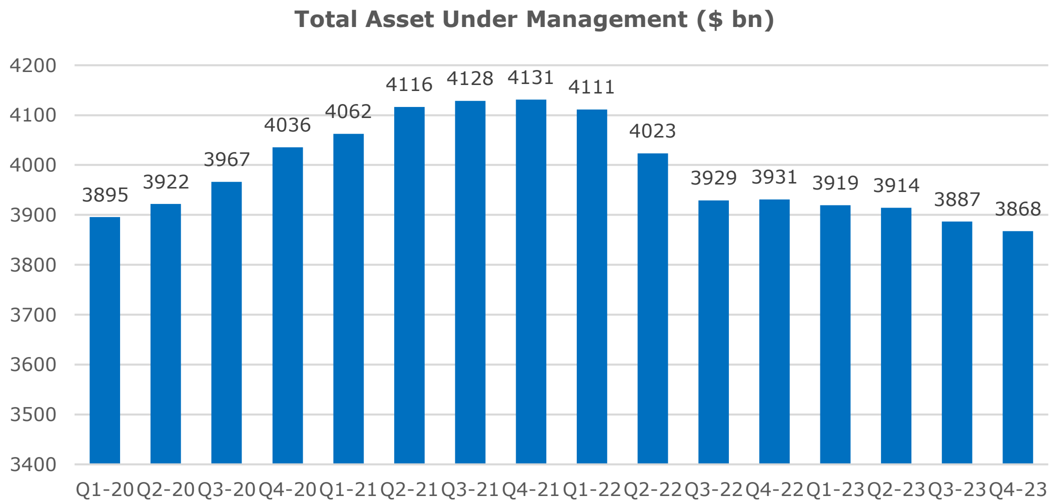
Hedge Funds Show a Sound Performance in 2023, but lag Equities

Although 2023 goes down in history as a positive year for hedge funds, the performance may raise questions in relative comparison to equities. The year was characterized by three very strong and relatively short upward movements in equities. Equities (MSCI World) made a phenomenal start to the year in January, rising +7.1%. In hindsight, most hedge funds were still very conservatively positioned at the beginning of the year and missed the January rally. Many managers were also unable to keep pace in the very strong month of November (MSCI World +9.4%) - a typical rebound month after three months of negative markets (August to October MSCI World -9.2%). In such an environment, qualitative and fundamental facts and analyses count for little, i.e. everything is driven upwards, regardless of whether the company is in a "good or bad" shape. Beta-driven markets are an extremely difficult environment, especially for market-neutral hedge fund strategies, as short positions are being pulled up at a loss (short squeeze). The sharp changes in direction in interest rates, currencies and equities, including sector and style positioning, require from managers to be extremely agile. In this environment, fundamental-oriented managers may be right with their analyses in the long-term, but in the short-term, markets turn against them.

2 Hedge Fund Industry Trends in 2023

The hedge fund industry recorded net outflows of USD 109 billion in 2023 in total (data until October 2023). This is significantly less than in the previous year when outflows of USD 164 billion were reported.

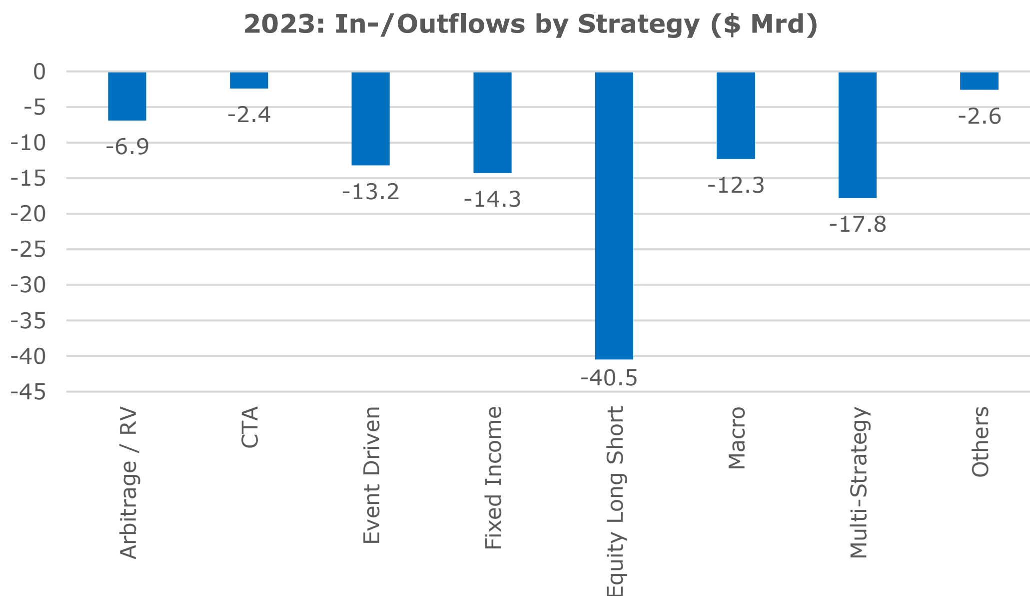
Chart III – Hedge Funds Assets



Quelle: Alpinum IM, Eurekahedge

According to data from Eurekahedge, the assets of the hedge fund industry account for USD 3.87 trillion, which is a decline of -1.6%. The highest assets were reached at the end of 2021 and amounted to USD 4.13 trillion.

Chart IV – In- and Outflows at strategy level



Quelle: Alpinum IM, Eurekahedge

At strategy level, equity long-short managers (USD -40.5 billion) and multi-strategy managers (USD -17.8 billion) experienced the largest outflows. The CTA/Trend Followers lost the least, suffering only slight outflows (USD -2.4 billion), despite a negative performance balance over the current year. No strategy

recorded inflows this year. A closer analysis reveals a contrasting picture. While European managers were responsible for over 60% of global outflows (USD 67.3 billion of global USD 109.0 billion), they clearly recorded the largest net performance growth (USD 27.3 of global USD 45.6 billion), even though the European hedge fund market only accounts for around 20% of the global market (USD 741 of USD 3,868 billion).

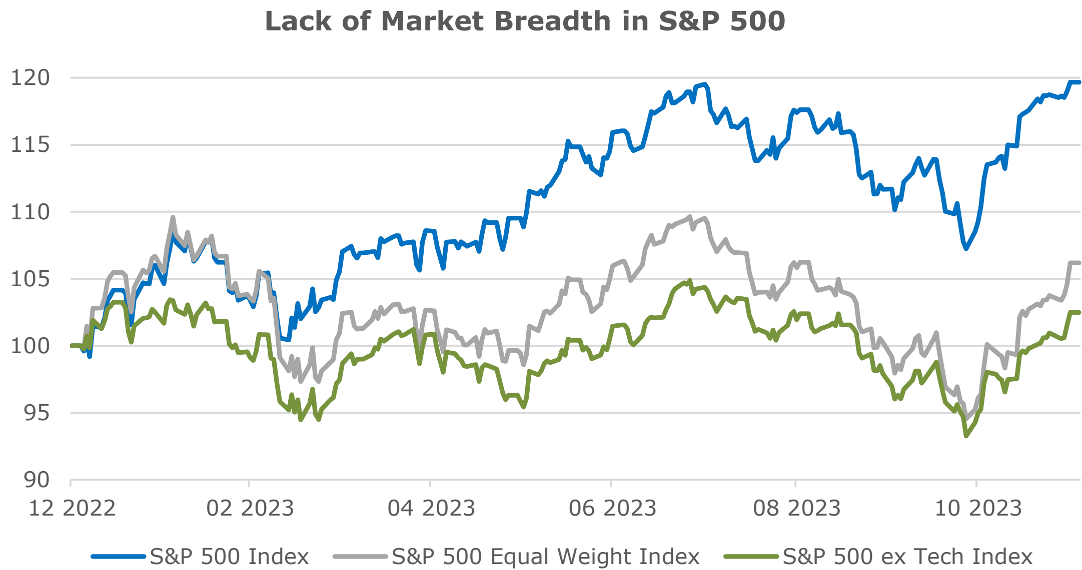
The extreme poles of the inflow/outflow analysis allow two conclusions to be drawn: On the one hand, quite a few hedge fund investors are chasing past performance, CTAs (trend followers) recorded their best result in 2022 for a long time, but this year they are left far behind. On the other hand, outflows in the equity long-short segment can be explained by the fact that some investors preferred a more directional equity exposure in a strongly rising market and reduced their hedged component.

3 Hedge Fund Focus Topic: Equity Long Short

As already described in the last two editions of the “Hedge Fund Outlook”, thanks to a completely new interest rate environment, attractive opportunities can be found on the fixed income credit side (please refer to the next section for further explanation). However, the new interest rate landscape will also offer a wide range of opportunities on the equity side over the next 12 months. The 2023 equity year was characterized by a strong recovery from the previous year's losses. However, there are some indications that a more selective approach will be needed again in 2024. Managers with strong selection skills and a flexible approach to risk will be in demand. Despite the currently negative macro and economic indicators, various regions are catching up from a low level with the United States. Equities in Europe, Asia and Latin America are relatively cheap in relative terms.

The following Chart V impressively illustrates how unbalanced the biased view of the S&P 500 Index is. Since March, the chart demonstrates remarkably how the mega-cap stocks have carried the entire index, while there was no market depth at all. To give an example: a stock like Apple has a weighting of 7.4% in the S&P 500, but only 0.2% in the Equal Weight Index. The so-called "Magnificent Seven" stocks performed almost 100% this year and thus "distorted" the overall picture considerably. While the conventional S&P 500 Index gained over 20% in 2023 (until November), the S&P 500 Equal Weight Index only rose by around 8%. If one extracts the entire technology sector, the S&P 500 ex-Tech Index rose by just 4%.

Chart V – S&P 500



Quelle: Alpinum IM

But also the P/E ratio (price/earnings ratio) of US equities give a false impression: if one excludes tech stocks from the index, the S&P 500 - although at a very high absolute index level - is not that expensive. The expected P/E ratio of the S&P 500 is 19.9, while the P/E ratio for 2024 of the S&P 500 ex-Tech is "only" 14.9 (as per November 2023).

In general, this could provide a better starting point for equity long-short strategies. But some uncertainties remain: 1) How long will the outperformance of just a handful of stocks last? Are the "Magnificent Seven" stocks really acting as a new kind of "commodity" (the whole world must hold them) - or is a normalization taking place? 2) As Chart V also shows, there are various challenges and opportunities at sector level that can be exploited by active managers. 3) The sharp rise in interest rates is an additional burden for companies' capital costs, the so-called "maturity wall" for corporate bonds will come in 2025/2026. Outstanding corporate debt is usually refinanced 12 months in advance. This will bring the level of corporate debt back into the focus of investors - perfect conditions for good long-short managers. 4) Equity volatility levels have fallen to new lows, the VIX (S&P 500) index has decreased to a level of around 13 points, which was previously reached in 2019. We would not be surprised to see temporary upward swings next year, although the overall level might not increase. This in turn creates opportunities for equity long-short strategies.

4 Outlook: Hedge Fund 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					

We always work with various macro-economic scenarios. Our base case is centred around the so-called "muddling through" scenario. Although the US economy will weaken in 2024 due to increased capital costs for companies, it is very likely that a "normal" recession can be avoided, as at the same time a noticeable cooling of the "hot" labour market will curb inflation risks. We are therefore dealing with two diverging forces, which could lead to increased volatility.

From our point of view, the clearest "visibility & conviction" over the next 12 months for hedge fund managers can be found in the Fixed Income Credit strategy. On the bond side, we see great opportunities - the new interest rate environment represents a paradigm shift for these strategies. For hedge funds in the entire fixed income sector, a window of opportunity has opened that has not been so attractive for a long time. On the long side, high-quality credits are attracting price discounts, while the coupons on newer securities are paying high interest rates. This allows managers on the long book to get paid for waiting. Opportunities on the short side will arise due to the increased cost of capital, as some companies will encounter difficulties with financing their capital costs due to the high interest rates. Hedge funds in the stressed segment can benefit from credit defaults and restructurings.

Specifically, Alpinum's strategy favours allocations in credit fixed income, but also in the fundamental equity long-short segment. The paradigm shift in interest rates has resulted in higher dispersion and provides active hedge fund managers with numerous opportunities on the long and short side, whether in equities or bonds. On the macro side, the focus is on good FX managers, but also on managers with expertise in emerging markets. The low deal volume of event-driven strategies is evidence of a disappointing 2023, with some merger deals falling through due to regulatory hurdles. The environment for this strategy is unlikely to improve

significantly. Without prolonged increased volatility, the coming year is likely to remain difficult for trend followers.

We recommend that investors in hedge funds continue to focus on a broad diversification. Active management and maximum proximity to the manager are important. Thanks to the access to non-traditional sources of return with low correlation to equities and bond markets, alternative investments could also in 2024 serve as a valuable portfolio stabilizer.

Assessment on Strategy Level

Equity Long Short: positive Environment

At first glance, the new highs of the US equity indices raise doubts as to whether there will be a good environment for Equity Long Short in 2024. Nevertheless, the strategy could surprise positively for various reasons: 1) 70% of the MSCI World Equity Index consists of the USA. Other regions such as Europe, Asia or Latin America have catch-up potential. 2) The S&P 500 is expensively valued, the expected P/E is 19.9, which provides no reason to be euphoric about 2024. However, as already explained, the expected P/E excluding the tech sector is at a more attractive level (14.9). Across the board, there are sectors offering interesting P/E levels. 3) The probability that the "Magnificent Seven" stocks will continue to pull the market up to new heights on their own decreases with every new high reached. 4) The paradigm shift in interest rates will cause headaches for more than only a few companies in 2024, as investors will focus on re-financing the liabilities of the balance sheet. This will lead to increased dispersion within the index - heavily indebted companies with a refinancing problem will be penalized, while companies with exemplary financing will be favoured. These are all reasons that are likely to create a good environment for fundamentally oriented equity long-short managers. Wide regional diversification at sector, style or company level offers many opportunities for talented managers on both the long and short side.

Long biased" long-short strategies behave somewhat differently. These are clearly heavily dependent on the performance of the equity markets. Many flexible and long biased long-short managers have abandoned their cautious market exposure from beginning of 2023 and increased their market beta. If market sentiment remains positive, these directional strategies will benefit - although they are naturally exposed to major fluctuations.

Equity Market Neutral: neutral Outlook

The "low hanging fruits" scenarios of 2022 were not repeated in 2023 - the strong movements, which occurred within a very short period, were difficult for many market-neutral managers to grasp (exaggerations in both books, painful short squeezes). The outlook remains (positive) neutral.

Event Driven (Merger Arbitrage): neutral Outlook

The expected success of event-driven strategies failed to materialize in 2023. The reasons for this are a lower-than-expected deal volume (Bloomberg data shows around 150 announced mergers in the region of USD 800 billion - which corresponds to a level slightly below the comparatively poor year of 2020), regulatory hurdles and major merger deals that fell through, such as the Amgen-Horizon deal, which threatened to collapse in mid-May and caught a number of event-driven managers completely on the wrong foot. Although the deal was completed in October, it didn’t save the annual performance of many managers. We now rate the strategy as "neutral"; although spreads are currently high, certain risks are unlikely to be reduced in 2024, whether from a regulatory or cross-border deal perspective - a certain degree of "crowding" has also been observed recently, with many managers interested in the same deals. On the positive side, it should be mentioned that private equity firms are sitting on USD 2.7 trillion of dry powder (cash). Should this money be increasingly activated, it would fuel the merger market.

Credit Fixed Income: very positive Environment

A completely changed interest rate environment suddenly opens new yield prospects. On the long side, high-quality bonds and loans at attractive levels are tempting, and the coupon will probably continue to pay high percentages for longer. On the short side, companies that can no longer refinance themselves appropriately at such high interest rates are coming under increasing pressure. This creates great dispersion in the market, which can be exploited by active hedge funds. Pressure on corporate debt was still low in 2023, but we expect defaults to increase in 2024 - the word "maturity wall" will soon be ubiquitous in the market. 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: neutral Assessment

Global Macro served as a perfect portfolio diversification in the crisis year 2022 - but the result in 2023 was mixed. Fundamentally oriented managers were positioned too conservatively and the economic outlook regarding inflation expectations were misjudged, which meant that the sometimes sharp movements on the interest rate and FX side could not be successfully monetized. We continue to believe that managers with specific expertise on the currency side or a knowledge advantage in emerging markets can benefit in 2024. However, we currently assess Global Macro strategies as follows: managers with a flexible, opportunistic investment style and the ability to react quickly are likely to outperform dogmatic and overly fundamentally oriented managers. Discretionary managers continue to be clearly favoured over systematic global macro models in the current environment.

Trend Following: slightly underweight

The year 2023 was characterized by two aspects that are difficult for traditional trend followers to master. On the one hand, there were striking and recurring trend reversals that required constant repositioning, only to be wrong again straight away. One example is November, when more than a few managers lost around 10% of their performance. On the other hand, market volatility across various asset classes, especially equity indices, has fallen since the beginning of the year. We do not expect the volatility complex to be persistently elevated in 2024, which will continue to make it difficult for trend followers to position themselves successfully and profitably.