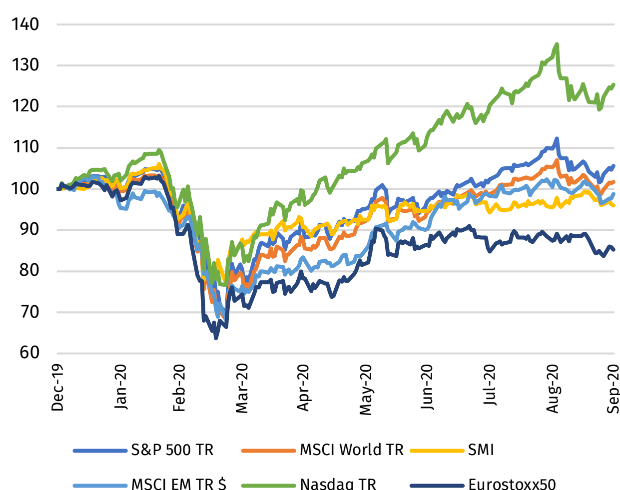
# THE ALTERNATIVE CAUSERIE

## THE 2020 ROLLER COASTER

Financial markets have experienced an incredible ride since the global pandemic crisis breakout in the first quarter of 2020. Equity indices were down almost -35% at some point in March and credit markets followed the trend as spreads widened to levels not seen since 2013. Investors fled to safe haven assets like gold, and interest rates fell to extremely low levels. By the end of the second quarter there was a big disconnect between financial markets and underlying economies. US GDP contracted -31.1% on an annualized basis, the worst number recorded since 1947, yet US equity markets were making new all-time highs with the US dollar declining to two year-low. By the end of September, most risk assets have vigorously bounced back thanks to massive interventions from Central Banks and Governments in order to support employment, companies and the economy at large. The progress of the pandemic is still unknown as there is no approved vaccine yet.

**YtD performance of major equity indices**




*Source: Bloomberg as of September 30, 2020*

## ALTERNATIVES: OFFERING ATTRACTIVE OPPORTUNITIES

In this context, Alternative Investments fared decently well by limiting the equity and credit downside and protected investors capital during very volatile markets. Given the extraordinary situation and market disruption, managers were able to operate seamlessly during the lockdown period, and showed the robustness, resilience and agility in their operations. The majority of the managers were able to profit from the rise in market opportunities caused by the pandemic as others had to liquidate positions and raise cash to face margin calls.

Moreover, some strategies with intrinsically less liquidity, like structured credit, had a very steep decline due to very low market making activity. Traders were working remotely and investors had no appetite to take on risk in the midst of the storm. Given the amplitude of the market moves, we have not witnessed major hedge funds suspensions or gating, which bodes well for the future of the industry. In the contrary, we saw a number of funds that were closed to subscriptions for many years that reopened, as well as, the launch of new special dedicated funds to capture investment opportunities. According to Preqin, total industry assets under management stood at $3.58 trillion thanks to the good market performance and inflows in the second quarter of 2020.

Hedge funds continued to deliver strong performance in the second and third quarter. According to HFR, hedge funds had the strongest five-month period since 2000 with the HFRI Fund Weighted Composite returning +15.0% from April to August 2020. Diving deeper in terms of strategies, directional managers profited from the rebound in risk assets and equity prices, and were able to capitalize on some sector rotations. Tech and Communication services companies led the pack with the FAANG hitting all-time highs. Another record was achieved by the S&P500, which posted the strongest monthly gain since 1984, with a return of +7.2% for the month of August.

**Index/Active portfolio performance as of September 2020**

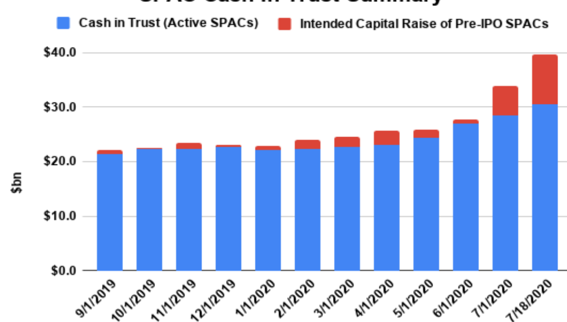
| HFRX Flagship Funds Index | Q1-20 | Q2-20 | Q3-20 | YtD-20 |
|---|---|---|---|---|
| Global Hedge Fund | -10.1% | 8.4% | 2.6% | 0.0% |
| Equity Hedge | -11.8% | 12.8% | 6.1% | 5.6% |
| Equity Market Neutral | 0.5% | 1.9% | 0.8% | 3.2% |
| Event Driven | -14.6% | 10.4% | 2.2% | -3.7% |
| Macro/CTA | -0.6% | 1.1% | -0.2% | 0.3% |
| RV Multi-Strategy | -7.0% | 6.0% | -0.1% | -1.5% |
| **EQUITY Index** | | | | |
| S&P500 TR | -19.6% | 20.5% | 8.9% | 5.6% |
| MSCI World TR | -21.4% | 19.2% | 8.1% | 1.4% |
| **ACTIVE Portfolio** | | | | |
| Absolute Return | -5.8% | 8.8% | 3.2% | 5.7% |
| Healthcare/Biotech | -8.1% | 15.2% | 3.5% | 9.5% |
| Macro Diversified | -4.1% | 4.7% | 2.0% | 2.5% |
| Alternative Income | 2.1% | 1.2% | 1.4%* | 4.9%* |

*Source : HFR and Bloomberg as of September 2020. *as of August 2020*

Having an allocation to an active portfolio of heterogeneous hedge funds with idiosyncratic risk-return profiles and diversified performance drivers can greatly help stabilize returns as shown in the table above. Portfolios of hedge funds could be seen as a good diversifier in times of high market volatility.

## SPACS IN THE SPOTLIGHT AMID PANDEMIC

Special Purpose Acquisition Company, a.k.a SPAC, has been in vogue in recent years and even more so this year in the hedge fund industry. Managers use these shell companies to raise capital from investors with the intention to merge/acquire a company instead of the company going public in a traditional IPO or direct listing. When SPACs go public they generally have a clean balance sheet with only cash on hand that simplifies the IPO documentation and time to market. In fact, one of the main advantages of this structure is the quick setup process and low cost. For investors, one of the benefit of SPACs is to potentially have a higher allotment of shares than in a traditional IPO. SPACs are also known as blank-check companies because the identity of the target company is not always disclosed beforehand to limit any investment leakage. Hence the importance of the management team experience and quality, to complete a transaction. However, investors with deep pockets that can provide the needed financing will under certain confidentiality circumstances know the identity of the company. Typically, the manager will have two years to complete the acquisition or merger, and in the meantime, investors will earn interest as the cash sits in a trust account, and be invested in treasuries. If the manager is unable to complete a transaction, he must return the capital raised back to investors plus the interest earned. Once the acquisition takes place the SPAC is then listed on one of the major stock exchanges. According to SPAC Research, this year alone more than $30 billions have been raised by SPACs with the aim to deploy in growth sectors such as technology and communication services companies.




*Source: SPAC Research*

SPAC managers tend to have close contacts with Venture Capital and Private Equity firms as they are most often in need of liquidity as their vintage funds come to an end or need late-stage financing. The largest ever SPAC offering this year was launched by a hedge fund manager, Bill Ackman that raised $4 billion from investors with the aim to merge with a private unicorn. For the time being the manager has not disclosed the target, however, there were rumours that he tried to approach Airbnb. Other notable companies going through a SPAC merger this year were Nikola Corp, Fisker, DraftKings Inc and Virgin Galactic Holdings.

## COVID-19 IMPACT ON DUE DILIGENCE

One important activity that is regularly performed by investment teams during the investment process, is the investment and operational due diligence. The importance of such activity strengthened during the GFC when many companies liquidated due to poor infrastructure setup, procedures, risk controls and frauds. The current pandemic also brought its set of additional risks for companies as they needed to address greater operational, human and financial risks.

The initial impact of the sanitary crisis for investments teams was to assess the potential impact on their investments and understand the risks mitigants put in place. At the midst of the crisis, the more difficult tasks were to obtain physical signatures, closing bank financings, and signings at the notary in order to close on investments. This has seen the rise of electronic signatures. The stringent lockdown measures had also a direct impact on one of the due diligence key steps, the on-site visit, as it could not always be performed. The physical interaction with the top management is very important in order to understand the working environment and the collaboration between team members. For some investors, this meant that new investments were put on hold before being able to continue their analysis process. The consequence of all this, was that investment teams had to adapt to a new working environment and be more flexible and innovative in their processes to efficiently take advantage of market opportunities without sacrificing risk controls.

This pandemic has caused many companies and industries to rapidly adapt to a "new normal" as governments and states have imposed strict lockdowns measures with closed borders and travel restrictions. The financial industry, and in particular asset managers, were fairly prepared for this event having built robust IT infrastructure, internal systems which enabled them to instantly work remotely. Obviously, it had a non-negligible impact on individuals and organizations as the pandemic disrupted their day-to-day routines and standard work practices. Companies internal organization had to be reshuffled, with meetings and communications taking place via video conferencing in order to continue operate normally and maintain close contact with colleagues and clients. It is very plausible that video conferencing will take a greater place in investment and operational due diligence processes in the future and that it could become the new norm. However, it will never replace entirely physical meetings, as the investment due diligence remains a people's business.

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