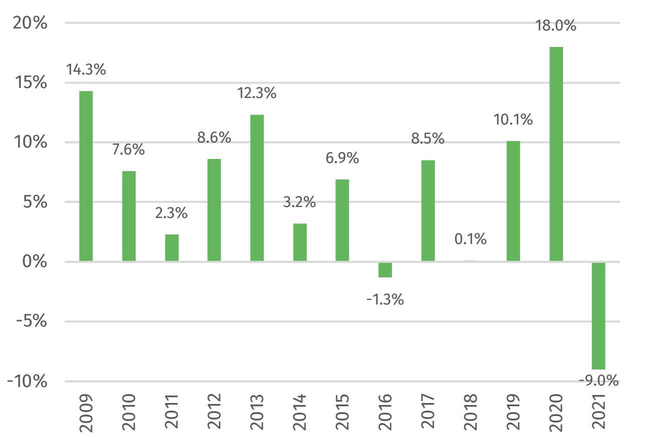
THE ALTERNATIVE CAUSERIE

HEDGE FUNDS READY TO CAPTURE GREATER VOLATILITY

With equities in the 12th year of a bull market and bonds no longer providing attractive yields or adequate diversification benefits, we could finally be at the point in the cycle where alpha in public markets is going to be far more important than beta. Beta-driven markets have certainly been detrimental to hedge fund managers over the last decade but things might be different going forward.

While we will recall 2020 as the best year of the last decade for hedge funds both in terms of absolute performance and alpha, 2021 has been a much different story. Last year, long/short equity managers' long alpha has turned deeply negative and was the worst year since 2009 by a wide margin according to Morgan Stanley Prime Brokerage, even worse than 2016 and 2018 which were already the most challenging years for the hedge fund industry in recent history. Region-wise, US positions suffered the most while European and Asian alpha was flat.

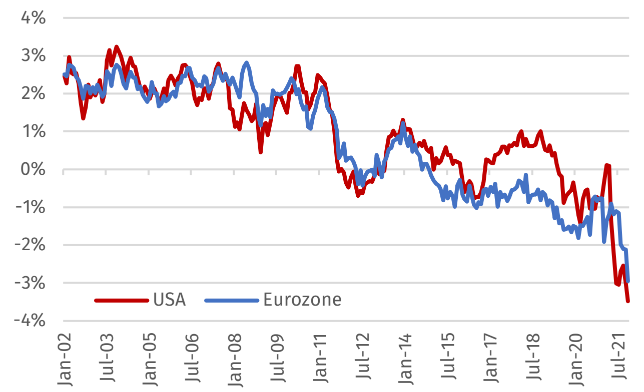
Long/short equity managers net alpha



Source: Morgan Stanley Prime Brokerage, as of December 10, 2021
Net alpha figures are based on a 100% long, 50% short exposure to reflect typical L/S exposure

From a macro perspective, the market regime is showing signs of change in respect to growth and inflation which may lay down optimal conditions for alpha generation in 2022. The recovery play continues to have some tailwinds as economies return to normalcy and economists expect solid growth in 2022 amidst higher inflation. Furthermore, the progressive reduction of liquidity by major central banks has already started to prop up volatility in the equity and fixed income markets. Given this backdrop, hedge funds should be in a good position to help investors reduce portfolio volatility and access alternative alpha opportunities across asset classes.

Deep negative real rates will prompt policy response



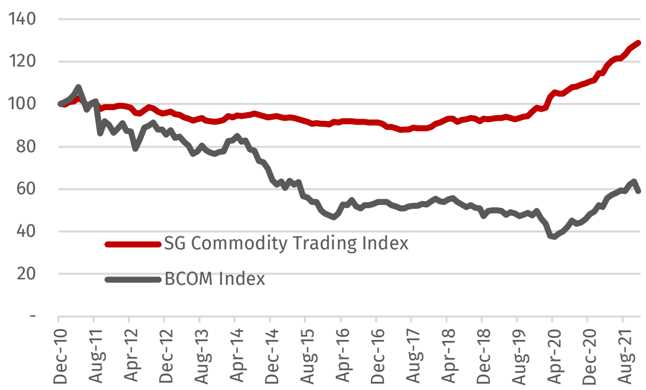
Source: Bloomberg

In this context, we favor less directional exposures and trading-oriented approaches. Relative value strategies should be able to benefit the most of increased dispersion within and across asset classes in addition to more fundamentally-driven markets. The opportunity set for global macro managers is highly attractive as a shift in policy regime will contribute to boost cross-asset volatility, which is usually a fertile ground for alpha generation. The outlook for long-biased long/short equity managers is unfavorable on the back of decelerating earnings growth, sky-high valuations (especially in some areas of technology and consumer) and inflationary pressures. In this space, we expect low-net managers, specialists and tactical traders to outperform. As we have seen during the first weeks of the year, 2022 is expected to be challenging for growth stocks as interest rates trend upwards. As such, analysts and managers call for a rebalancing towards more value names and geographies where equities are more reasonably priced, e.g. Europe and Japan.

Following an outstanding 2020 for the biotechnology sector, market exuberance cooled down in 2021 as investors started to question the industry's excessive valuations and the quality of companies brought to public markets by a record wave of IPO. Looking forward, we remain very constructive on small-cap biotech on the back of historically high innovation, more clarity on drug pricing in the US and the potential resurgence of M&A.

As for commodities, it looks like all stars are aligned after having been neglected by the investment community for more than 10 years. Most managers are excited by one of the best trading environments they have seen in their careers, a perfect combination of high volatility and fundamentally-driven commodity prices. Demand is exploding on the back of the post-pandemic recovery and the massive shift towards renewables and electric vehicles while supply has been lagging due to structural underinvestment during the past decade.

Commodity managers gain traction after a decade of underperformance

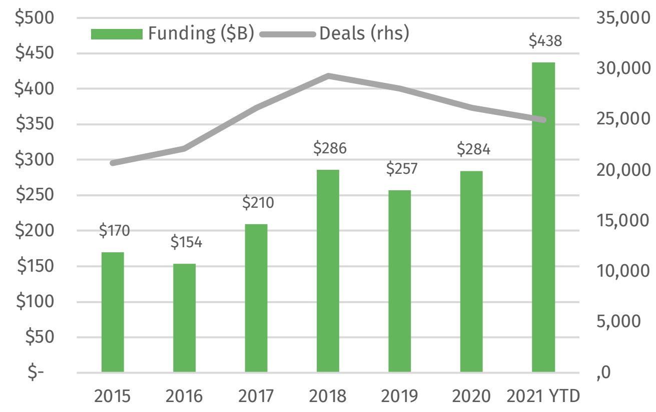


Source: Bloomberg

EXPANDED OPPORTUNITY SET IN PRIVATE MARKETS

VENTURE CAPITAL

2021 was an outstanding year for Venture Capital, with record funds raised, record deployment of capital and record exits. According to CB Insights, global deals and funding reached all-time highs in the third quarter of 2021 with $158.2B across 9,363 deals. It is worth noting that the average deal size has been trending higher as more capital is chasing venture opportunities. In 3Q21, mega-rounds of $100M or more represented 4% of total deals but accounted for 60% of total dollars invested. From a geographical standpoint, the US dominated global venture funding activity ($72.3B in 3Q21), followed by Asia ($50.2B) and Europe ($24.2B).



Source: CB Insights Venture Report Q3 2021

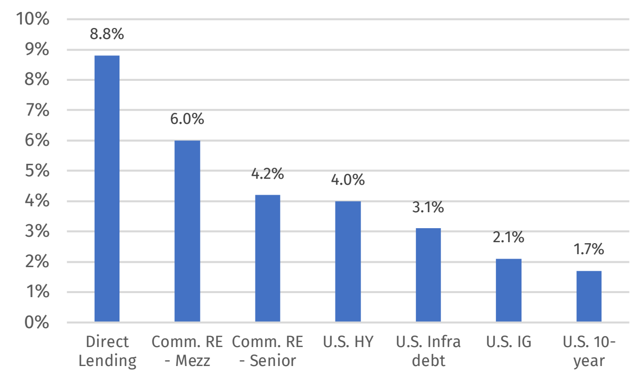
For 2022, even with the massive outstanding "dry-powder", we expect some sort of rationalization that translates into less aggressive valuations and less companies going public. From a thematic perspective, web3 and metaverse/gaming are expected to be hot topics during the upcoming quarters, and environmental-tech is gaining traction as well. We also see pressures to change the way VCs organize themselves: Sequoia Capital for instance announced that they are gathering all their U.S. and European investments around a singular, open-ended fund in order to extend their investment period beyond IPO for some companies. Overall, we expect that being "picked" by the iconic VCs will continue to be as important as choosing the right startups for a successful VC manager.

PRIVATE DEBT

As a consequence of the low-yield decade that followed the 2008 financial crisis, institutional investors have been reviewing their fixed income allocation to include more alternative sources of income. According to bfinance's September 2021 wealth manager investment survey, 52% of respondents are already invested in private credit. A majority of long-term institutional investors such as pension funds and insurers are also planning to boost allocation to private debt as traditional public debt investing faces the threat of soaring inflation and interest rates.

Private Debt strategies have become an essential toolkit for investors that seek steady income streams, higher yields and additional diversification thanks to the breadth of risk/return profiles and industry exposures. According to Preqin, private debt assets under management should near $1.21 trillion in 2021 and forecasts that it will continue to grow, with AUM more than doubling to $2.69 trillion by 2026.

Direct lending offers the best yield in fixed income



Source: J.P. Morgan AM, Bloomberg