

A large graphic on the left side of the slide features a grid of triangles. The top section has light blue triangles, while the bottom section has darker blue triangles. A white triangle is positioned to the left of the main title text.

# **PERSPECTIVES THAT DRIVE ENTERPRISE SUCCESS**

NOVEMBER 2015  
Hedge Fund Environment



# Table of contents



---

VERUSINVESTMENTS.COM

SEATTLE 206-622-3700

LOS ANGELES 310-297-1777

---

Executive summary	3
-------------------	---

---

Industry overview	4
-------------------	---

- Industry assets and alpha
- Short term return composition
- Long term return composition

---

Hedge fund styles review	8
--------------------------	---

- Alternative beta
- Event driven
- Long/short equity
- CTA / global macro
- Relative value

---

Summary	14
---------	----



# Executive summary

In this annual hedge fund review, we shed some light on the market environment and resulting headwinds or tailwinds facing common hedge fund strategies. Most investors allocate to hedge fund strategies to capture return streams that are uncorrelated to equity and bond markets. This simplistic goal has been hard to achieve in an environment flooded with monetary stimulus, characterized by low security dispersion and limited areas of distress. Managers work harder to find unique ideas that can scale. As a now-\$3 trillion industry pursuing similar strategies, capturing alpha is proving much harder than in years past. There is no short rebate available to short sellers, the borrow is often more costly and almost everywhere they turn, hedge fund peers already hold significant stakes in portfolio companies securities. We suspect episodic sell-offs and rebounds driven by liquidity concerns and “crowded-ness” could become more normal than unique.

The macroeconomic environment may be evolving from one of continued easing to one of inability to ease, or even tightening. Tightening could impact corporate confidence which has driven M&A activity and could set off a new distressed cycle. While many activist and merger strategies have benefitted over the past two years, many other equity managers have suffered as their short positions rise in anticipation of potential takeovers.

Slowing global growth has impacted commodity-oriented sovereigns and corporate securities, and oil prices continue to remain volatile. This should be helpful for CTA and global macro managers able to identify strong directional trends and differentiate between countries and currencies positioned to benefit or suffer from lower oil prices.

Still-high equity valuations suggest potential for alpha in short books since further return potential from margin improvement or P/E expansion appears more difficult. Distressed strategies bemoan a dearth of existing opportunities, but salivate at what may be just around the corner, especially in the energy complex. Funding costs for levered strategies remain extremely low, but then again so does volatility; selling any sizable position is likely to incur significantly lower realizations from what we hear.

While our annual hedge fund environment will generalize many hedge fund styles, we recognize each hedge fund is unique in a number of ways; there is a very wide distribution of individual skills, styles and approaches. Paying careful attention to the headwinds and tailwinds that may affect hedge fund betas is an important part of hedge fund selection, as is careful diligence on managers that are capable of producing unique alpha.

Despite a few growing concerns and disappointing recent returns, many hedge fund strategies continue to provide the diversification and capital preservation roles they are intended to serve in the broader portfolio.



# Industry overview

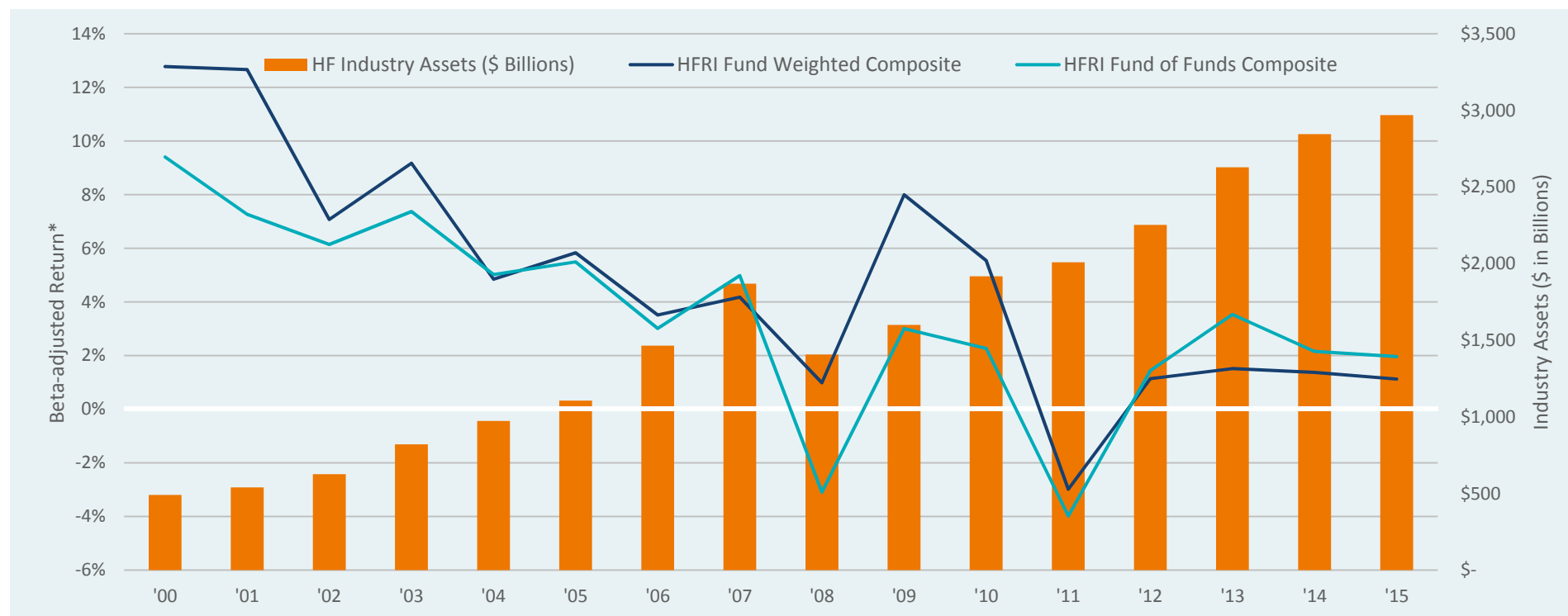


# Hedge fund industry growth

## Is capital crowding out alpha potential?

As hedge fund assets have grown to nearly \$3 trillion, beta-adjusted returns suggest broadly declining ability to capture alpha.

### INDUSTRY ALPHA VS. INDUSTRY GROWTH



\*12 month return reduced by rolling 36 month beta vs. MSCI ACWI Index. Source: Barclays Hedge, HFR, Verus



# Hedge fund performance (1-year)

## One tough year

Recent negative hedge fund returns are partly a function of their underlying exposure to broad based equity and credit markets. These environments have been challenging; so has hedge fund performance.

### HFRI composite

Return	Beta (to S&P)
(1.1%)	0.3

### Long/short equity

Return	Beta
(2.6%)	0.4

#### Fundamental value

Return	Beta
(2.1%)	0.5

#### Fundamental growth

Return	Beta
(6.9%)	0.5

### Event driven

Return	Beta
(3.6%)	0.3

#### Distressed / restructuring

Return	Beta
(8.7%)	0.3

#### Activist

Return	Beta
(1.8%)	0.6

### Macro

Return	Beta
(2.5%)	0.1

#### Discretionary / thematic

Return	Beta
(0.2%)	0.2

#### Systematic / diversified

Return	Beta
(5.7%)	0.1

### Relative value

Return	Beta
(0.2%)	0.2

#### Fixed income - corporate

Return	Beta
(3.3%)	0.2

#### Multi-strategy

Return	Beta
(1.0%)	0.1

*\*Net returns as of August 2015. All beta figures shown relative to the S&P 500. Source: Morningstar, HFR, Verus*



# Hedge fund performance (7-years)

## End points still dominate the optics

Over the past seven years, which includes the last half of 2008, broad equity market exposure retains significant explanatory power over hedge fund returns – exposure investors may not recognize or want.

### HFRI composite

Return	Beta (to S&P)
(3.5%)	0.3

### Long/short equity

Return	Beta
(3.3%)	0.5

### Fundamental value      Fundamental growth

Return	Beta	Return	Beta
(4.7%)	0.5	(2.6%)	0.6

### Event driven

Return	Beta
(4.5%)	0.4

### Distressed / restructuring      Activist

Return	Beta	Return	Beta
(4.3%)	0.3	(4.0%)	0.7

### Macro

Return	Beta
(2.0%)	0.1

### Discretionary / thematic      Systematic / diversified

Return	Beta	Return	Beta
(1.0%)	0.2	(2.7%)	0.0

### Relative value

Return	Beta
(5.6%)	0.2

### Fixed income - corporate      Multi-strategy

Return	Beta	Return	Beta
(4.7%)	0.3	(5.0%)	0.2

*\*Net returns as of August 2015. All beta figures shown relative to the S&P 500. Source: Morningstar, HFR, Verus*



# Hedge fund styles review



# Alternative beta

## Good climate for momentum, mild to harsh conditions for others

Alternative or “exotic” beta strategies hinge on the existence of common factors that many hedged strategies employ to generate a substantial portion of their overall returns. Many of these factors can be obtained with relatively less expense.

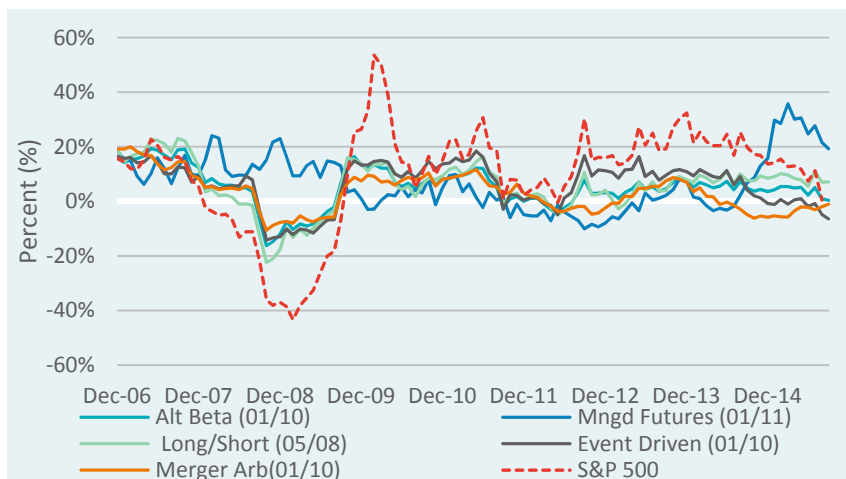
Examples of “naïve” strategy or factor replication include merger arbitrage or delta hedged convertible bond trading.

Over longer periods of time, some of these factors have demonstrated persistent ability to explain significant proportions of active hedge fund manager returns; this in turn argues for active risk benchmarks or explicit fee reductions.

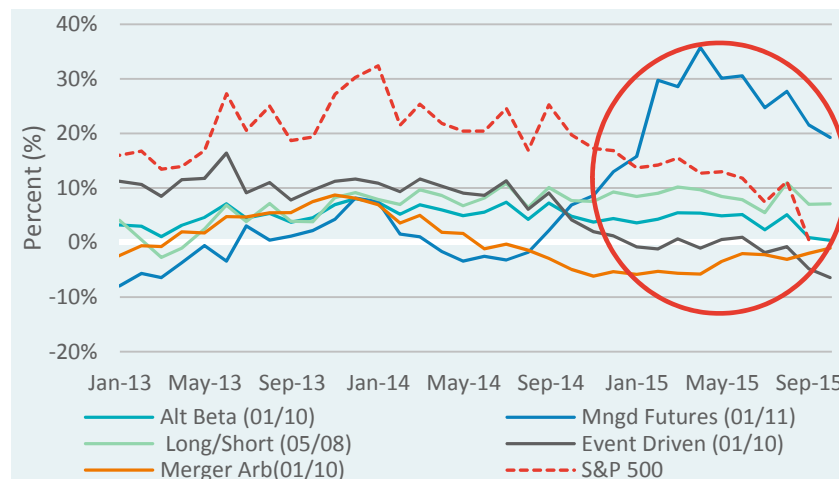
The data presented below suggests the performance of a set of factors, while variable, has generally been positive. Recent experience reflects the significant influence of momentum throughout 2014, but a reversal has been coincident with weakness in the S&P 500.

Dispersion of these factor returns enhances the risk-adjusted return for strategies that employ a mix of these strategies despite lower aggregate return expectations; active sizing decisions among these factors may enhance value-added returns.

**ALT BETA - ROLLING 1 YEAR RETURN COMPARED TO THE S&P 500**



**MOST RECENT TWO YEARS**



Source: Credit Suisse, CSLAB “Liquid” indexes, data as of 9/30/15; hypothetical performance until date noted in legend.



# Event driven

## The house is getting crowded

Event Driven strategies target equity or debt securities involved in mergers, acquisitions, corporate spinouts, debt refinancing and distressed, bankruptcy and restructuring. This category of funds represents 10% of the broad index and 900 funds.

These strategies are driven by M&A volume and deal spreads, debt maturities leading to defaults, credit availability, the level of activism and general corporate activity.

Many claims related to crisis-period vintage bankruptcies are now being realized; biopharma and other healthcare-related M&A has been strong the past 9-12 months.

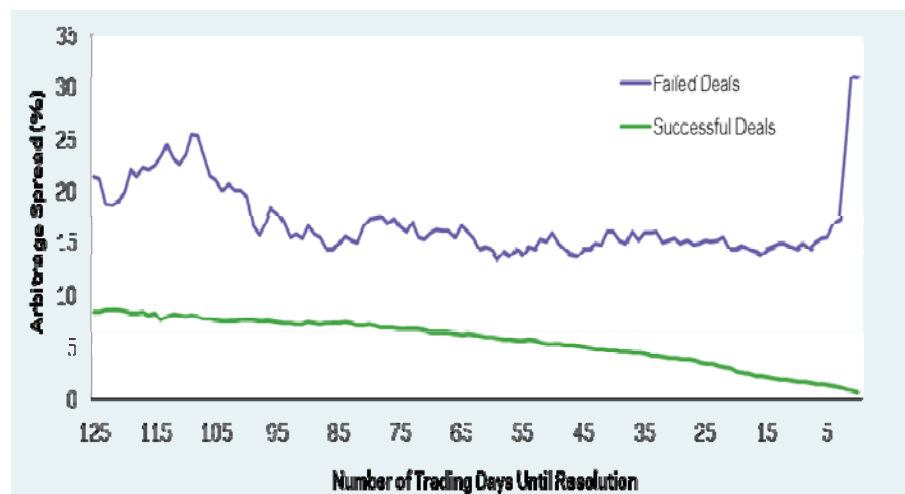
Anecdotally, managers admit short positions and forays into the energy space appear to have been so far premature.

Best opportunities for investment have typically been near inflection points in the economic cycle: beginning of pro-growth upturn or beginning of distressed cycle brought about by slowing economy; we are likely closer to the latter today.

HF DARLINGS	Sector	Equity Cap (\$B)	# Funds w/ stock (6/30/15)	Funds w/ position in Top 10 (6/30/15)	% equity owned by HFs (8/15/15)	Total Return YTD (8/15/15)
ALLERGAN PLC	Health Care	\$124	90	46	12%	22%
VALEANT PHARMA.	Health Care	\$84	50	20	16%	72%
CHARTER COMM.	Consumer	\$20	48	18	17%	8%
CHENIERE ENERGY	Energy / MLP	\$16	43	17	27%	-2%
TIME WARNER CABLE	Consumer	\$53	48	16	13%	22%
JD.COM	Consumer	\$38	41	15	28%	22%
SUNEDISON	Technology	\$4	48	13	67%	-26%
WILLIAMS COS	Energy / MLP	\$39	43	11	17%	19%
AIR PRODS & CHEMS	Industrial	\$32	42	11	16%	2%
AERCAP HOLDINGS	Technology	\$9	36	11	23%	24%
<b>Average of the Top 50 Names</b>		<b>\$113</b>	<b>45</b>	<b>13</b>	<b>9%</b>	<b>14%</b>

Source: HedgeMind-VIP: 50 Stocks That "Matter Most" to Hedge Funds

## MORE MERGER FAILURES MEANS HIGHER RISK, LESS REWARD



Source: "Characteristics of Risk and Return in Risk Arbitrage" by Mark Mitchell and Todd Pulvino, *The Journal of Finance*, 2001. Research extended by CNH.



# Long/short equity

## Strong trends for growth and quality continue for now

Fundamental long/short equity strategies pursue views of intrinsic value or growth estimates that differ from consensus. More than 3,400 funds representing 27% of the index apply this most common strategy.

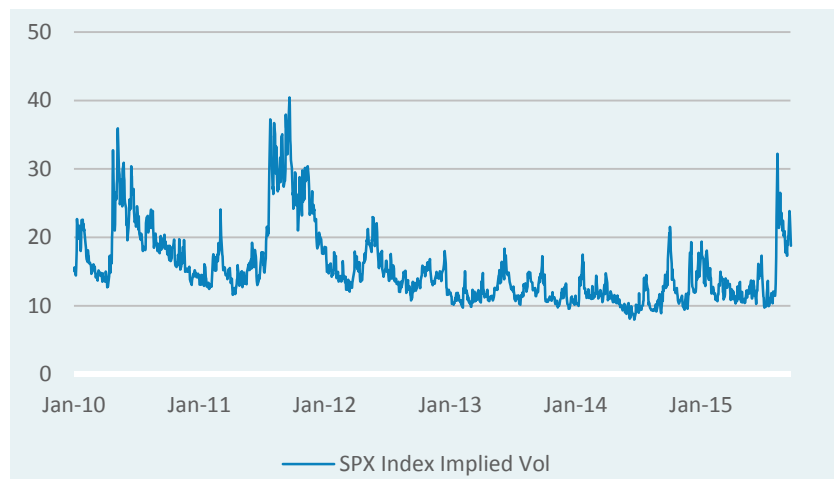
These strategies are driven by dispersion of fundamentals, operating margins and general M&A activity in addition to volatility in the market.

Companies that have levered the balance sheet (at the expense of bold holders) or which have pursued accretive acquisitions have been rewarded with higher stock prices by growth oriented investors.

Anecdotally, most short positions have been a drag on performance; more recently they have offset some of the damage done by abrupt market sell-offs but not enough to overcome losses on net long positions.

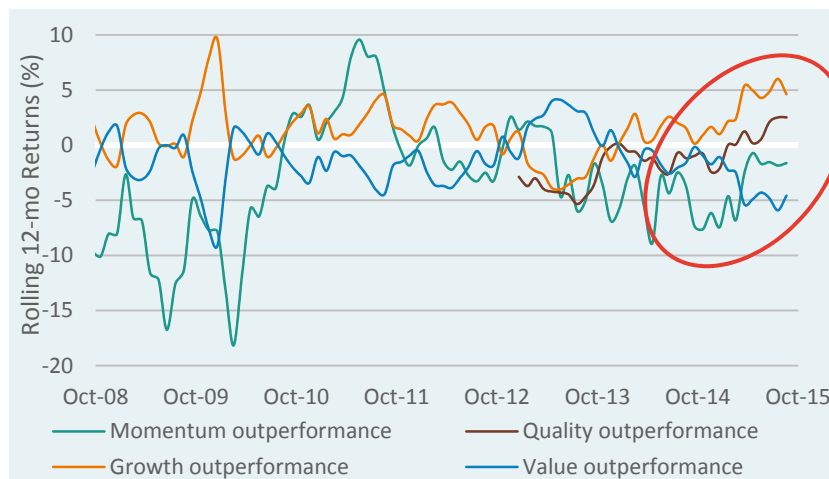
Many managers state they expect increased market volatility will be helpful to their cause because it will push their short “poor outlook” companies down more than their “quality company” holdings.

### S&P 500 IMPLIED VOLATILITY APPEARS TO BE MOVING UP



Source: Bloomberg, as of 9/30/15

### MSCI FACTOR PERFORMANCE VALIDATES GROWTH BIAS



Source: MSCI, as of 8/31/15. MSCI USA factor indices minus MSCI USA Index.



# CTA and global macro

## Shared consensus in both positions and outlook raises concerns

Systematic CTAs seek trends they can exploit across sovereign rates, equities and commodities, while discretionary macro managers attempt to position portfolios to benefit from anticipated market direction. Approximately 2,800 firms classify themselves as systematic or discretionary macro representing a third of all hedge fund assets.

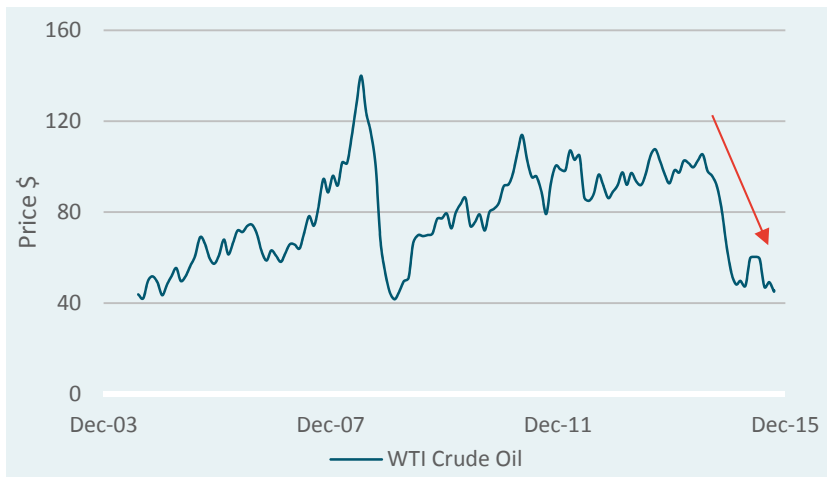
These strategies are driven by central bank policies, currency volatility and strong directional trends.

Positions in long dollar, short commodities and short emerging markets have worked well for the past year, but positions on interest rates have been far less consistent.

Abrupt reversals and short trends have been fairly common over recent quarters; anticipation of central bank divergence is a broadly held consensus view and this is problematic since a “rush to exit” could exacerbate global asset volatility.

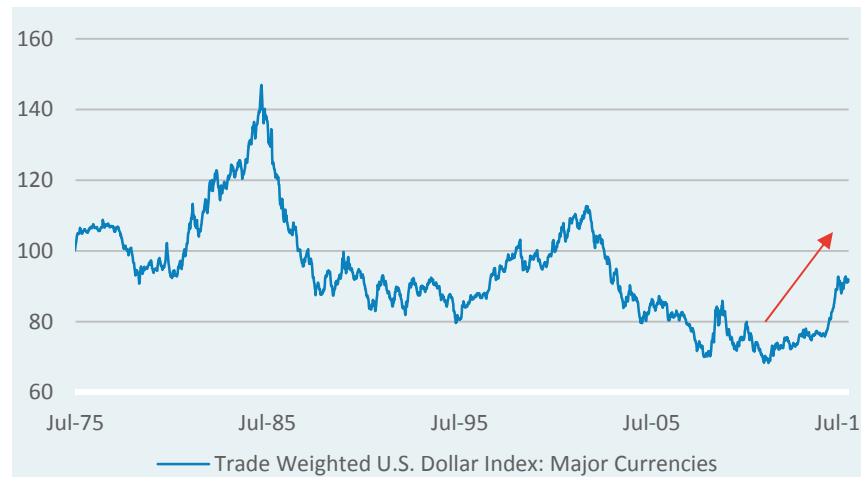
Some managers expect a sanguine, slow growth outlook while a few others are aggressively bearish on longer-term prospects for low commodity prices, low global growth and low inflation in a world with a slower-growing China no longer a tailwind.

### SLIPPERY SLOPE FOR THE FRONT MONTH FUTURES CONTRACT



Source: Bloomberg, as of 10/2/15

### US DOLLAR INDEX STRENGTH – WILL IT CONTINUE OR PLATEAU?



Source: FRED, as of 9/25/15



# Relative value

## Minding the gaps and earning the spread offers non-directional returns

Relative value strategies span a broad spectrum of securities (rates, credit, structured) and often employ significant leverage to magnify small differences in pricing. These mostly quantitative strategies remain neutral to market volatility and direction. Approximately 1,500 funds represent 17% of hedge fund assets.

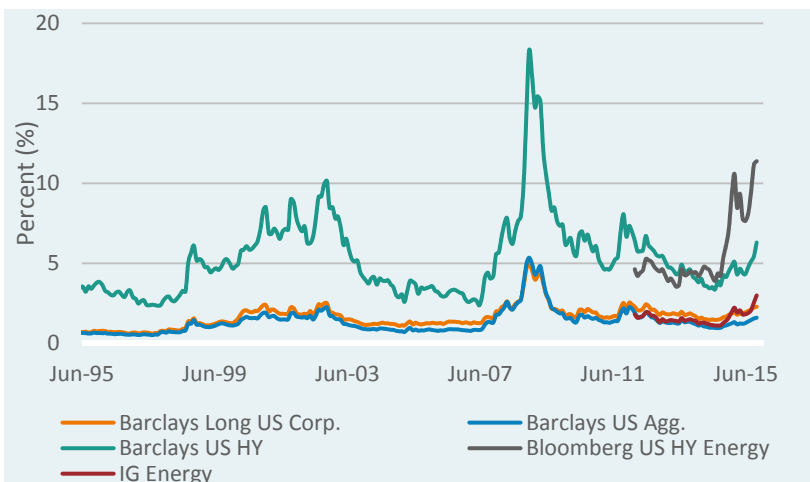
These strategies are driven by frequency and size of sovereign issuance and corporate M&A activity as well as credit tightness, pace of mortgage repayments and ability to margin trades.

Cash vs. futures rates trades, legacy structured securities and low quality vs. high quality trades worked quite well recently.

Auction rate strategies, trading in recently structured asset-backed products and their hedges as well as capital structure arbitrage related to energy, metals or mining have not worked for managers throughout 2015.

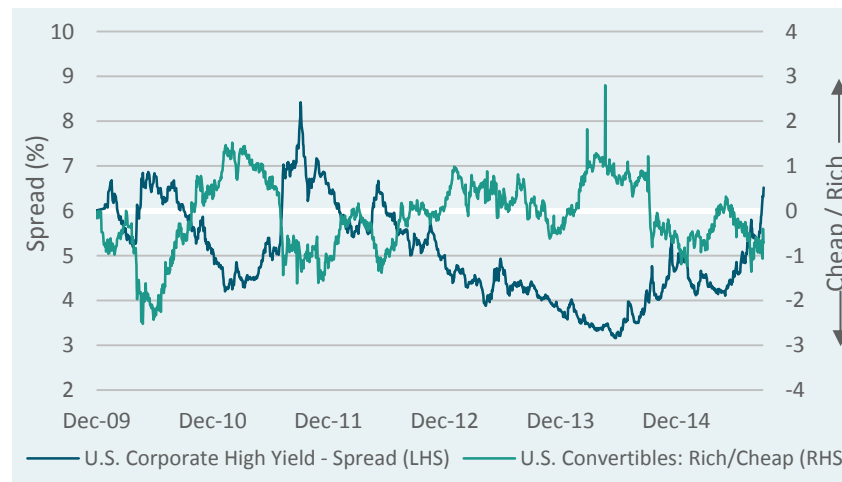
Recent quality spreads and convertible bond strategies appear more profitable now; as volatility increases, the opportunity set available to fixed income RV strategies could improve.

### CREDIT SPREADS DIFFERENTIATING BY QUALITY AND SECTOR



Source: Barclays Capital Indices, Bloomberg, as of 8/31/15

### CONVERTIBLE BOND VALUATIONS REMAIN "CHEAP"



Source: Barclays, as of 9/30/15



# Summary



# Forward-looking views across styles

We recognize the broad, categorical statements and role definitions below do not capture the diversity of managers' approaches. While no two managers within a given strategy are the same, we believe this framework is useful for setting investors' expectations for performance and portfolio diversification given the likely market environment impacting their exposures.

Strategy	Strategy Role in Portfolio	Current Opportunity Set	Intermediate Outlook
Multi-Strategy / Alternative Beta	Diversifier	— QE unwind should lead to increased influence of fundamentals, increased price dispersion within and across markets (sectors, countries), and differentiation among factor returns.	Favorable
Event Driven	Return Enhancing	— M&A volume remains robust, but credit market volatility may dampen confidence. — Stressed commodity producers and emerging markets may indicate a coming distress cycle.	Neutral
Long/Short Equity	Lower Volatility Higher Sharpe	— Fundamental earnings growth should overcome blind multiple expansion characterized by the recent beta-driven market which favored longer-biased strategies. — Relatively high valuations evokes potential alpha for managers with short stock-picking skill.	Favorable
CTA / Macro	Risk Reducing	— “Unconventional” monetary policy will take some time to unwind; this suggests a slowly diminishing headwind to macro strategies, but many participants share the same views. — Divergent policy responses to differing macro challenges (wind down of QE, Japanese & ECB reflation theme, slowing growth in China) creates opportunities for discretionary strategies.	Neutral
Relative Value	Diversifier	— Fed-provided liquidity dampened volatility for short-term interest rates and tightened spreads across all assets which has been a headwind to relative value strategies trying to capture divergence in fair value amongst various sovereigns, agencies, and credits. — The decoupling of policy cycles across developed markets should lead to increasing market volatility and provide an array of relative value and flow-driven opportunities.	Favorable



# Notices & disclosures

**Past performance is no guarantee of future results.** This report or presentation is provided for informational purposes only and is directed to institutional clients and eligible institutional counterparties only and should not be relied upon by retail investors. Nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security or pursue a particular investment vehicle or any trading strategy. The opinions and information expressed are current as of the date provided or cited only and are subject to change without notice. This information is obtained from sources deemed reliable, but there is no representation or warranty as to its accuracy, completeness or reliability. Verus Advisory Inc. and Verus Investors, LLC expressly disclaim any and all implied warranties or originality, accuracy, completeness, non-infringement, merchantability and fitness for a particular purpose. This report or presentation cannot be used by the recipient for advertising or sales promotion purposes.

The material may include estimates, outlooks, projections and other “forward-looking statements.” Such statements can be identified by the use of terminology such as “believes,” “expects,” “may,” “will,” “should,” “anticipates,” or the negative of any of the foregoing or comparable terminology, or by discussion of strategy, or assumptions such as economic conditions underlying other statements. No assurance can be given that future results described or implied by any forward looking information will be achieved. Actual events may differ significantly from those presented. Investing entails risks, including possible loss of principal. Risk controls and models do not promise any level of performance or guarantee against loss of principal.

“VERUS ADVISORY™ and VERUS INVESTORS™ and any associated designs are the respective trademarks of Verus Advisory, Inc. and Verus Investors, LLC. Additional information is available upon request.