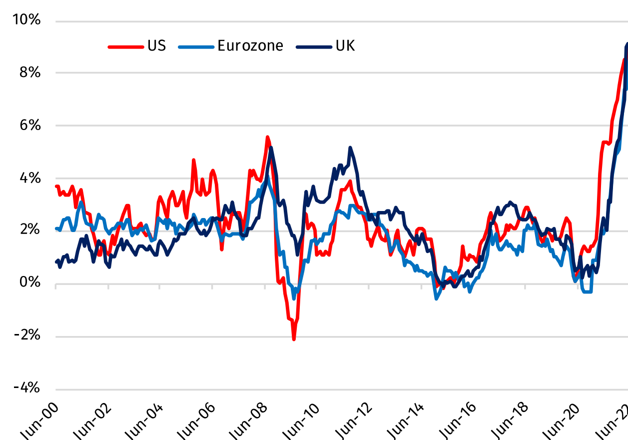
THE ALTERNATIVE CAUSERIE

SENTIMENT CHECK FROM THE HEDGE FUND INDUSTRY

We were pleased to attend a handful of hedge fund conferences over the course of the second quarter following a two-year black-out due to COVID. With the exception of Asian countries which are still subject to some restrictions, business travel in Europe and the US is almost back to normal. We were able to travel to Barcelona (Morgan Stanley), Rome (Goldman Sachs) and New York City (Barclays and Jefferies). In-person events feel definitely better than virtual ones and both allocators and managers were delighted to swap their Zoom conference rooms for live chats. We felt that allocators were constructive on hedge funds and continue to believe in their potential for outperformance going forward. Higher cross-asset volatility and multiple developments on the macro front have been painful to the traditional equity and bond allocations so far this year but hedge fund managers have had plenty of compelling opportunities to extract alpha from. Investors are starting to acknowledge the end of the concept of "secular stagnation" as developed countries have now to deal with the combination of rising prices, higher cost of capital and persistent volatility. All those ingredients are usually favorable to hedge fund strategies since they can employ a variety of trading strategies to deliver returns across market cycles.

In this context, global macro managers have been the primary beneficiaries of increased demand for cross-asset strategies. As discussed in previous letters, we have been ourselves increasing our allocation to this space to capture alpha in fixed income, foreign exchange and commodities. The playbook remains very much unchanged since the start of the year for these managers: long energy (and selectively other products in metals and agriculture), long USD (vs. EUR, GBP and JPY predominantly) as well as short rates across the US and Europe. Bullishness in commodities is still supported by meaningful supply-demand imbalances across the globe which were exacerbated by the Ukraine-Russia conflict. Finally, opportunities in fixed income and currencies have been driven rising rates and red-hot inflation prints.

Record-high inflation numbers are the mother of all fears in 2022



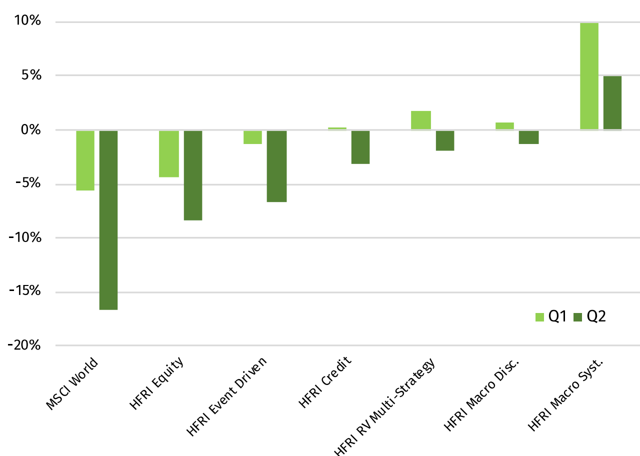
Source: Bloomberg, headline CPI YoY

Furthermore, we have witnessed a strong preference for multi-strategy/multi-PM funds as well since they typically provide stable uncorrelated returns and low volatility. These portfolios are usually a blend of various sophisticated strategies which offer a low-net exposure and optimal diversification in terms of geography, asset class, market cap and investment horizons which makes them very attractive from a risk/reward perspective, especially during periods of high volatility. Multi-PM funds have been historically heavily weighted towards equity strategies but they are now extending their capabilities in fixed income relative value, global macro and even crypto arbitrage, although more cautiously. Nevertheless, multi-strategy managers have lately been offering less liquid share classes as they attracted more capital: investors would now need up to several years to fully redeem a position under the new terms (due to restrictive investor-level gates).

By contrast, equity-centric funds were less sought after due to their poor performance so far this year, especially during the second quarter.Equity long/short and event-driven strategies have delivered mid to high single-digit negative returns in 2022 on the back of structural correlation to risk appetite. Performance was even more painful for growth-focused managers as investors are gradually turning their back on high beta expensive stocks (predominantly within technology, consumer discretionary and healthcare). As inflation and recession fears fueled portfolio

liquidations across the board, the bulk of equity long/short and event driven managers showed their vulnerability to market downturns and have failed to protect investors' capital. Overlapping positions between managers have exacerbated the share price decline in some crowded names and was an additional source of negative alpha. As a result of growing losses, equity long/short managers have been actively trimming both gross and net exposures over the past 6 months. From a style standpoint, value has been the clear outperformer this year and most equity long/short managers are progressively building back their allocation to this factor as growth investing has faltered with higher rates. Identifying high growth innovative companies was the most rewarding approach over the past decade but now cash flow generation, cost control and pricing power are becoming key selection criteria.

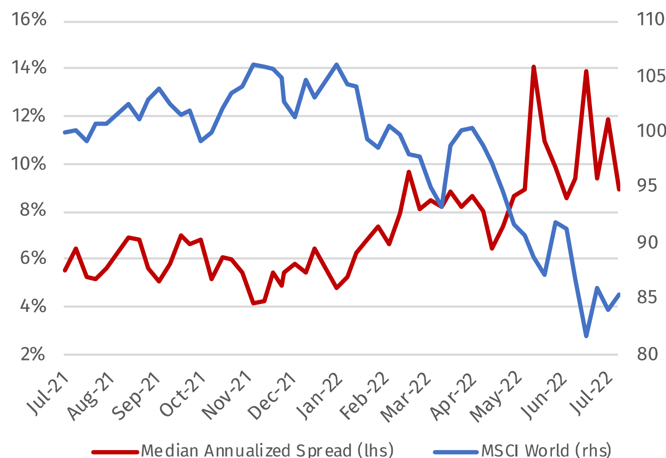
Hedge Funds YTD Performance



Source: Bloomberg, as of June 30, 2022

Within equities, biotech investments have been the source of abysmal losses as investors shrugged speculative investments in this area. Frenetic IPO activity in 2020 and early 2021 have brought several low-quality companies to public market at unsustainable valuations and earlier stages of development. Albeit all the negative headlines, the managers we met remain optimistic on the continued pace of innovation while valuations appear now to be very attractive: a large portion of the universe trades now at cash levels. The current environment should certainly push for consolidation (M&A) to increase capital efficiency through synergies as cost inflation are threating margins across all industries. They also expect clinical trial operations to be less disrupted by COVID after months of delayed subject enrollment, data analyses and regulatory interactions.

M&A spreads have widened meaningfully starting from January as equities collapsed



Source: UBS Special Sits, Bloomberg. Definitive deals with more than 5 days to closing

In Event Driven, Merger Arbitrage managers remain confident on the opportunity-set since they are adding risk as M&A deal spreads widen on the back of macro fears while individual transaction fundamentals continue to be robust with the usual dispersion between high-quality and second-class deals. M&A activity remained strong, despite market volatility, although there has been a reduction in private equity and large-cap transactions which has brought the overall volumes down compared to 2021. Merger Arbitrage specialists expect a scenario *à la* March 2020 when deal spreads spiked as economies shut down but eventually tightened back weeks later with no material deal breaks. Solid corporate balance sheets and meaningful dry powder from private equity should continue to support M&A activity going forward but the impact of higher cost of capital could put at risk the viability of some levered deals. The SPAC market remains volatile after an unprecedented growth in size with a record number of IPOs issued during the past couple of years. SPACs were trading at 3% *premium* to cash in trust at the beginning of 2021 but are now trading at 2-3% *discount*. The speculative bubble has cooled off as retail investors left the space and it is now acting more like it should be: a cash enhancement arbitrage strategy providing a modest rate of return.

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