HEDGEWEEK

INSIGHT REPORT

H1 UPDATE:

Hedge funds traverse 2022's economic turmoil

AUGUST 2022

SUPPORTED BY

Sentieo

EXECUTIVE SUMMARY

Just as the worst of the Covid-19 pandemic had been receding from view, with economies looking to build on the tentative recovery following almost two years of unprecedented turmoil, the first half of this year has thrown up a whole new set of challenges to financial markets: soaring inflation, interest rate rises, a historic stock market slump, and renewed geopolitical turmoil.

This latest Hedgeweek Insight Report examines in detail how hedge fund managers of various strategy types – long/short equity, macro, managed futures, event driven and more – are now getting to grips with a rapidly evolving investment landscape.

Taking the temperature of the global hedge fund industry at 2022's midway point, it explores how the key market developments and themes over the past six months have affected managers' returns so far, and considers how the ongoing turbulence across different markets, assets classes and economies will shape performance and investor sentiment for the rest of the year.

The insights gathered here are drawn from a Hedgeweek survey of around 70 hedge fund managers across the globe, along with a series of in-depth interviews with industry participants, and further ongoing background research.

In this most competitive of industries, which is often defined by winners and losers, performance dispersion continues to reign. Around a third of hedge fund managers surveyed for this report believe their flagship strategy exceeded performance targets during H1. On the flipside, however, roughly a quarter say their main fund has fallen short of expectations during the same period.

Despite H1's mixed fortunes, and the risk of a recession and sustained macroeconomic volatility looming large on the horizon, a majority of hedge fund managers remain bullish on their ability to identify opportunities and generate positive returns in the second half of the year.

As allocators now look to insulate their portfolios from an assortment of investment hazards up ahead, how hedge funds convert that optimism into returns is set to come into increasingly sharp focus over the coming months.

HUGH LEASK, HEDGEWEEK EDITOR
REPORT AUTHOR

CONTENTS

METHODOLOGY

Hedgeweek surveyed more than 70 hedge fund managers globally, representing a broad range of AuM sizes and investment strategies, throughout May and June. Survey participants were asked about their first-half performances, what factors influenced H1 returns, and their performance outlook for the second half of 2022.

KEY FINDINGS

THE HEDGE FUND INDUSTRY IS SPLIT ON H1 PERFORMANCE

1/3

One-third of all hedge funds say their first half returns exceeded expectations

1/4

but close to one in four managers say they underperformed expectations

CONFIDENCE REMAINS HIGH DESPITE MIXED RETURNS

71%

46% of all hedge funds are 'somewhat positive' on their second half prospects – and a further 25% are 'very positive'

STOCK MARKET PERFORMANCE AND INFLATION / INTEREST RATE RISES DROVE H1 PERFORMANCE

29%

of hedge funds pinpointed inflation/interest rate rises as the biggest influence on H1 returns

Additionally, 29% named equity market performance as the major factor

EQUITY HEDGE FUNDS' OPTIMISM HAS BEEN DENTED

58%

of equity hedge funds are optimistic on their H2 performance prospects after the stock market rupture

95%

of macro or managed futures funds are positive on the second half of 2022.

SECTION 1 | INDUSTRY SNAPSHOT

"VEHICLE OF CHOICE"? PATCHY PERFORMANCE FAILS TO DENT INDUSTRY CONFIDENCE

After years of rising markets, the current economic reversal has placed alpha generation firmly in focus after hedge funds were hit by the first-half global turmoil

Hedge fund managers are sharply divided on their first-half performance, reflecting the considerable dispersion in returns during the volatile investment environment between January and June. Dispersion reigns across asset classes, strategies and AuM sizes, with macro hedge funds and trend-following strategies taking profits, and long/short equity managers sliding into the red.

As a result, manager sentiment is decidedly mixed at 2022's midway point. One-third of hedge funds surveyed by Hedgeweek say their flagship strategies exceeded expectations during H1 (see Fig 1.3). But almost a quarter of hedge funds say their main fund underperformed target expectations in the same period, reflecting the mixed fortunes of across the industry beyond the headline figures.

Although the industry as a whole ended H1 in negative territory, hedge funds comfortably outflanked broader markets over the six-month period, which saw the S&P 500 diving more than 20%. Overall, the numbers mark hedge funds' biggest outperformance of the stock market in the first half since 1990, according to data published by Hedge Fund Research.

Still, this rapid unravelling of the market during the first half of the year upended many strategies that had continued to be positioned for the rising market in recent years.

"The first half of 2022 has proven to be challenging as a combination of tightening global monetary conditions and entrenched inflation has led to concerns around stagflation and an impending global recession becoming increasingly probable," says Polina Kurdyavko, head of emerging markets at BlueBay Asset Management, and senior portfolio manager of BlueBay's Emerging Market Credit Alpha Fund.

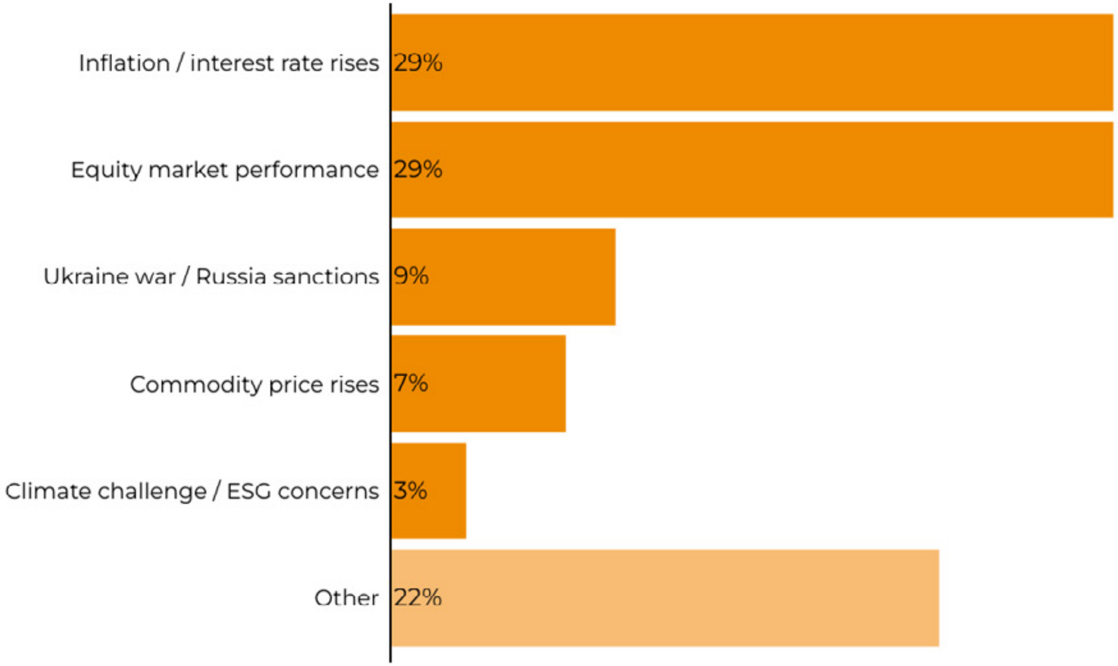
Ben Axler, founder and chief investment officer, Spruce Point Capital, observes how the past decade had remained difficult for alpha generation, adding that many short sellers had left the market because such an investment approach proved challenging given the equity benchmarks continued to rise.

In the midst of the coronavirus pandemic, central banks took what many managers describe as "extreme measures" to maintain liquidity and support businesses. Now, though, the tide has turned and banks are withdrawing liquidity in a bid to tame inflation.

'Aberration'

"They realise that they have kept rates too low for too long, and that was driving excessive speculation – not just in equities, but in other asset classes, with cryptocurrencies a prime example of a new and emerging asset class," Axler says.

Figure 1.1: The biggest influences on hedge fund performance in H1, according to hedge fund managers



Analyst note: Respondents were asked in late May and June, 'What has been the single biggest factor influencing your flagship hedge fund's performance in H1?'

Source: Hedgeweek survey, Q2 2022

"So the environment has finally changed, at least for short sellers."

The ability for many hedge fund managers to be long rather than to hedge has led to some false confidence in recent years, observes Manoj Jain, co-founder and co-CIO, Maso Capital.

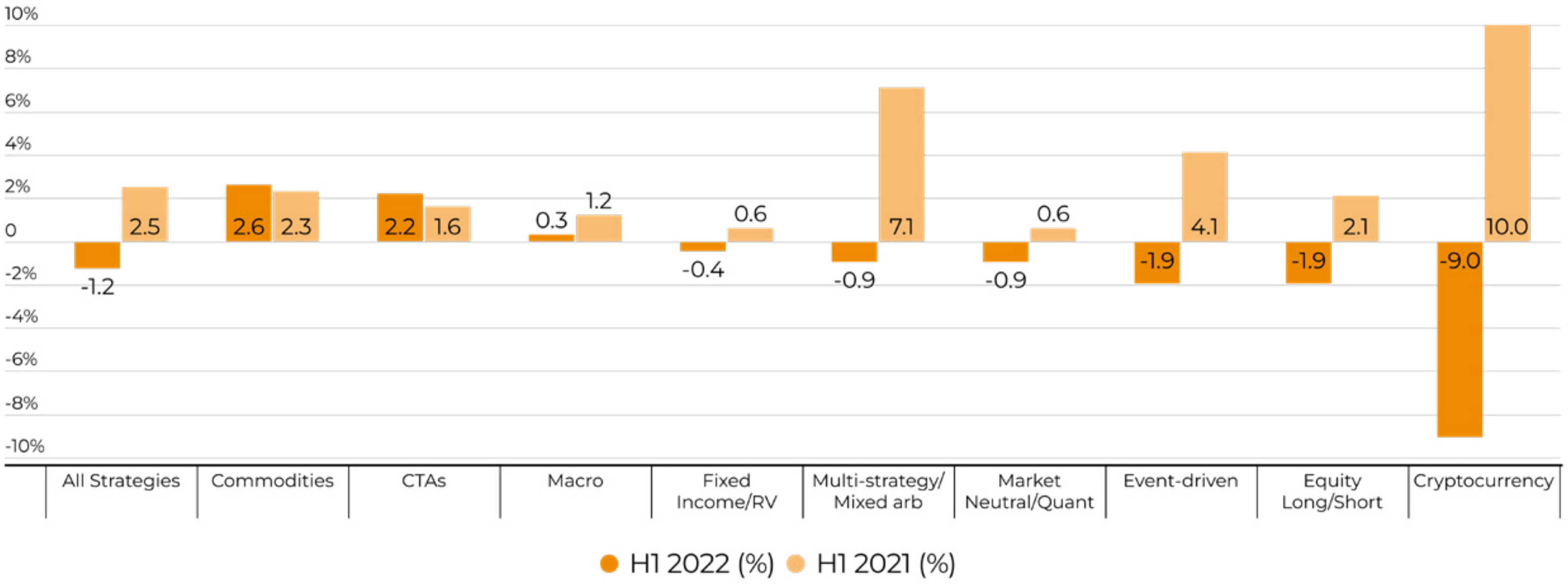
"Now, though, we've gone back to a more normalised environment – zero rates were an aberration. A lot of participants, to their credit, have done well and have benefitted from a performance perspective. But that's also made the current environment more challenging for certain investors," Jain adds.

Asked what has been the single biggest factor influencing their flagship fund's performance during 2022, close to one in three hedge fund managers surveyed name inflation and interest rate rises as key. Similarly, almost a third believe that equity market performance has been the decisive factor in shaping H1 returns, the research data shows (see Fig 1.1).

At 2022's midway point, attention is now quickly turning to how managers of all strategies will fare in a rapidly-evolving investment environment during H2, and what role hedge funds can ultimately play in insulating investors' portfolios from renewed economic difficulties.

For their part, most managers are confident they can generate positive returns. Around 46% of all hedge funds surveyed hedge funds surveyed by Hedgeweek are "somewhat positive" on their performance prospects for the second half of the year, and a quarter are "very positive" (see Fig 1.4). But some 12% take a negative stance on their H2 outlook, while 9% expect their second half performance to be flat, as another 9% don't know what the remainder

Figure 1.2: Hedge fund performance by fund strategy, H1 2022 versus H1 2021



Analyst note: Data as of 26 July 2022. Figures represent the average total return (TRR). Macro excludes cryptocurrency.

Source: Bloomberg Data

of 2022 holds in store.

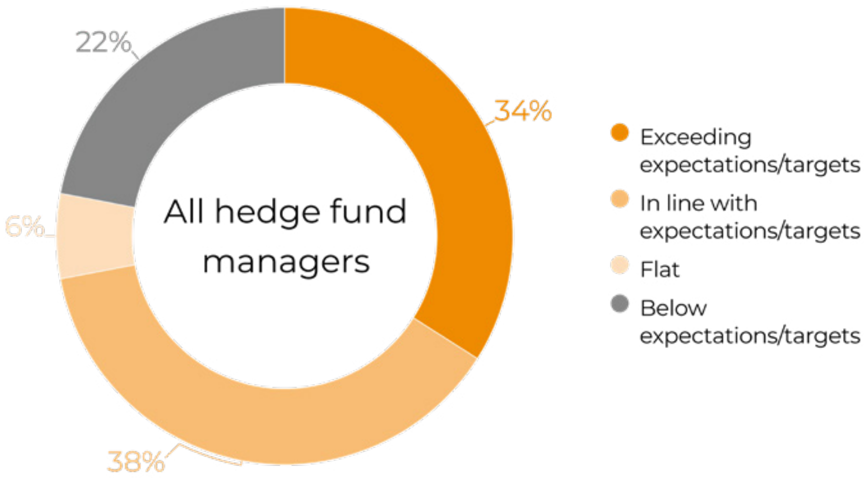
Similarly, recent research by the Alternative Investment Management Association shows hedge fund managers' sentiment remains upbeat. AIMA's Q2 Confidence Index, published jointly in June with Simmons & Simmons and Seward & Kissel, found that hedge fund managers' overall Q2 confidence score totaled +17.8 on a scale of -50 to +50. Overall, more than 85% of hedge funds surveyed by AIMA are confident in the economic prospects of their business over the coming 12 months - despite greater market turbulence, increasing geopolitical tensions in Ukraine, and growing regulatory and compliance hurdles.

'Binary'

"Hedge funds, historically and still, invest in sectors where the long-term returns of the individual companies have very wide dispersion," says Nick Mazing, director of research, Sentieo.

"If you look at, say, utilities – which are essentially regulated monopolies – or consumer staples, which are extremely steady, the returns are very clustered. In contrast, if you look at the long-term returns of sectors such as healthcare and technology which is where hedge funds are angling for outsized returns, there are huge

Figure 1.3: Hedge fund managers' descriptions of their flagship strategy's performance in H1 2022



Analyst note: Respondents were asked in late May and June, 'Which of the below best describes the H1 performance of your flagship hedge fund strategy?'

Source: Hedgeweek survey, Q2 2022

---

winners and huge losers. It's very binary with very wide dispersion. But both sectors got hit as the rates started moving up – both technology and biotech sectors declined," he says.

'Correlated'

Mazing adds: "Hedge fund-heavy sectors such as these have been doing very poorly. Meanwhile, going into June, energy was about 70% above the worst performing sectors, such as communications, consumer discretionary and technology. While some of those gains have gone out, energy still continues to be extremely strong."

Reflecting on the prevailing market challenges, Jason Josephiac, senior vice president, Meketa Investment Group, says: "It's tough to add diversification. Because equities are equities, credit is credit, rates are rates, commodities are commodities. So, unless you're capitalising on long and short opportunities, as well as long volatility opportunities, then a lot of things are going to be correlated during the worst types of market environments."

"Generally speaking, hedge funds should show absolute return – absolute positive return – and not be tied to any benchmark," says David

NICK MAZING,
DIRECTOR OF RESEARCH, SENTIEO

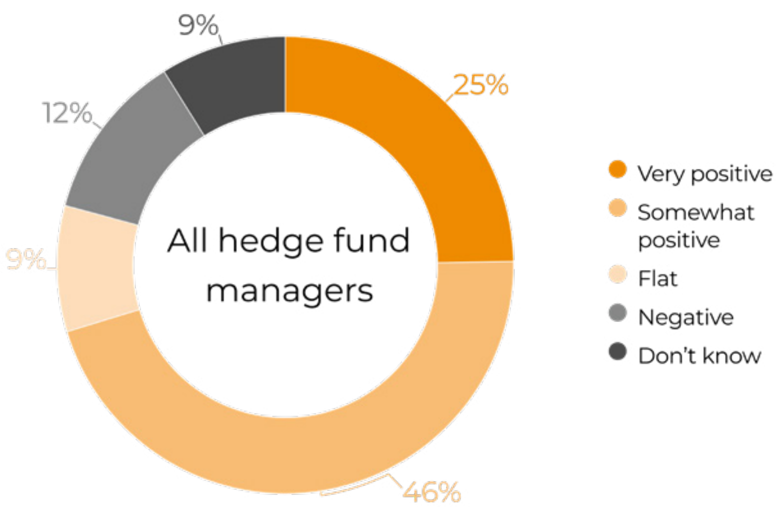
"When we look at the second half of the year, and how confident people should be in their performance, what we see from the macro perspective is that, because inflation is so high, the Fed does not have our back anymore. It's very political - inflation is out of control, but the Fed is not going to step in and react to any sort of turmoil in the markets in the way they have been in the last 10-plus years.

"The second half is going to be rocky just as much as the first half was. Theoretically, this should be a good environment for hedge funds, but that's probably not what happened - when you look at some of the crowding in, for instance, software stocks, many household-name hedge funds were down 30-40%.

"As a research platform that integrates AI-powered search, data, and research management, we have both fundamental equity and credit funds using us.

"As well as the investment management side, when you look at the operating costs, compliance costs, things such as technology infrastructure costs, then just to be in the business - just to compete - the barriers get higher and higher over time. Not only are they barriers to entry, they also continue to drive consolidation. Regulation is increasing, there is the Department of Justice's investigation into short selling in the US, and it is the smaller hedge funds in aggregate tend to have disproportionately higher costs."

Figure 1.4: Hedge fund managers' performance outlook for H2 2022



Analyst note: Respondents were asked in late May and June, 'What is your performance outlook for the remainder of 2022?'

Source: Hedgeweek survey, Q2 2022

Amaryan, founder, Balchug Capital.

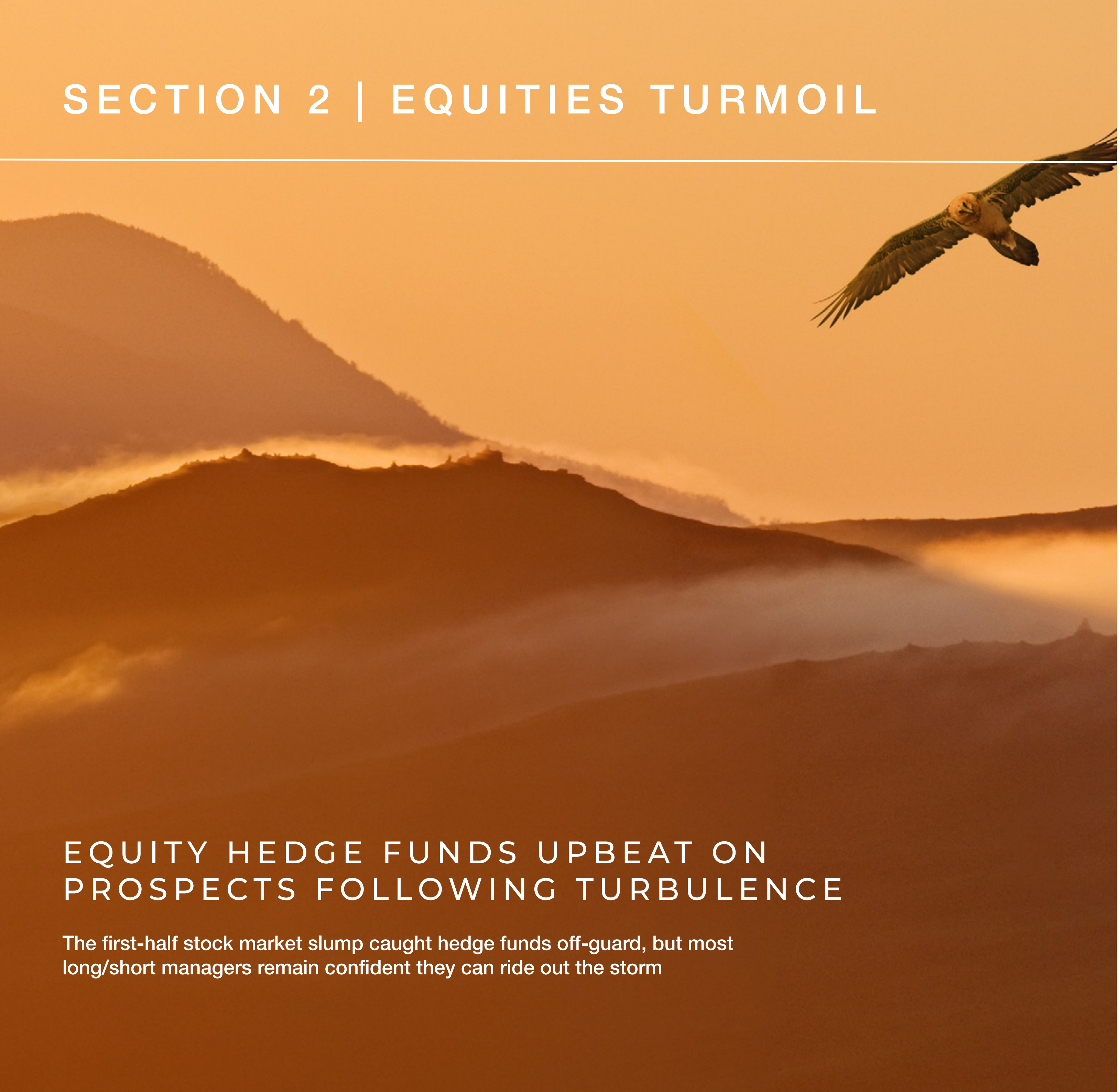
"As a hedge fund manager, whenever there's volatility and I can more or less understand what's going on, I can always think of some opportunities where I can be long or short, or use some other approach to take advantage of the situation."

Kurdyavko says: "We cannot speak on behalf of other hedge fund managers; however, it is precisely in this market environment that hedge funds should be the vehicle of choice for investors. The uncertainty prevailing across all asset classes has left investors unclear regarding market direction and the ensuing volatility can lead to overshooting of prices.

"Hedge funds that are able to take both long and short positions can capitalise on both negative and positive stories in this context. Moreover, managers that can couple this with bottom-up analytical capability can quickly identify mispriced assets and be very well positioned to generate positive returns on both the long and short side." ■

KEY TAKEAWAYS

- The hedge fund industry experienced mixed fortunes and returns dispersion in the first half of 2022. As inflation soared and stock market turbulence reigned, a third of managers say their investment performance exceeded expectations, but a quarter say it fell short
- Hedge funds remain confident they can capitalise on continued market dislocation: more than two-thirds of managers surveyed by Hedgeweek are optimistic on their H2 performance prospects
- For investors, some strategies' first-half gains and ability to deliver uncorrelated returns again demonstrated the industry's ability to stem losses in portfolios



SECTION 2 | EQUITIES TURMOIL

EQUITY HEDGE FUNDS UPBEAT ON PROSPECTS FOLLOWING TURBULENCE

The first-half stock market slump caught hedge funds off-guard, but most long/short managers remain confident they can ride out the storm

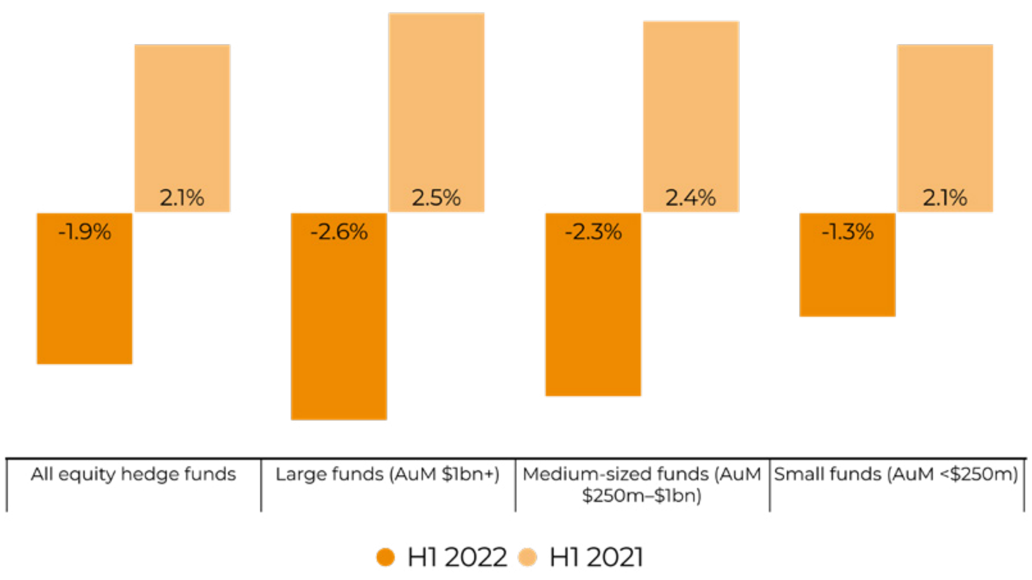
As the stock market endured a sustained slide over the first six months of 2022, with the S&P 500 shedding more than 20% (the index's biggest H1 loss since 1970), long/short equity funds – often considered the cornerstone strategy of the hedge fund industry – fell into negative territory as the slump wreaked havoc on portfolios (see Fig. 2.1).

Despite the negative performance, most long/short equity hedge funds say their first-half returns have either kept in line with, or even exceeded, expectations, according to Hedgeweek research (see Fig. 2.3). That said, more than a quarter (26%) of equity-focused managers believe their H1 showing fell short of their target return, the survey data shows. This reflects the sharp reversal in fortunes experienced by a sizable swathe of long/short managers this year.

Equity hedge fund managers point to a "tremendous amount of money" in the market that has been structurally long in recent years, and designed to participate when assets rise. But this "beta-chasing" approach has not necessarily been proven as skilled in hedging on the downside, particularly after a multi-decade environment of declining interest rates.

"The magnitude of market corrections probably caught a lot of people in the industry

Figure 2.1: Equity hedge fund performance by fund size, H1 2022 versus H1 2021



Analyst note: Data as of 26 July 2022. Figures represent the average total return (TRR).

Source: Bloomberg Data

off-guard," says Ben Axler, founder and chief investment officer, Spruce Point Capital Management, of the first-half stock market shocks.

"There are a lot of fund managers that haven't been through a rate-rising cycle and haven't really been through a sustained correction, absent the brief market declines during Covid a couple years ago," Axler observes.

Barry Norris, founder, CEO and CIO, Argonaut Capital, suggests inflation is more structural than either the bond market or the Federal Reserve currently anticipates, which heralds far-reaching consequences across asset classes.

"In the June FOMC the Fed communicated it was willing to kill inflation even if that meant a deep and painful recession; risk assets sold off, whilst treasuries and the US dollar were well bid," Norris says.

"By the July FOMC, Powell seemed to have already backtracked: he was already worried about the economy, which suggests he is trying to engineer a soft landing, which we think is impossible. He also thought that the 'neutral rate' for US rates was just 2.5% which, given CPI is currently 9%, is a conclusion you can only make if you still believe inflation is still largely 'transitory.'"

As a result, Norris - who runs the UK firm's Argonaut Absolute Return equity long/short hedge fund - believes the Fed has reopened the risk window, meaning that the nominal growth boom is likely to continue.

"This is supportive of nominal assets like commodities but also corporate profits and wages. But for investors - whose returns are being eroded by inflation - it is mainly negative, and should result in a continued contraction of valuations of all financial assets."

'Value'

Looking ahead, long/short equity hedge funds remain confident in their ability to weather continued stock market turmoil. More than 40% of equity-focused fund managers surveyed by Hedgeweek say they are "somewhat positive" about their performance prospects for the remainder of 2022, with a further 16% taking a "very positive" stance on their H2 outlook (see Fig. 2.4). Nevertheless, more than one in every four managers running equity-focused hedge funds have a "negative" outlook on the rest of the year.

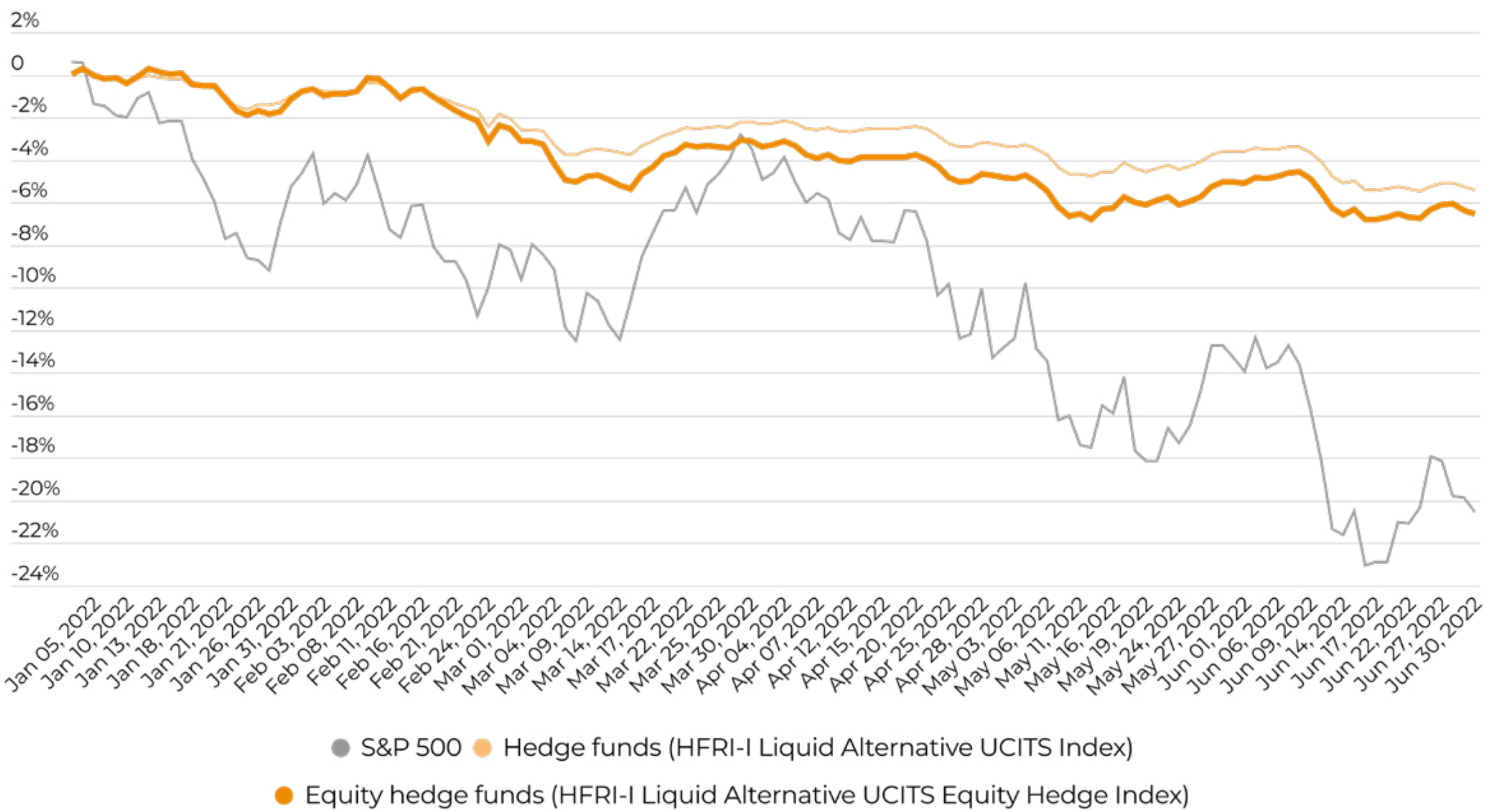
"Long/short equity has been challenged, but this is the strategy that was the best performing strategy from 2017 through to and including 2020," says Dave McMillan, CIO, hedge funds at Mercer. "So we still believe a diversified approach, a mix of managers and a mix of strategies, is the best way. I do believe there's some embedded value in long/short equity portfolios and I'd like to think maybe the worst is behind them, but that remains to be to be seen."

So, in light of long/short managers' continued upbeat stance, where can strategies hope to generate returns during the second half of this year?

Industry participants note how the environment for equities will potentially remain challenging, with possible difficulties in finding reliable longs coupled with increased volatility in crowded shorts.

"In periods like this, investors become more discerning on what they own and some of the weaker companies tend to get punished a little bit more in a bear market, whereas in a bull market, some investors might give these types of companies a pass

Figure 2.2: Cumulative daily equity hedge fund performance versus S&P 500, 1 January 2022–30 June 2022



Sources: Hedge Fund Research, Investing.com and overlook certain things," says Axler. "We look for promotional companies and companies with high aspirational goals, and so when the business environment gets weaker, those goals tend to be missed and when corporates miss goals, investors tend to punish them by selling their stocks."

Building on this point, Axler says: "We're more than just directional short sellers - we look for companies that we think have problems in their business, or are using aggressive business practices, or have problematic accounting, or bad financial statements.

"That's why we think the background is more conducive for us because investors are paying more attention to what they own in their portfolio as we're on the precipice of a recession, and generally companies missing their targets and missing their goals."

'Hedging'

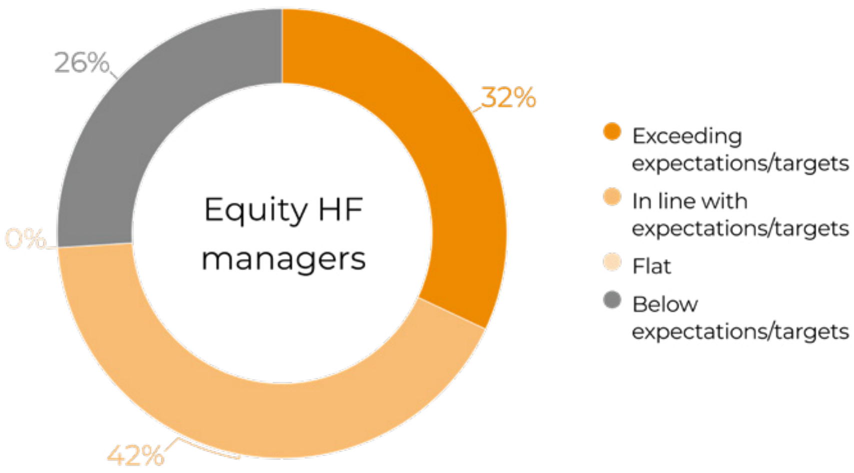
Further afield, David Amaryan, founder of Balchug Capital, which trades long/short equities and fixed income on an event driven basis with a geographic focus on Russia and the former Soviet Union, has tapped into range of value opportunities that emerged from the forced selling of equities at the onset of the Ukrainian war.

"This market has been at a very steep discount, but right now if you are willing and able, and you have the knowledge and experience to be here, I don't see anywhere in the world where you can get the kind of upsides you can get within a year that you can get in Russia, if you know what you are doing," says Amaryan, explaining how his strategy has taken positions in both OTC stocks and fixed income assets in Russia and the former CIS territories.

"In the beginning of the year, we were light on Russia - we were expecting some sanctions and some turbulence, but to be honest none of us expected any kind of escalation of this type. This is our market, our home turf, we know it very well.

"It's not just us; there are other investors like us - smaller western hedge funds and US family offices who are not bound by various regulatory and social pressures who are out there looking for these assets and buying them. There's a market already – people who have to sell, even if they don't want to, and people who want to buy,"

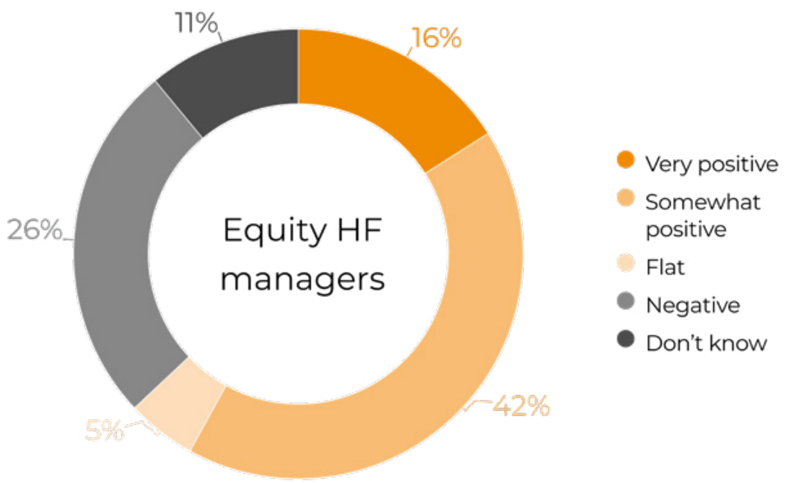
Figure 2.3: Equity hedge fund managers' descriptions of their flagship strategy's performance in H1 2022



Analyst note: Respondents were asked in late May and June, 'Which of the below best describes the H1 performance of your flagship hedge fund strategy?'

Source: Hedgeweek survey, Q2 2022

Figure 2.4: Equity hedge fund managers' performance outlook for H2 2022



Analyst note: Respondents were asked in late May and June, 'What is your performance outlook for the remainder of 2022?'

Source: Hedgeweek survey, Q2 2022

adds Amarayan. "We are an event driven fund, so when events of this magnitude are happening in one of the main markets we focus on there is no way we can sit on the sidelines."

Axler says: "The operative theme centres around who was hedging and who wasn't hedging. We will probably see what separates the winners from losers, or specifically the ones that have been able to either mitigate, or take advantage of, the declining asset prices, and opportunistically take advantage, or hedge, that downside risk.

"We are in the hedge fund industry, and hedge funds were borne out of the idea that investors could play both sides of the market, both long and short." ■

KEY TAKEAWAYS

- Long/short equity – the cornerstone strategy of the global hedge fund industry – was caught off-guard in H1 with losses sliding into double-digit territory
- Though more than one in five equity hedge fund managers are bearish on H2, most managers are upbeat on their second-half prospects. Following years of long-beta positioning, both managers' and investors' focus is likely to shift towards active management, short-selling themes and alpha generation amid ongoing market ruptures

SECTION 3 | THE MACRO VIEW

MACRO STRATEGIES AND CTAs SOAR AMID INFLATIONARY PRESSURE AND GEOPOLITICAL UPHEAVAL

As the H1 inflation surge pushes central banks to hike interest rates, seismic shifts in bonds, commodities and currencies brought stellar returns for some

As the US Federal Reserve raised interest rates in a move to stem runaway inflation – which neared a 40-year high at 2022's midway point – macro managers, who bet on broader economic and geopolitical events using equities, currencies, commodities, futures and more, ended the first half of 2022 in positive territory, capitalising on the H1 regime shift which has also been underpinned by rising energy costs as a result of the Ukraine war.

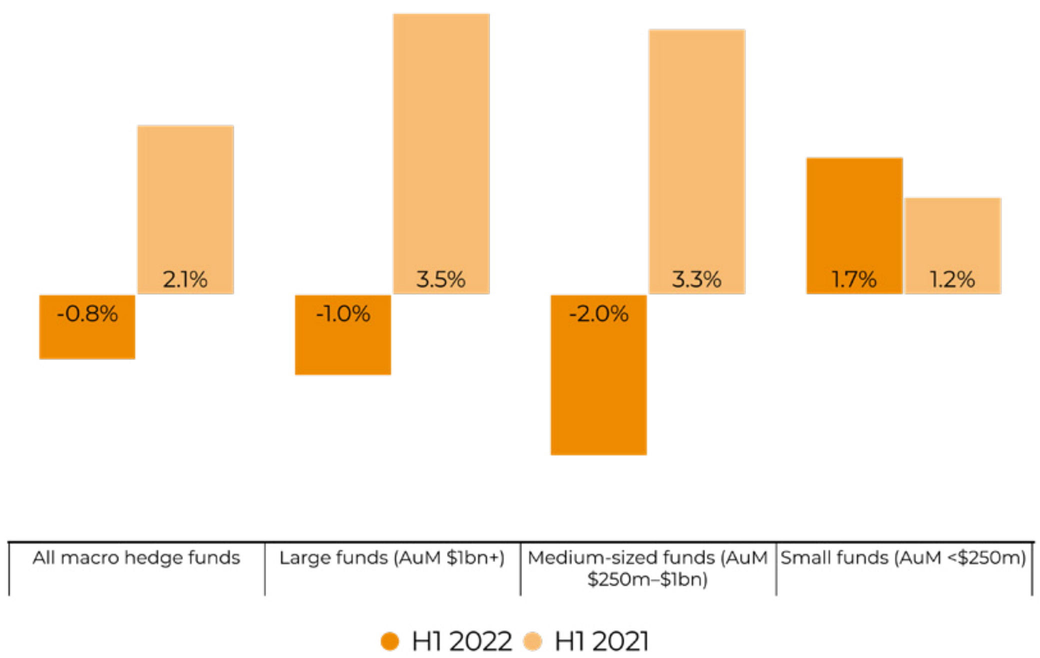
Similarly, CTAs and trend-following strategies, which typically utilise computer-based models to trade on directional signals and themes across a range of assets and markets, have also outperformed the broader hedge fund industry during 2022, locking onto a range of strong trends, namely the strengthening dollar, rising commodities and falling equity and bond markets.

Société Générale's main CTA index – a key industry barometer which tracks the daily performance of 20 of the largest managed futures hedge funds' returns – advanced more than 21% in H1 (see Fig. 3.4), its best start to the year since the benchmark launched in 2000.

Reflecting on their first half successes, some 44% of macro and managed futures hedge funds say their H1 gains have outperformed expectations, according to Hedgeweek research, with a further 37.5% saying that returns are in line with targets. By comparison, only 12.5% of macro and managed futures funds surveyed said first-half returns were below expectations.

Hedge fund managers of various strategies and stripes have had to contend with "outstanding and extraordinary" market moves against the backdrop of the Ukraine war and the end of quantitative easing,

Figure 3.1: Macro hedge fund performance by fund size, H1 2022 versus H1 2021



Analyst note: Data as of 26 July 2022. Figures represent the average total return (TRR). Excludes cryptocurrencies.

Source: Bloomberg Data

industry participants note. These moves include oil markets rocketing 100%, gold falling by around 13% from its March high, the S&P 500 losing 20 per cent, and the dollar up 9%. At the same time, the first half of the year saw the 60/40 S&P Bloomberg Equity/Bond Index fall 16.1%; by comparison, in the midst of the Global Financial Crisis, the benchmark was down only 6.7% in the first half of 2008.

"That gives you a sense of how truly extraordinary the end result of money-printing and balance sheet expansion, then further exacerbated by the invasion of Ukraine, has been," says David Gorton, founder of systematic managed futures manager DG Partners.

"Like a lot of people, we have been expecting a rise in inflation in response to this constant balance sheet expansion and yield curve control. It's probably taken longer than a lot of macro managers would have anticipated. But, this year, it has hit with a vengeance – you have high CPIs everywhere, whether it's 8.5% in the US, 8% in Europe, and similar in the UK (see Fig. 3.3). We also now even have inflation of 3-4% in Switzerland."

Industry pros also point to the "incredibly poor" performance in bond markets, which has dented financial asset prices, with credit spreads widening and equity markets falling. But that has also offered powerful trends for many managed futures models, with CTAs' ability to stay on track and rapidly adapt to new regimes proving to be a resilient inflation hedge.

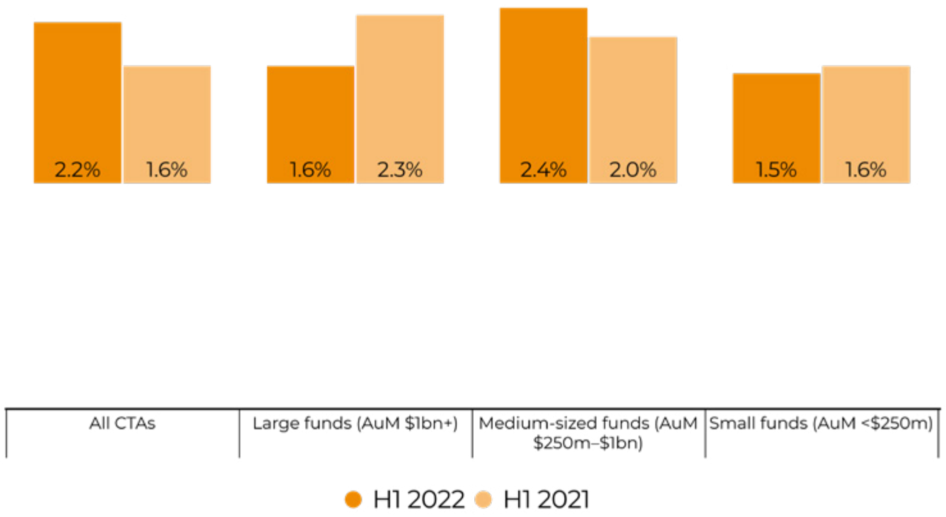
'Criticisms'

"For the CTA sector, this year has been good," Gorton says. "One of the criticisms that was often levelled at CTAs was that for so long they were really just long-biased towards bonds. But this year has answered a lot of those criticisms."

With bond markets enduring the "most pronounced bear market in history" during H1, trend-following funds have generated sizable returns in the asset class. "For us in particular, broadly half our risk has been in a model that is not preconditioned by prior price action – it purely trades consensus. That has allowed us to be more short, more quickly," Gorton explains.

"In the first half we have had significant moves in all three areas – higher rates,

Figure 3.2: CTA performance by fund size, H1 2022 versus H1 2021



Analyst note: Data as of 26 July 2022. Figures represent the average total return (TRR).

Source: Bloomberg Data

lower equity prices, and a stronger dollar - and as a result most CTAs and trend-following strategies have delivered strong performances."

"Diversifiers, CTAs and managed futures are generally performing well – trend followers so far this year have been working really well across most areas," says Jason Josephiac, senior vice president, Meketa.

"We try not to have any bias – it's more about the rate of change of inflation to either the upside or downside in an inflationary environment or deflationary environment, as well as growth, whether growth is increasing at an accelerating rate, or decreasing at an accelerating rate. And that's why we build our hedge fund programmes with risk mitigating strategies which can capitalise on regime shifts across multiple different types of macro environments and drivers of risk."

This shifting macroeconomic and geopolitical landscape has also formed the basis for successful trades further afield in certain hedge fund strategies.

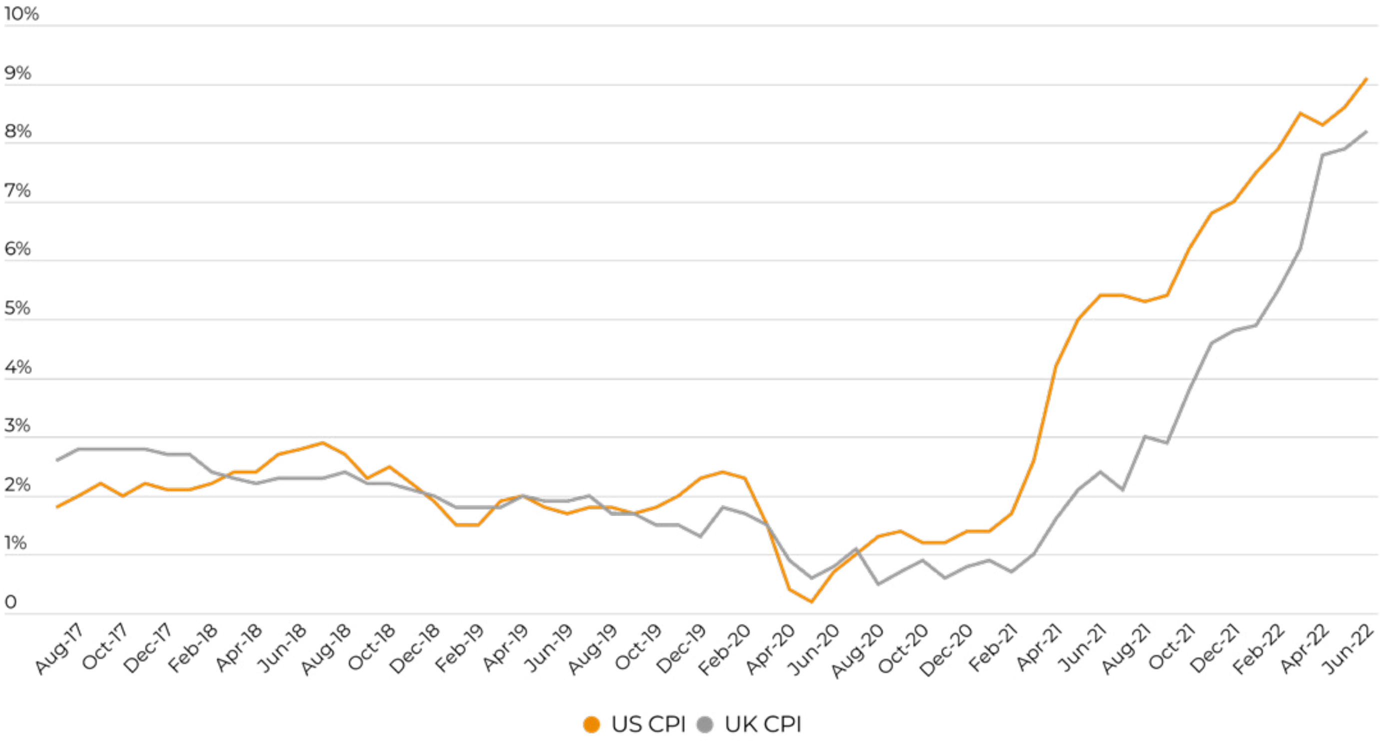
Polina Kurdyavko, head of emerging markets at BlueBay Asset Management, and senior portfolio manager of BlueBay's Emerging Market Credit Alpha Fund, says macro hedges – specifically a short view on US rates – proved beneficial for the strategy, along with idiosyncratic shorts on Honduras, Pakistan, Egypt and Turkey, and an avoidance of assets vulnerable to the Ukraine war.

Opportunities

"We hedged the portfolio against broader credit risks through CDS indices such as CDX EM and CDX HY which added value," Kurdyavko says. "The portfolio benefitted from a net short Russia position both through credit and FX hedges as well as sovereign and corporate shorts. We also had CDS hedges in Ukraine which helped to protect the portfolio."

Kurdyavko also points to opportunities in Argentina, where political volatility has

Figure 3.3: US and UK annual rate of inflation, July 2017–June 2022



Analyst note: US consumer price index (CPI) represents YoY change for all items tracked across all urban consumers.

Sources: The US Department of Labor, The UK Office of National Statistics

cast doubt on the economic backdrop, leaving bonds trading in the low 20s. "Here, our view is that the recovery value of the bonds is likely to be considerably higher."

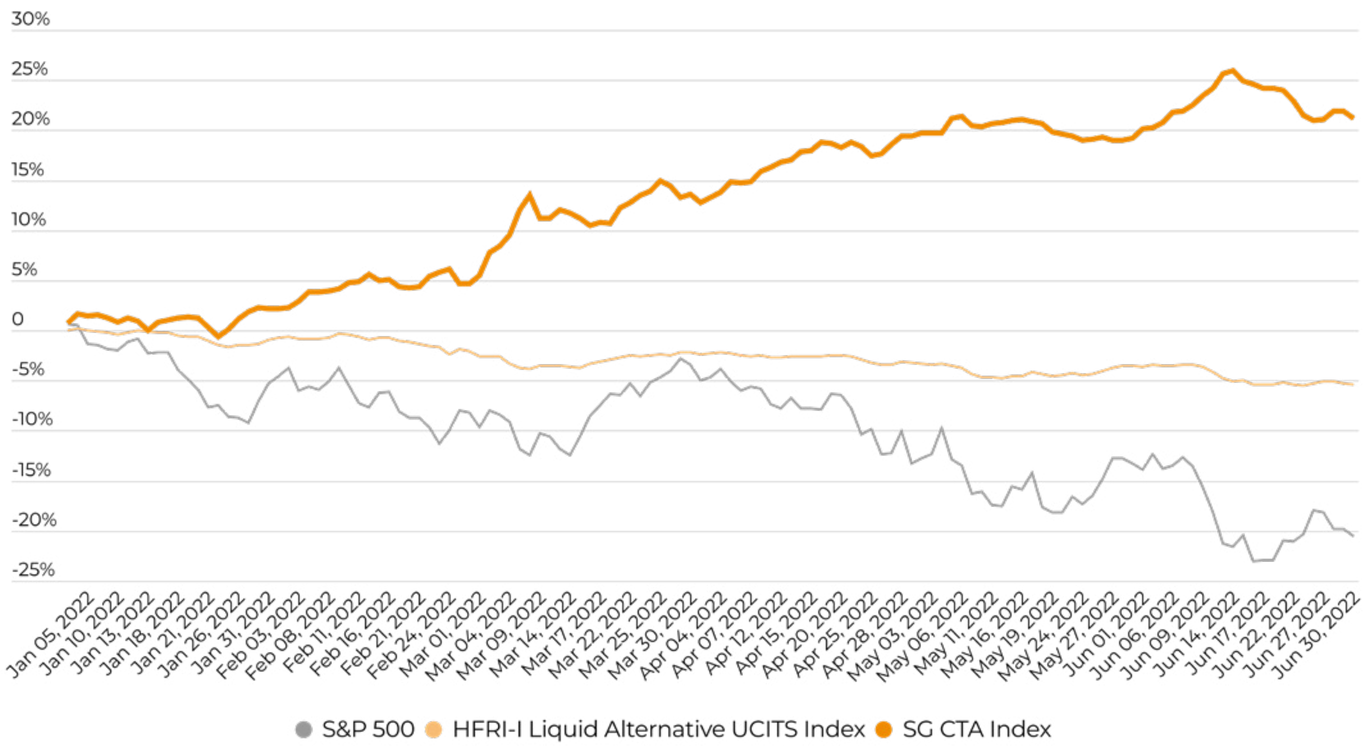
Looking ahead more broadly, macro-focused hedge funds and trend-following managers are overwhelmingly confident on their second-half outlook amid the new investment backdrop. Data shows that 50% of managers running macro or managed futures strategies surveyed by Hedgeweek are somewhat positive' on their H2 performance prospects, while an additional 44% are 'very positive'.

"It's been a treacherous market - the 60/40 is down 16% for the first half, and that would be the third worst year out of the past 100 I believe. So hedge funds are doing quite well in this environment, relatively speaking," Dave McMillan, CIO, hedge funds, at Mercer, observes of the prevailing investment backdrop.

"Leading the way is macro and managed futures, as trend following strategies have produced very strong returns, as well as credit and event driven. Those managers by-and-large have done really well to preserve capital or generate gains. Anything in the low single digits year-to-date, plus or minus is very accretive when stocks and bonds are down in high double digits. Long/short equities have been the most challenged."

Peter Kisler, portfolio manager at Trium Capital, adds: "If you look at sentiment towards global macro, it's improved from a few years ago when equities were doing well and global macro was being

Figure 3.4: Cumulative daily CTA performance versus S&P 500, 1 January 2022–30 June 2022



Sources: Societe Generale Prime Services Indices, Hedge Fund Research, SocGen, Investing.com

somewhat ignored.

"Now that equities are doing poorly, investors are looking for strategies that can make you money quickly, that can make you money in an environment where, like this year, most asset classes have fallen. So there's definitely more interest there.

"CTAs have had a very good year for the most part. Any reversal of these trends would cause them to perhaps underperform. Strategies like emerging markets have had a pretty poor year. We see value there, so we'd probably expect some sort of outperformance, if not in the next month or two, then later down the line." ■

KEY TAKEAWAYS

- A shifting inflationary regime drove strong trends across currencies, commodities and bonds which in turn powered macro hedge funds and trend-followers to stellar H1 returns. More than 90% of firms in these strategies remain positive about their second-half performance prospects
- Allocators are also eyeing value in emerging markets strategies, with managers here looking to unlock developing investment themes stemming from continued geopolitical upheaval and market volatility

SECTION 4 | INVESTMENT OUTLOOK

HEDGE FUNDS PIVOT ON RECESSIONARY CONCERNS

As investors turn to hedge funds for portfolio insulation during market turmoil, commodities-focused strategies and event driven managers look to navigate fresh market volatility amid a worsening economic outlook

The steady rise in oil prices since the end of last year, which has been driven higher by the war in Ukraine, helped strengthen returns among an assortment of hedge fund strategies exposed to commodities for much of the first half of 2022 (see Fig. 4.1). But growing fears of recession have sparked an investor retreat in recent weeks, with the West Texas Intermediate and Brent Crude benchmarks experiencing a price slide throughout June.

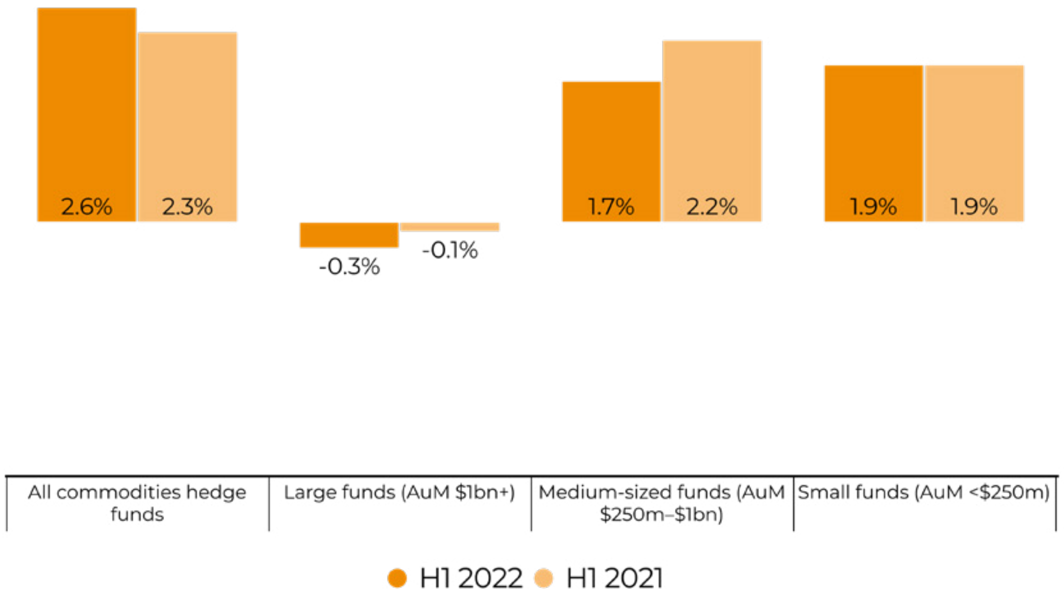
Commodities and other raw materials had earlier soared on the back of the ongoing economic thawing post-Covid, with costs further fueled by tightening supply stemming from Russia's invasion of Ukraine, and constraints on new mining and production activity.

But the renewed volatility in oil and gas markets means hedge fund managers are now urging caution during H2 in light of the June sell-off.

Westbeck Capital Management - whose Westbeck Energy Opportunity Fund trades long and short across the oil sector using futures, options and equities - says the current investment backdrop calls for "a pause on our bullish view and positioning" until conditions are clearer, adding that while the physical energy market remains tight, "summer liquidity is simply dreadful".

"Increasing recession fears and USD breakout have compounded weaker oil inventory data and led to a very aggressive sell-off across the commodities complex," Westbeck managers observed in a recent strategy update. "Technically, oil is testing the

Figure 4.1: Commodities hedge fund performance by fund size, H1 2022 versus H1 2021



Analyst note: Data as of 26 July 2022. Figures represent the average total return (TRR).

Source: Bloomberg Data

bottom of the bullish trend we have been in since the lows of the pandemic. A break could send us sharply lower."

Nick Mazing, director of research, Sentieo, observes how the WTI benchmark and US 10-year treasuries had been moving fairly steadily in line until recently (see Fig. 4.3).

"Is that now over? Some people would argue yes, if we are going into a recession; others would say no, and that there is still plenty more to go in terms of rates and commodities," Mazing says.

He notes that certain soft commodities are already negative year-to-date, noting that consumer sentiment has worsened and instances of the word "recession" in global corporate conference call transcriptions have ticked upwards in recent months.

"If we are in a recession, then a lot of the momentum shown in oil is going to reverse. The big bull market in commodities might be over, and it is highly likely that 2022 is the near-term peak year for commodities," Mazing adds.

'Vibrant'

The reversal is also reflected in the positioning of CTAs, which had earlier made sizable gains from the energy price rally. The trend-following hedge fund sector is said to have flipped to around 10% short in recent weeks, in contrast to the maximum longs of 10% earlier this year.

Recession fears also loomed over the event driven and special situations hedge fund sphere during H1, with managers here ending the first half marginally in the red as the volume of corporate activity tailed off from 2021 (see Fig. 4.2). However, certain specialist funds have captured positive gains in M&A activity, with private capital supporting a number of global 'mega-deals' as firms look to insulate their businesses from inflationary pressure.

Maso Capital, a Hong Kong-based merger arbitrage, event driven and convertible arbitrage-focused hedge fund investing across developed markets in the Asia-Pacific region, has generated "differentiated and uncorrelated" returns in what it calls a "vibrant" M&A marketplace.

'Protected'

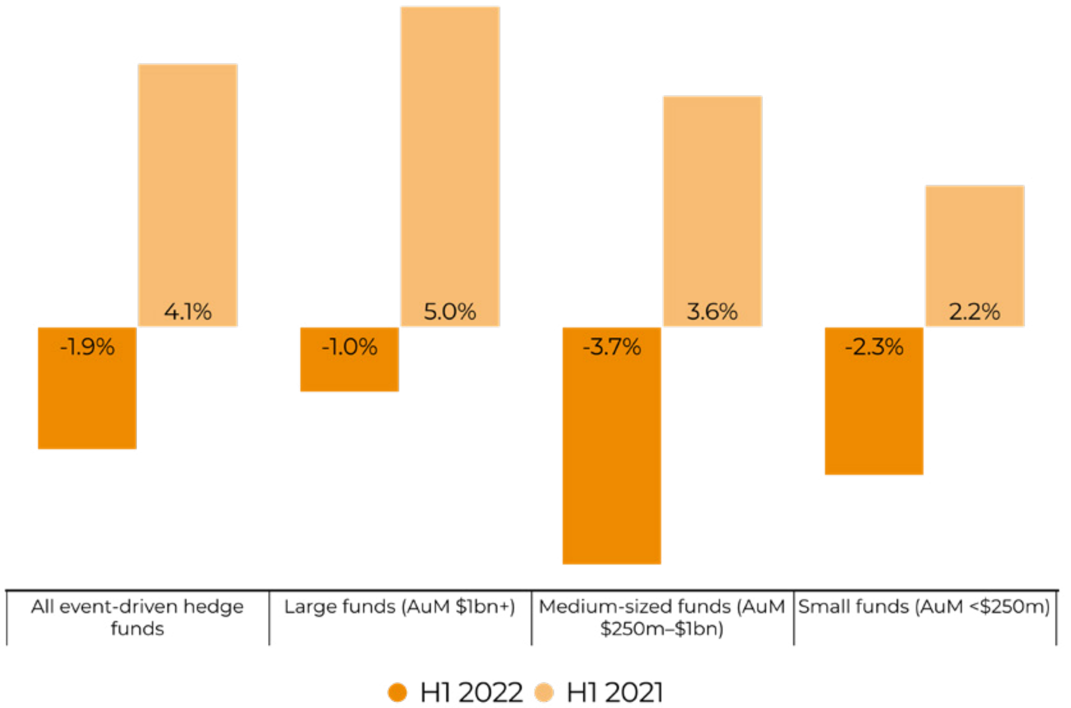
"There are large deals and complex cross-border deals with large spreads that we are capturing and those have led to roughly half our returns," says Maso co-founder and co-CIO Manoj Jain, pointing to a raft of private capital being put to work in restructurings throughout the APAC region.

"Japan is having a top-down, bottom-up paradigm shift in terms of corporate activity that will continue to be the case. In Australia, a wall of private equity money has been raised. You have strategic activity, you have inbound activity, you have outbound activity - there are a number of M&A transactions there."

Jain notes how there are now higher barriers to entry in event driven and M&A trades as a result of the growing deal complexity and macro concerns. But that has led to less-experienced operators and M&A "tourists" sitting on the sidelines, which in turn means "fewer players, and more opportunities with wider spreads albeit more volatile," he adds.

"We are able to play across the capital structure, so there are certain scenarios where we can own a convertible bond, rather than the equity, which offers a different up-down profile which we think has been pretty unique. That cross-asset capability

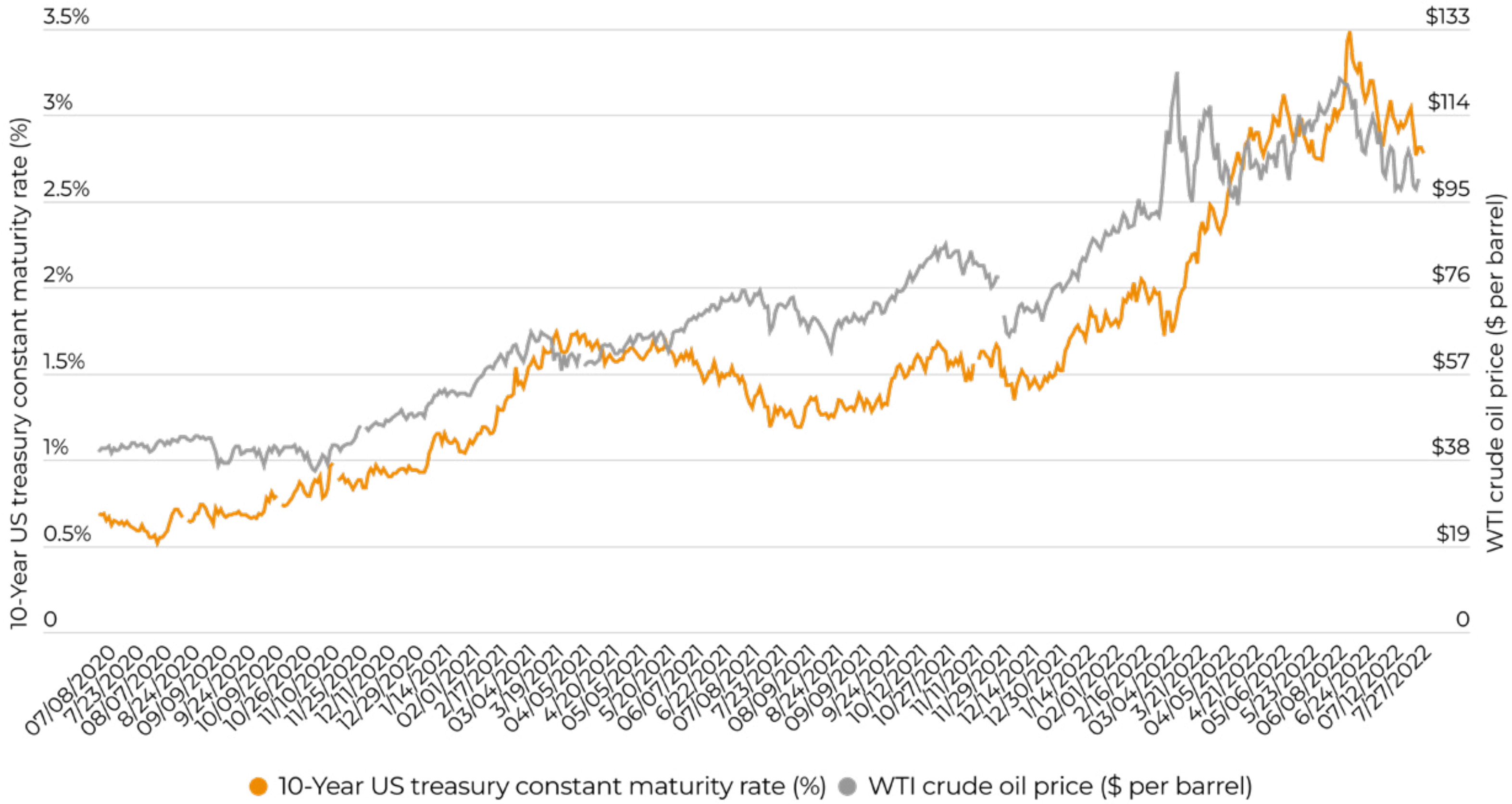
Figure 4.2: Event-driven hedge fund performance by fund size, H1 2022 versus H1 2021



Analyst note: Data as of 26 July 2022. Figures represent the average total return (TRR)

Source: Bloomberg Data

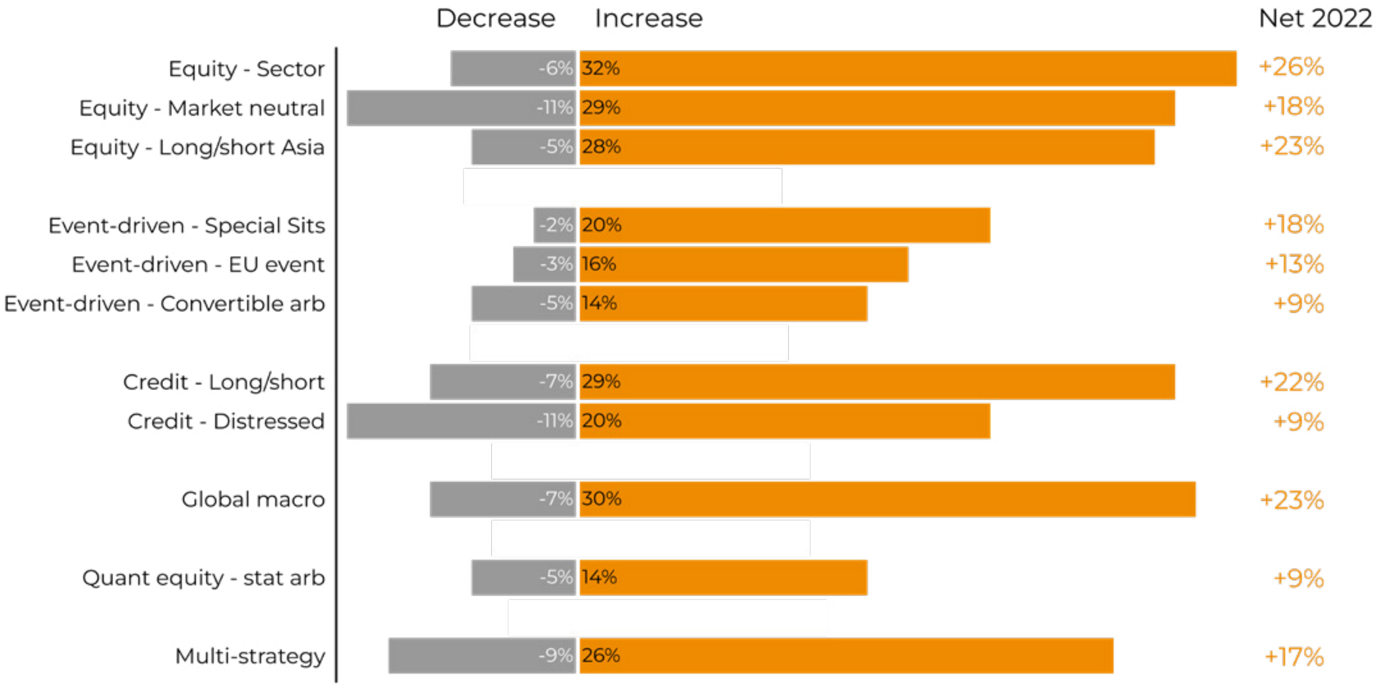
Figure 4.3: Ten-year US treasury price versus WTI crude oil price, July 2020–July 2022



Analyst note: WTI refers to West Texas Intermediate.

Sources: US Department of the Treasury, US Energy Information Administration

Figure 4.4: Percentage of investors planning to increase/decrease asset allocation in 2022



Analyst note: Survey conducted between mid-November 2021 and mid-January 2022.

Source: Barclays Hedge Fund Outlook 2022

has proven very useful in this region."

"We have been using certain macro tail edges since the summer of last year. We can use derivatives to hedge their overall portfolio – that has helped us whether it's interest rates, or the NASDAQ, or what's happening in Ukraine or FX moves."

Jain continues: "Our strategy is, and continues to be, a well-hedged, event driven portfolio; hedged to the position level with single-name or sector hedges. That approach has protected us as we come through to the event or takeover." ■

KEY TAKEAWAYS

- Industry data shows growing appetite among investors for hedge fund strategies to insulate portfolios from the worsening economic outlook. Over four-fifths of managers expect institutional investors to increase their allocation to hedge funds over the next two years
- Commodities-focused funds made gains from soaring oil prices in H1, but managers are now trimming positions following June's sell-off and heightening recession fears, with trend-following models also turning bearish
- Recessionary and inflationary pressures are also fueling a flurry of large and complex deals within the global M&A space, offering fresh opportunities for merger arb and event driven hedge funds

HEDGE FUNDS WILL PROVE POPULAR WITH INVESTORS IN H2

After years of pushing for the hedge fund space to become more professional, regulated and transparent, investors are increasingly looking to allocate some of their portfolio to hedge funds

According to SigTech's latest Hedge Fund Research Report, 83% of managers expect institutional investors to increase their allocation to hedge funds, especially quant funds, over the next two years.

Hedge funds are proving attractive in volatile markets with managers expecting them to generate absolute returns, mitigate risk, and offer a solution to portfolio diversification.

The interest is primarily being driven by family offices (68%) and endowments and foundations (55%), according to data from AIMA.

Recent research from the Managed Funds Association has found that university endowments with larger hedge fund investments receive higher returns.

The report shows that an average university with a $5 billion endowment and a 10% allocation to hedge funds earns nearly $240 million more over five years than an endowment with no allocation to hedge funds.

Meketa Investment Group and Mercer also believe there may be a correlation between pension plans who are often more liability-focused and aware.

"They may look to risk mitigating strategies for some diversification. Since, in theory, endowments and foundations have perpetual capital, they may be a bit more comfortable taking more risk on the return-seeking side. However, it's less about the absolute return that you receive and more about what the path of that return is, relative to the environment you're in," says Jason Josephiac, senior vice president, Meketa.

Dave McMillan, CIO, hedge funds, at Mercer says that all the "usual suspects" are allocating but adds that investors who previously chose not to allocate are revisiting this decision in their portfolios.

"Investor sentiment is currently very favourable, from what we're seeing and hearing. Investors who don't currently have an allocation to hedge funds are anxious to have the conversation about revisiting this in their portfolios, and we're delighted to carry out those dialogues," says McMillan.

Strategies

The hedge fund landscape looks very different to a year ago, and funds have had to adapt accordingly.

"Hedge funds have had to change investment strategies drastically from a year ago, with firms going from bullish to bearish in an effort to stabilise some of the drawdowns experienced," notes Peter Kisler, portfolio manager at Trium Capital.

CTAs and diversifiers (neutral beta and neutral markets) will be key to tackling ongoing market volatility and inflation over the next few months, and trend followers are also working well in the space.

"It hasn't been a good month for equities or crypto, but for a lot of the fixed income market, high yield and the high yielding emerging markets, it's been as bad a month as October 2008 and as bad as, or worse than, March 2020. So there have been some really brutal moves in the past month in some of these markets," adds Kisler.

According to Barclays Strategic Consulting survey, sector equity (26%) global macro (23%), credit long/short (22%) and multi-strategy (17%) will all prove popular with investors in 2022 (see Fig. 4.4).

Looking ahead, McMillan believes that trend following will be well-positioned in the coming period, but that ultimately having a diversified portfolio is always crucial.

"I do believe that trend following is likely to continue to be well-positioned for the market. So managed futures, macro – those are the strategies that are really top of mind to us. I wouldn't be surprised if long/short equity is able to deliver some good results.

Ultimately, if we do end up having a recession, distressed investors will certainly be able to provide capital and restructure balance sheets, positioning their portfolios well going forward. Predicting the relative performance of strategies can be a difficult game, but a diversified portfolio is usually the safe bet," he says.

This increase in appetite also comes at an interesting time, as benchmark returns in private markets slow and certain investors find themselves overweight in private equity.

"A lot of money has gone into private markets, which is now locked up and doesn't allow investors the ability to allocate back into risk assets, such as equities, after a sell-off. Hedge funds are more liquid and so offer this flexibility," says Duncan Moir, senior investment director at abrdn.

Due to increasing demand for passive alternatives from investors, the firm has recently launched the abrdn Eclipse platform which provides passive exposure to alternatives for institutional investors. The platform is underpinned by indices from Hedge Fund Research.

Moir believes that hedge funds are being given the opportunity to "do what they're meant to do" and thinks that certain investors may back riskier allocations.

HEDGEWEEK

CONTRIBUTORS:

Hugh Leask
Editor
hugh.leask@globalfundmedia.com

Fiona McNally
Reporter
fiona.mcnally@globalfundmedia.com

Scott Newman
Art Director
scott.newman@globalfundmedia.com

Tony Griffiths
Head of Content, Hedgeweek
Tony.Griffiths@globalfundmedia.com

FOR SPONSORSHIP & COMMERCIAL ENQUIRIES:

Jamie Home
Associate Commercial Director, Hedgeweek
jamie.home@globalfundmedia.com

Published by: Global Fund Media, Lion Court, 25 Procter St, London WC1V 6NY

Investment Warning: The information provided in this publication should not form the sole basis of any investment decision. No investment decision should be made in relation to any of the information provided other than on the advice of a professional financial advisor. Past performance is no guarantee of future results. The value and income derived from investments can go down as well as up.