ITERAM

THE ALTERNATIVE CAUSERIE
Q4 2022

YOUR TRUSTED PARTNER FOR ALTERNATIVE INVESTMENTS

THE ALTERNATIVE CAUSERIE

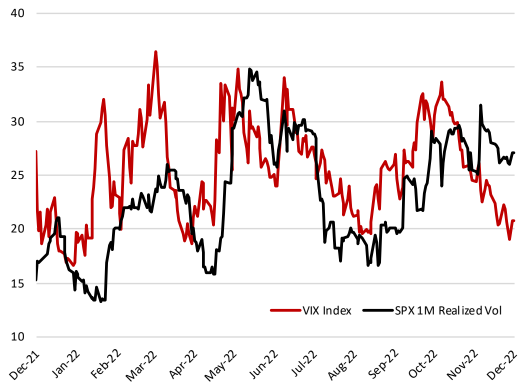
HEDGE FUNDS RENAISSANCE

As the year is drawing to a close, we feel pleased to have navigated successfully through such a complex market environment. We also welcome investors' renewed interest in our industry since they have started to acknowledge hedge funds' value as true portfolio diversifiers and that TINA ("There Is No Alternative" to equities) is probably not a sound investment strategy when central banks do not offer meaningful backstop facilities.

In November, ITERAM's investment team members travelled to New York and London to attend industry conferences and meet managers (existing investments and prospects). The mood remains upbeat for hedge funds thanks to honorable performance this year, while traditional equity and fixed income investments have been the source of deep losses. Yet, in reality, equity long/short managers hold the lion's share of hedge fund allocations and most investors have experienced sharp drawdowns this year due to the excessive beta in their portfolios. We discussed in previous publications how the resilience of multi-strategy funds through this bear market has drawn the attention of investors for their alternative allocation. For this reason, an increasing number of managers has embarked in a transition to a multi-strategy offering either by hiring new portfolio managers in-house or through allocations to external managers.

From a performance standpoint, November 10th resulted in significant unwinds worth elaborating on. The US CPI print missed to the downside (headline YoY at 7.7% versus 7.9%) and caused sharp reversals across equities, foreign exchange and interest rates. On the news, the S&P 500 and NASDAQ Composite indices closed the day up +5.54% and 7.35% respectively. In other asset classes, the Dollar index dropped by -2.12% and the US 2-year yield fell by 25bps in anticipation of less hawkishness from the Fed. Consequently, several global macro managers and multi-asset systematic programs lost ground due to their consensual positioning: long USD, short fixed income and short equities.

Erratic volatility behavior has left traders scratching their heads this year

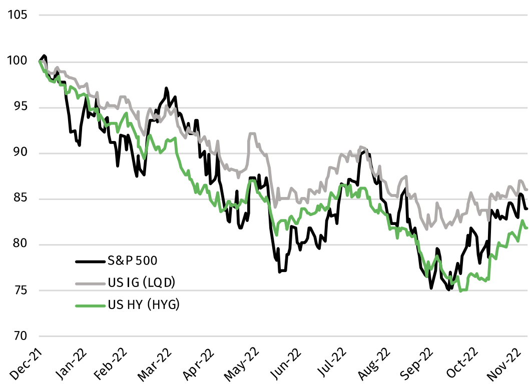


Source: Bloomberg, as of December 6, 2022

One of the most popular and mainstream *premia* harvested by relative value traders is the persistent premium of index implied volatility over realized volatility which can be captured using different trade structures. 2022, however, was different in two respects. First, implied volatility has remained contained despite markets trending down for an extended period. Second, realized volatility has traded higher than implied volatility during multiple occasions. One of the reasons behind this anomaly seems to be the continued monetization of tail hedges which sterilized implied volatility. In late 2021 and early 2022, institutional investors initiated meaningful hedging positions using derivatives in anticipation of higher interest rates and a weak equity market. Due to this positioning, there has been no rapid de-risking or major liquidations of such magnitude to create investor panic despite the uninterrupted flow of negative headlines. In spite of these unusual developments, our positive view in volatility relative strategies remains unchanged and we believe that niche strategies exploiting these dislocations will thrive in the post-TINA world.

There has been extensive media coverage and investor interest in global macro and multi-strategy hedge funds in 2022 and it's also what allocators perceived to be the strategies offering the most compelling opportunities. In the meantime, credit long/short managers went through a rough patch this year due to the painful combination of rising interest rates and widening credit spreads. That being said, it seems like investors are now more constructive on the asset class as it recovers from the lows of September. Allocators believe that skilled manager are now in a good position to deliver high returns by snapping up good quality issuers at attractive prices after a widespread sell-off driven by macro fears.

Credit has been the source of abysmal losses in 2022

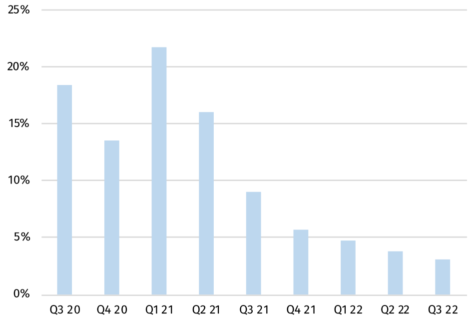


Source: Bloomberg, as of December 6, 2022

With market participants pricing peak rates for Q2 2023 in the US, investors feel more confident accepting some duration risk to take advantage of the recent market dislocations. Distressed, in particular, might offer great bargains when corporate default rates rise (still record low at 1.6% in September 2022 for US trailing 12m speculative grade, source: S&P Global Ratings Credit Research & Insights). We have been exploring the space recently and will continue to reassess our thesis as we get more clarity on the macro outlook. Nevertheless, we are cautious not to be early if more trouble is to come with sticky inflation and a global synchronized economic slowdown.

Looking further, we keep following our 2022 playbook as we don't see any sign of abating macro nervousness. If anything, the level of uncertainty has increased compared to the fourth quarter of 2021. In this context, global macro managers should continue to benefit from high volatility in rates, currencies and commodities. The supply-demand imbalance story in commodities is here to stay with Russia being progressively unplugged from the global energy and metals markets. Demand for natural resources will be mainly driven by China which is the marginal buyer of several key commodities such as iron ore, cooper, nickel, aluminum, soybean, corn and hogs among others. Therefore, the timing and pace of the country's reopening will set the tone for commodity markets in the next few months.

Average earnings surprise for S&P 500 index constituents has been trending down

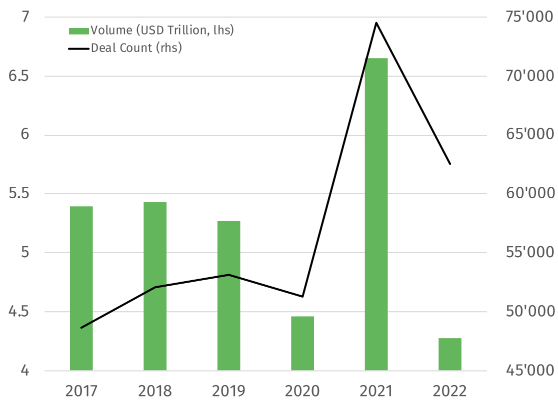


Source: Bloomberg

The backdrop for directional strategies remains challenging and it seems premature to adopt a risk-on stance. Robust post-pandemic economic activity has been supported by massive households' excess savings from stimulus programs, but higher than usual spending and inflation is eroding that war chest. The pressure on earnings is intensifying as companies are already sending warnings about slowing sales growth and increasing costs from raw materials, services and wages. This environment remains our central scenario and we are still wary of our beta exposure. However, we remain ready to deploy more risk in equity long/short or credit long/short (as detailed earlier in this note) should the market regime turn more favorable to these strategies. We believe that we can only deliver superior risk-adjusted returns by maintaining an open mindset and being nimble.

Within event driven and despite the challenging market backdrop, we continue to favor merger arbitrage as the strategy is robust, exhibits low volatility and can benefit from a rising interest rate environment.

Deal counts in M&A remains strong



Source: Bloomberg

Although deal volumes are down significantly in 2022, deal activity remains relatively strong. Compared to 2019 as a baseline level, deal counts are up 22% despite volumes being down about 4%. While financing costs are higher, financing markets remain open, particularly for deals with strong strategic rationale. Even private equity has started to step back into deal making, especially in areas where assets have fallen to levels at which they can make fully-equity funded deals work.

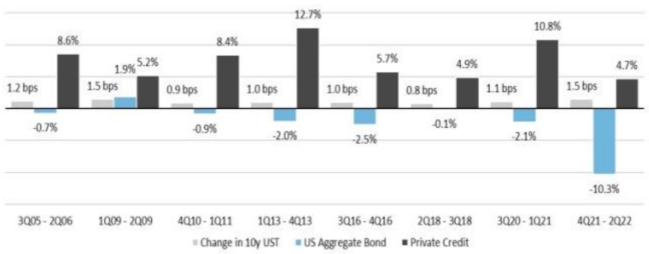
PRIVATE MARKETS: A VALUABLE DIVERSIFIER

The continuous geopolitical and market uncertainties are giving a headache to many investors as how to thrive in this environment. Private market investments offer alternative and stable sources of return while smoothing out portfolio returns over the medium to long term. However, it comes at a cost given the illiquidity of such investments and investors have to manage carefully their portfolio and plan well in advance their future cash requirements.

PRIVATE DEBT

Private debt can be seen as a good inflation hedge as higher yields can compensate for interest rates increases, inflation and widening credit spreads. The higher yield component and additional yield features earned in private debt transactions, give investors a further differentiated income stream uncorrelated to traditional bond markets. Moreover, these loans are well secured, offer higher recovery rates than bonds and are not subject to the daily mark-to-market since these loans are typically held to maturity.

Private credit returns in rising rate environment
Performance in periods when 10-year US Treasuries increased by >=75bps



Source: Reuters, FactSet, Morningstar Direct, Cliffwater Direct Lending Index, 30.06.22

We therefore have a preference owning and financing real assets, real estate and infrastructure assets and as well cash-flowing businesses that can weather inflation as prices readjust. Historically during high market volatility and uncertainties, private debt has been quite resilient and provided diversified and uncorrelated returns to investors with enhanced downside-risk protection.

VENTURE CAPITAL

While 2021 saw a record year in capital deployed in VC, 2022 gave way to a welcome rationalization with many funds slowing down their investment and fund-raising pace. However, there is still significant amount of dry powder available to fund innovation and this represents a strong opportunity for transformational businesses to emerge, as VC activity remains robust compared to pre-pandemic levels, with global start-up funding reaching $109 billion in Q2 2022 vs $66 billion in Q2 2019.

From an historical perspective, the best vintages have been those invested after-market corrections. A study recently published by Cooley highlighted that the median pre-money valuations for all stages came back to much more comfortable levels, allowing investors to take advantage of the private market conditions to deploy capital. In this current environment, the fear of missing out (FOMO) is gone, and we are moving to a more investor-friendly level for the first time since early 2020. Furthermore, history tells us that economic slowdowns are rich times for creativity and innovation, as entrepreneurs are constrained to focus on challenges facing the world in a more efficient manner. Indeed, roughly half of the Fortune 500 companies were founded during economic downturns, including, Microsoft and Apple, founded in 1975 as the US was plunged into recession. Amazon made its online debut in 1995 right before the dot-com bubble and Airbnb was founded at the start of the great recession in 2008.

Discipline in picking top decile funds, and diversifying risk across industries and geographies remains, in our view, the key success factors in Venture Capital. Despite economic challenges, the adoption of technology by businesses is necessary as in most cases this is the only way to achieve efficiency and meet customer demand as evidenced by the recent launch of the new GPT chatbot by OpenAI which is a breakthrough in the AI industry. Similarly, entrepreneurs have plenty of opportunities to use technology to address new challenges like building a more sustainable power network, providing cutting-edge healthcare solutions or offering disruptive financial services.