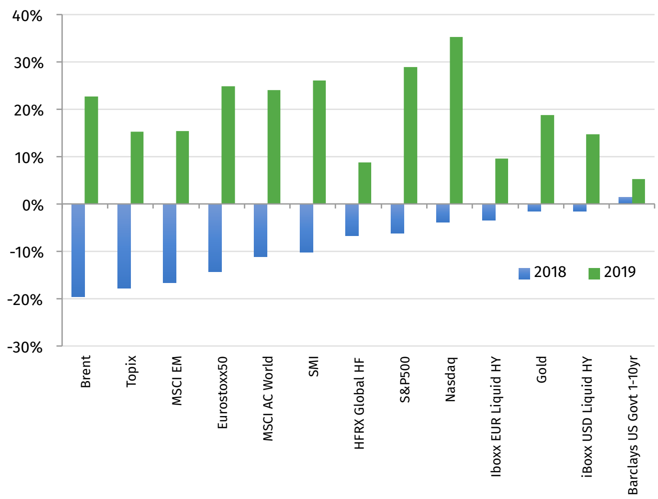
THE ALTERNATIVE CAUSERIE

2019 MARKET REVIEW

What a difference a year makes! 2019 was the exact opposite of 2018 where almost all asset classes were in negative territory. Hopefully investors profited from this market exuberance. Nevertheless, at the beginning of the year, it was unimaginable that 2019 would end with a double-digit return for most asset classes. The stellar performance of 2019 hid an eventful year with bouts of volatility along the way stemming from the trade war, US yield curve inversion, the great factor rotation out from momentum into value, Brexit uncertainty, and the sudden rate increase in the repo market. More importantly, it was the turnaround in the accommodative stance by most central banks globally that supported risk assets, especially equities and bonds, to perform extraordinarily well. Furthermore, even though the US-China trade tension was persistent throughout the year, it helped markets reach new historical highs.

Performance of main global indices in 2018 and 2019

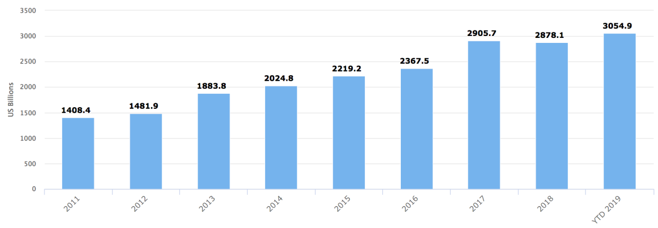


Source: Bloomberg

STRONG PERFORMANCE FROM HEDGE FUNDS BUT SELECTION REMAINS KEY

Hedge Fund strategies benefited from the rise in risk assets during the year by delivering good risk-adjusted returns, with positive performance across almost all alternative strategies. This helped the industry to consolidate at high AUM levels, around $3tn, the past years. However, the industry saw some net outflows during the year with more Hedge Funds shutdowns than launches but it still remains an important source of investments for investors.

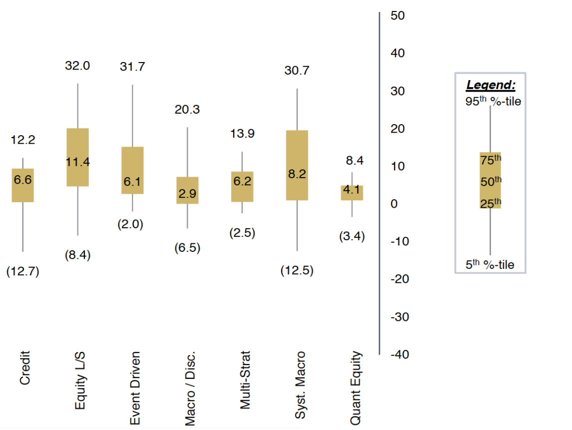
Historical Hedge Fund industry assets



Source: BarclayHedge, data as of September 2019

Manager and strategy allocation is key in managing Hedge Fund portfolios in order to allocate to funds having the greatest competitive advantage in the market. This can be appreciated by the significant dispersion in performance among managers and strategies. According to the HFR Market Microstructure Report, the HFRI constituent performance had the highest dispersion between the top-decile and bottom-decile funds. The trailing 12-month decile dispersion was +40.8% as of Q3 2019, with the top HFRI decile gaining +21.3% while the bottom decile fell -19.5 % over the same period. Morgan Stanley's Prime brokerage team made the same observation where the dispersion was more accentuated in Equity L/S and Systematic Macro/CTA strategies.

Performance dispersion (95th percentile and 5th percentile) of main HF strategies in 2019 collected by Morgan Stanley



Source: Morgan Stanley Prime Brokerage (MSPB), Investor letters collected by MSPB. Morgan Stanley does not and cannot verify the accuracy of the information contained in investor letters. For strategies with smaller samples, it calculated the median performance using Nov '19 YTD data or Oct '19 YTD data for those funds that have not sent Nov '19 data yet.

The direct collateral damage of these unprofitable funds led to closures and return of capital to investors and even high profile managers were vulnerable in 2019: Paul Brewer (Rubicon), David Tapper (Appaloosa), Louis Bacon (Moore Capital), Mick McGuire (Mercato), Nick Niell (Arrowgrass), and Jens-Peter Stein and Kornelius Klobucar (Stone

Milliner) to name a few. The main reason behind these closures was performance related and the high cost to run the business. Regarding performance, it could also be argued that the poor results came from managers being more concerned about managing the company risk due to redeeming investors rather than focusing on delivering better returns. Though, this is very healthy as it confirms the growth and maturity of the industry and the fact that capturing alpha is becoming harder to achieve and tends to be more limited in time. Managers will need to innovate and find new sources of alpha with alternative data information.

HEDGE FUNDS ARE A COMPLEMENT NOT SUBSTITUTE TO EQUITIES

Whether rightly or wrongly, investors still compare Hedge Funds return to equity indices in order to gauge their relative performance. This was perhaps the case in the early innings of the industry when the majority of the Hedge Funds were in equity related strategies with higher net market exposure. Since then, the industry has evolved in more sophisticated strategies combining technology, machine learning and complex financial instruments. It is true though that overall Hedge Fund performance has been disappointing in the last decade due to supressed volatility and massive monetary easing that have favoured passive investments as all assets moved in tandem. However, investors should allocate to Hedge Funds as a true diversifier from their standard beta equity and bond exposure as it gives significant advantage in terms of risk reduction. Furthermore, some alternative strategies by their investment approach will tend to lag equity bull markets however, over time, they offer stable and consistent returns in changing market environments. Hedge Funds have the potential to generate returns that are independent of broader market directionality by providing portfolio diversification in a downturn as they seek idiosyncratic alpha by focusing on security selection in a tight risk management framework. Having an allocation to an active portfolio of heterogeneous Hedge Funds with distinctive risk-return profiles and performance drivers can greatly help stabilize returns with steady and positive performance as shown in the table below.

Performance of main HF indices and active FoHF

HFRX Index	**2019**	**2018**	**2017**	**3yr p.a** annualised
Global Hedge Fund Index	+8.6%	-6.7%	+6.0%	+2.4%
Equity Hedge	+10.7%	-9.4%	+10.0%	+3.3%
Equity Market Neutral	-1.9%	-3.2%	+1.7%	-1.1%
Event Driven	+10.0%	-11.7%	+6.5%	+1.1%
Macro/CTA	+4.8%	-3.3%	+2.5%	+1.3%
RV Multi-Strategy	+6.2%	-1.2%	+3.6%	+2.8%
Fixed Income Credit	+6.2%	-2.6%	+3.9%	+2.4%
ACTIVE FoHF Portfolios				
Absolute Return Strategy	+8.8%*	+1.0%	+8.4%	**+6.0%**
Healthcare/Biotech Strategy	+29.3%*	+2.2%	+23.3%	**+17.8%**
Macro/CTA Strategy	+2.1%*	+0.1%	+2.6%	**+1.6%**

*Source : HFR and Bloomberg. *Estimate*

In 2019, the best performing strategies were equity related as equity markets (MSCI AC World TR) had their best year since 2009. Managers with a sectorial equity bias towards technology and healthcare fared better than global portfolios. Relative value and fixed income strategies also did well as spreads continued to tighten and more discrepancies were found in corporate bonds (CCC vs B). Equity market neutral managers were the laggards in 2019 due to their zero/low equity beta exposure and their fundamental trading approach. Global Macro managers were able to capture trends in fixed income and FX and to a lesser extent in equities.

Preview of selected HF managers performance in 2019*:

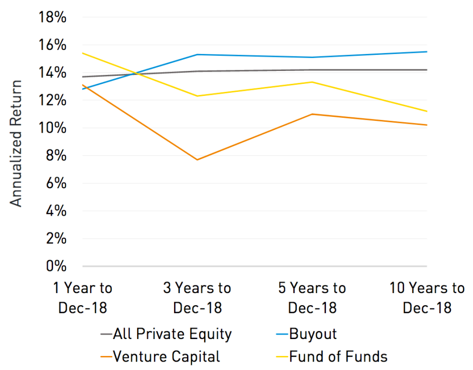
- **Event Driven:** ED1 +39.8%; ED2 +19.9%; ED3 +3.7%
- **Long/Short Equity:** LS1 +28.4%; LS2 +21.8%; LS3 +9.9%
- **Healthcare L/S:** HLS1: +59.9%; HLS2 +44.6%; HLS3 +53.7%; HLS4 +27.5%; HLS5 +31.0%; HLS6 +14.8%; HLS7 +12.1%
- **Global Macro:** GM1 +10.0%; GM2 +13.6%; GM3 +34.4%; GM4 +23.8%; GM6 -4.7%; GM7 +5.9%
- **CTA/Managed Futures:** CTA1 +25.7%; CTA2 -2.3%; CTA3 -9.8%; CTA4 +4.0%; CTA5 +3.0%; CTA6 +1.1%; CTA7 +5.1%
- **Low Net/Market Neutral:** LMN1 +12.5%; LMN2 +6.7%; LMN3 +1.2%; LMN4 +4.3%; LMN5 +4.1%; LMN6 +10.0%; LMN7 +4.8%; LMN8 +12.9%
- **RV Arbitrage / Multi-Strategy:** MS1 +9.2%; MS2 +7.3%; MS3 +6.4%; MS4 +6.5%

**Estimated performance based on latest available data*

PRIVATE MARKETS GOES MAINSTREAM

Investors have been increasingly attracted by the more illiquid space in the alternative industry, namely Private Debt, Private Equity and Venture Capital due to higher targeted returns and less correlated returns to traditional capital markets. Private Markets assets represented more than $5.8tr as per the McKinsey Report and have seen a growing interest in the last decade. Interestingly this has also been the case for Hedge Fund businesses that have been converging into Private Markets by adding resources and talents in order to get greater information access and differentiated alpha sources.

Horizon IRRs by Fund Type

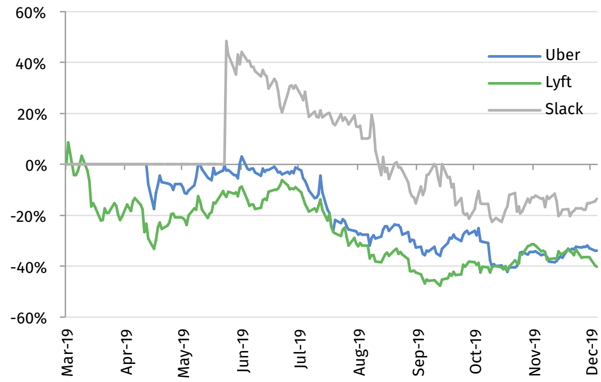


Source: Preqin Pro

The main factor behind this fervour is that investors are seeking more and more beyond traditional asset classes due to supressed yields globally (and even negative for some issuers) and stretched equity valuations that are decoupling from fundamentals. Investors are also looking to access certain markets that are inaccessible otherwise, that have unique market drivers. In fact, investments in private companies will be less sensitive to financial markets fluctuations and involve less market volatility. Their performances will predominately depend on the company's management team execution and real value creation without having to be bound to a timeline. In bad market environments, GPs will usually be able to hold on to the assets until better times and not panic sell. Historically, Private Equity investments have delivered strong performance, and investors are chasing the returns due to a lack of better options. This is of course a potential trap for inexperienced investors as there are risks inherent to this asset class, and investors need to be very diligent as investment selection and due diligence are critical. As an example, some of the so-called Unicorns (pre-IPO companies valued at +$1B) had a difficult time when they hit the market due to their high pre-valuations, and their stock prices are now trading below the IPO level (Uber, Lyft and Slack as an example).

Additionally, the failed WeWork IPO was a reminder of the possible valuation issues in private companies.

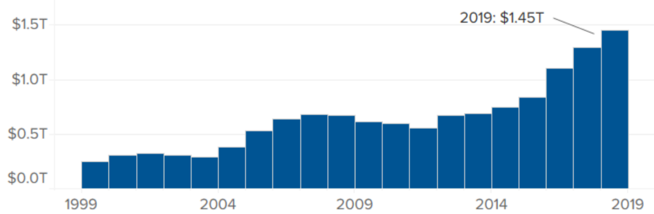
Unicorn equity performance after their IPO



Source: Bloomberg

Since the financial crisis, banks have forsaken most of their lending activity caused by new regulations and tighter capital requirements. This has helped the emergence of bank disintermediation and technological innovation with specialized asset managers and alternative lenders to replace traditional commercial banks as companies were in need of fresh capital in order to refinance existing loans or to spur business growth. However, the growing interest by investors in Private Markets, the high cash balances in funds, and the competitive investment and lending environment are pushing returns downward.

Private Equity and Venture Capital cash reserves



Source: Perqin

With the growing number of funds raising new capital, GPs have to be more cautious in deploying their capital and avoid the valuation trap in some parts of the market. The same goes in the Private Debt space where alternative lenders have mushroomed in recent years offering lighter credit documentation and lower interest rates. This could be illustrated by the gross returns of unitranche debt that today are around 7-9% for 5x/6x corporate leverage versus 8-11% for 4.5x/5.5x few years ago. This is an important aspect to consider, as more money is poured into the asset class, the more disciplined investment managers must be.