THE ALTERNATIVE CAUSERIE

BEST FIRST HALF-YEAR FOR HEDGE FUNDS IN A DECADE

Hedge funds continued to deliver strong performance in Q2 and year-to-date thanks more dovish central banks rhetoric, which benefited risk assets and bond yields. According to HFR, Q2 performance was positive for almost all hedge fund strategies apart from equity market neutral that continued to underperform. Macro/CTA led the way with a solid rebound of +3.5% during the quarter followed by event driven and RV multi-strategy. Equity managers were flat as the month of May proved to be a difficult trading environment due to trade war resurfacing and concerns over slowing global growth.

Having an allocation to an active portfolio of heterogeneous hedge funds with distinctive risk-return profiles and performance drivers can greatly help stabilize returns as shown in the table below.

HFRX Index	**Q2-19**	**2019**	**2018**
Global Hedge Fund Index	+1.6%	+4.2%	-6.7%
Equity Hedge	+0.0%	+6.0%	-9.4%
Equity Market Neutral	-0.5%	-1.1%	-3.2%
Event Driven	+1.7%	+2.5%	-11.7%
Macro/CTA	+3.5%	+2.6%	-3.3%
RV Multi-Strategy	+1.5%	+3.9%	-1.2%
Fixed Income Credit	+1.6%	+2.9%	-2.6%
ACTIVE FoHF Portfolio			
Absolute Return Strategy	+2.0%*	+6.3%*	+1.0%
Healthcare/Biotech Strategy	+4.2%*	+17.7%*	+2.2%
Macro/CTA Strategy	+1.4%*	+3.0%*	+0.1%

*Source : HFR and Bloomberg. *Estimated performance*

Global Macro and CTA strategies performed well during the quarter and more particularly CTA trend follower managers were able to capture the sustained downward trend in fixed income yields most notably in Europe and in the equity rally while losing on their short oil and long USD exposure. The large exposure in fixed income markets is the highest-level not seen in many years and will be very sensitive in case of an upward move in yields. Global Macro managers with an EM bias also fared well with gains in rates and sovereign credit (Long Venezuela, Brazil, South Africa) and long FX (Thai Baht). Other Global Macro managers underperformed due to their short G4 duration exposure and got whipsawed on the long GBP trade. Long/short equity managers had a volatile quarter as risk assets sold-off in May but were able to fight back and recoup most of the losses in June led by financials, materials and consumer discretionary. In contrary, almost all low net and market neutral managers were able to weather the May volatility by posting positive returns thanks to their short books. Fixed Income and Credit managers profited from the good carry and credit spread tightening in a more benign environment.

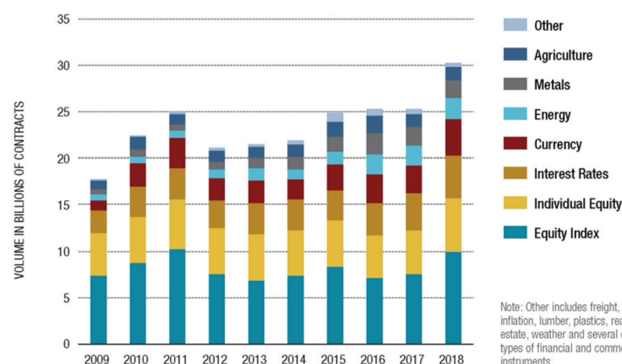
Performance of selected HF managers in H1 2019*:

- **Event Driven:** ED1 +25.2%; ED2 +15.1%; ED3 +3.5%
- **Long/Short Equity:** LS1 +21.4%; LS2 +14.8%; LS3 +4.2%; LS4 +37.4%; LS5 +28.6%
- **Global Macro:** GM1 +10.2%; GM2 +7.5%; GM3 +32.9%; GM4 +7.7%; GM5 -2.8%; GM6 -5.2%; GM7 +0.4%
- **CTA/Managed Futures:** CTA1 +21.9%; CTA2 -2.4%; CTA3 -2.0%; CTA4 +6.3%; CTA5 +0.1%
- **Low Net/Market Neutral:** LMN1 +7.2%; LMN2 +1.4%; LMN3 +2.6%; LMN4 +5.4%; LMN5 +5.4%; LMN6 +6.1%; LMN7 +4.4%
- **Multi-Strategy:** MS1 +4.5%; MS2 +4.7%

**Estimated performance based on latest available data from the fund administrator or found in the public domain*

VOLATILITY ARBITRAGE IN FOCUS

Managers involved in volatility arbitrage strategies considers Volatility as an asset class per se and will tend to enter relative value trades, directional trades, market neutral trades or a combination, on different tradable assets such as equities, fixed income, FX and commodities.



Source: FIA

Historically volatility trading was mostly used to hedge against market corrections and was expensive as most users tended to be long volatility. Nowadays, with more informed investors and the use of trading systems managers are able to identify deviations in implied volatility caused by macro/corporate events or supply/demand imbalances and will enter specific spread trades in order to capture these market inefficiencies. Managers can go both long or short and capture increases in volatility during uncertain times or go short to capture the mean reverting tendency. Managers implement the strategy either through a systematic or discretionary approach and the underlying instruments tend to be transparent, liquid, short-term and exchange-listed securities (futures, swaps and options). The major difference today versus the pre-financial crisis era is that these

instruments were mostly OTCs carrying higher counterparty risk, valuation risk and had lower liquidity.

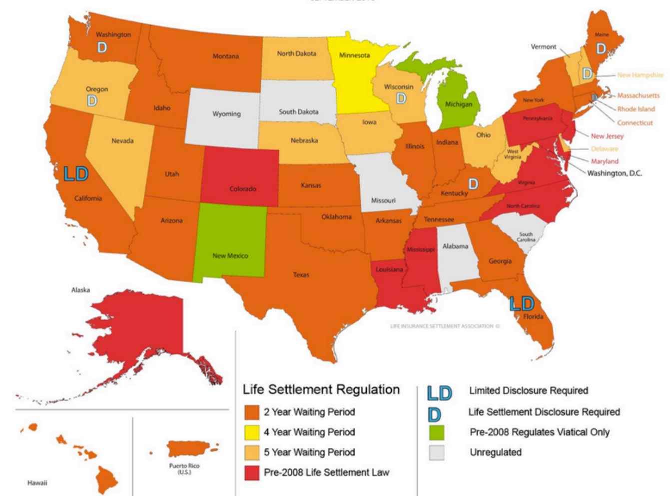
The most common return drivers for volatility arbitrageurs are:
- Carry: trading implied volatility versus realised volatility of an asset (volatility risk premium) and the term structure.
- Mean reversion: trading from implied volatility mean reverting. It is generally done on an index level like the VIX for example as the bid/ask spread is more tight than for a single-stock RV volatility trading.

The best-trading environment for this strategy is during high volatility periods that are persistent, however, erratic volatility spikes can be challenging for managers. The strategy is uncorrelated to the broader financial markets and acts as a diversification tool for a portfolio during market stress.

PRIVATE MARKETS: LIFE SETTLEMENTS

The industry of Life Settlements is growing tremendously in the US and has become more mature and regulated. The US demographics with baby boomers reaching an all time high will provide plenty of supply of life insurance policies that could be monetized by investors. Life Settlements are different from Viatical Settlements where policyholders are at least 65 years old and not terminally and chronically ill. It has become more and more common for policyholders to sell their life insurance policies instead of surrender them or stop paying the premiums. Policyholders have the ability to create a liquidity event to enhance their quality of life during retirement, to stop paying an unaffordable insurance and reduce monthly expenses, to pay for legal/tax issues or it could be used to pay for expensive longer-term medical needs. This market opportunity gives the option to policyholders an alternative to monetize an unwanted insurance. Moreover, it creates a positive social impact and could be viewed as a solution for the aging demographic.

The industry has become more institutionalised and more financial institutions are entering the asset class. This has helped the secondary and tertiary markets to grow and to deepen liquidity. Life Expectancy calculations have become more standardised with market-based input data from independent providers and stricter medical underwriting gives more comfort in assumptions and fair values. Still most actors in the industry calculate the fair value of their life policies using mark-to-model inputs that will vary significantly and there is no uniformed valuation methodology.



Source: LISA Life Insurance Settlement Association

For investors, Life Settlement provides an interesting investment case with 8-12% returns with low correlation to traditional asset classes and to economic market cycles. These policies are traded on a regulated market, which is expanding rapidly and offers exposure to investment grade insurance companies with insurance policies remaining a senior obligation.

The transaction consist of the acquisition of the policies legal rights from licensed life settlement providers (regulated on a state level) at a discount to the full policy benefit value which will always be higher than the price paid by an insurance to repurchase the policy. The investor will continue to service the policy and pay premiums that are owed to the insurance company and in exchange the investor will be the beneficial owner of the full policy benefit value.

The two main risks in this strategy concerns longevity risk (policyholders live longer than the Life Expectancy) and valuation risks (marked-to-model with subjective inputs). This means that investors returns will be impacted if the expected life expectancy used in pricing the models were too optimistic and so have to pay more premiums for longer (indeed raise more capital) but also the final face value would also occur later which discounted back will reduce profits. Other risks are more operational/legal in nature to make sure the policies are serviced correctly, premiums don't increase and benefits are paid without challenge.

Life Settlement strategy is a very interesting and uncorrelated asset class for investors seeking to diversify their portfolios. However, it needs to be thoroughly researched and analysed in order to avoid the numerous pitfalls.

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