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# Executive summary



# Hedge funds remain a viable solution

#### HEDGE FUNDS PROVIDE ALTERNATIVE SOURCES OF RETURN WITH LESS BROAD MARKET RISK FACTOR SENSITIVITY

Beyond the drumbeat of negative hedge fund news, we see advantages with hedge funds offering less broad market risk factor sensitivity. While some managers adhere to a similar approach, many have abandoned low correlation and chased returns within equities, trading against equally skilled peers in an efficient market. No wonder investors are disappointed by meager returns that mimic the volatility of broad equity and bond markets.

#### **HEDGE FUND STRATEGIES ARE INHERENTLY COMPLEX**

Along with complexity comes increased costs related to regulatory compliance, risk management, operational infrastructure, and intense competition for skilled traders that elevates the compensation burden for the underlying manager. Managers charge a high fee relative to passive beta indexing and traditional long-only managers to offset these expenses; they also charge an incentive fee for performance since they ostensibly generate skill-based returns that are less correlated to the market. The manner by which these managers trade is often opaque or obfuscated to protect their edge or remain hidden from competitive peers. Each of these characteristics reduces the appeal of such strategies for many investors who largely ignore this alternative set of exposures altogether.

#### HEDGE FUND OF FUNDS OFFER EASY IMPLEMENTATION BUT FACE THEIR OWN HEADWINDS

Other investors desire the diversification benefits but for reasons of governance, lack of administrative support or ease of implementation choose a "manager of managers" approach via hedge funds-of-funds. This is an appropriate choice for many investors who do not have a sufficiently large enough allocation to achieve strategy diversification through direct investing. We detail some of the current headwinds facing the hedge fund-offunds sector later in this report, and generally believe some of the larger managers have deep enough teams and broad enough coverage of the opportunity set to provide diversification, lower volatility, capital preservation and unique access to higher returning investment ideas. Unfortunately, many others are too banal in their strategy allocations or have too few assets to negotiate favorable economics with unique managers and thus achieve little more than replicating the broad hedge fund index, delivering similarly disappointing returns and higher than desired correlation to broad market risks.



# Recent perspectives across hedge funds

#### **LONG/SHORT EQUITY**

- Significant market correlation early in the year was exacerbated by growth-to-value reversal and negative short alpha
- Crowding and long-biased exposure were actually beneficial for recovering returns despite volatility
- Pursue geographic diversity given the large number of managers and assets competing for opportunities in North America

#### **EVENT DRIVEN**

- Market sensitivity continues to obscure idiosyncratic returns; energy exposure explains credit returns
- Headline grabbing stumbles and high beta-sensitivity have contributed to significant capital withdrawal year-to-date
- This may present an opportunity to negotiate more favorable fee concessions on a go-forward basis

#### **CTA AND GLOBAL MACRO**

- Low risk-taking resulted in low returns but risk management has limited losses
- Trends have been few and not well-sustained
- The systematic sub-sector has garnered more attention from investors seeking strategies expected to exhibit lower correlation and less market directionality during equity and credit market drawdowns

#### **RELATIVE VALUE**

- Factor volatility negatively affected quantitative strategies but structured product fundamentals continue to improve despite an early year technical sell-off
- High yield debt remains relatively attractive in low yield environment despite a 40% spread tightening since late-February's deleveraging concerns

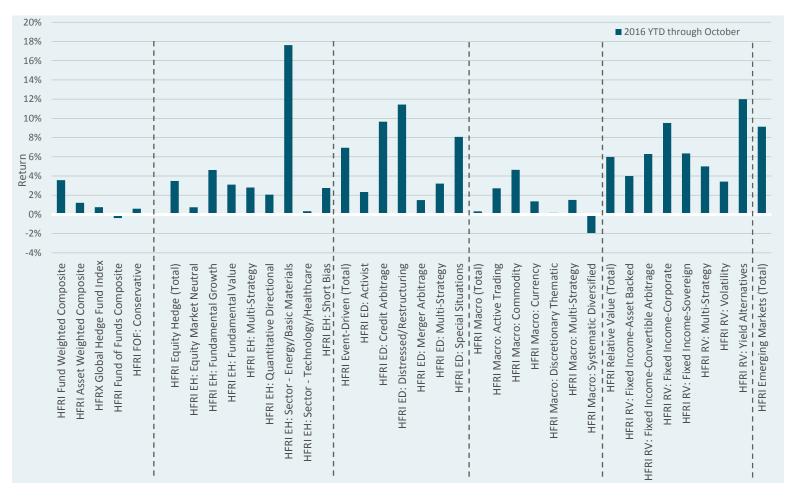
#### **MULTI STRATEGY AND ALTERNATIVE BETA**

- Headline risks take front page as insider trading charges lead to another large fund's demise and highlights the need for investors to focus on operational due diligence and the culture of compliance
- Concerns beginning to percolate about exacerbated volatility and/or crowding due to the growth of assets pursuing similar "naïve factor investing" strategies



# Disaggregating 2016 performance

Disappointing absolute level of return for diversified portfolios of hedge funds



Investor return expectations not being met despite some outsized winners and few actual negative returns

Source: HFR. HFRX Global HF Index is asset weighted.



# Hedge funds-of-funds

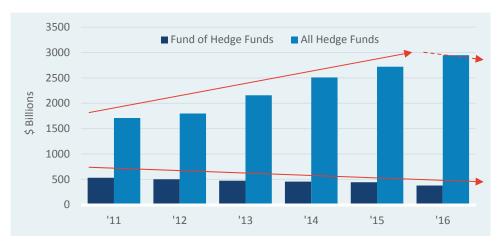


# Industry facing first year of AUM decline

#### Disappointment with returns leads large investors to reduce allocations

- Hedge fund industry assets have grown by more than \$1 trillion in the past five years while fund of hedge fund assets have fallen by more than \$120 billion over the same time, down to \$380 billion in 2016. It appears many investors are choosing to access these strategies directly.
- Negative media portrayals of hedge fund strategies supported by continuing weak returns, higher market correlation and the perception of high fees. Recent focus on large pension investors reducing or completely eliminating hedge fund exposure has contributed to multiple quarters of net declines in assets under management for the "industry" year-to-date. Some investors have
- found that "alternative beta" products with superior liquidity, increased transparency, and lower fees are still able to generate reasonable return streams uncorrelated to traditional markets.
- The HFRI Fund-of-Fund index has consistently been unable to generate any excess return over the broader-market HFRI Composite; however, the actual performance experienced by direct hedge fund investors is also likely worse than what the "uninvestable" HFRI Composite suggests.

#### HEDGE FUND INDUSTRY ASSET GROWTH... AND PLATEAU OR DECLINE?



#### HFRI FOF EXCESS RETURNS VS. HFRI COMPOSITE



Source: BarclayHedge



# Evolving to remain relevant

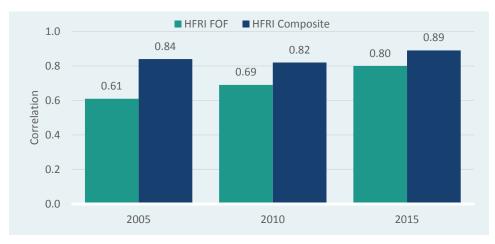
#### Improving margin, enhancing value-add, and getting close to the client

- Funds of funds are adapting to higher return and lower fee demands of investors in various ways, but generally are less liquid, more concentrated:
  - Fees: Funds of funds use their size advantage and network relationships to obtain a higher proportion of incentive-based terms; this helps offset poor hedge fund performance and often buffers the aggregate fee burden toward "rack rate" achieved by smaller direct investors.
  - Piece of the action: Many fund of funds avoid traditional commingled fund investments, opting instead for managed accounts, direct co-investment opportunities, launching internal hedge funds or PM platforms, seeding startup managers in exchange for economics or specializing in unique sectors by dedicating more resources to researching strategies outside traditional sub-categories and markets.
  - Client-facing focus: Many of the larger funds-of-funds have deployed technology to lower implementation costs for large, fund-of-one investors by establishing less liquid sidecar investments in managers' best ideas; they also secure longer-term fee revenue through hybrid structures that may involve drawdown features, multi-year incentive periods and claw-backs if future realizations are below expectation.
- Despite these improved terms, concern about higher correlation and inability to perform the desired role in portfolios remains a challenge.

#### FEES PAID BY INVESTOR TYPE



#### 5-YEAR TRAILING CORRELATION TO S&P 500



Source: HFR, MPI, Verus. Returns as of 9/30/2016.

Source: Goldman Sachs



# Hedge fund styles



# Long/short equity

#### Growth-to-value reversal and negative short alpha

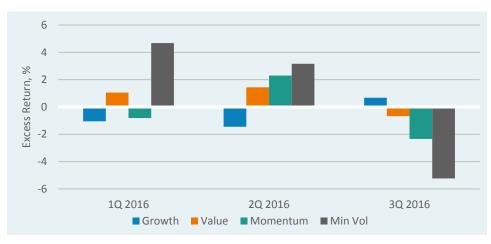
- Fundamental long/short equity strategies pursue views of intrinsic value or growth estimates that differ from consensus. More than 3,400 funds representing 27% of the index apply this most common strategy.
- These strategies are driven by dispersion of fundamentals, operating margins and general M&A activity in addition to volatility in the market.
- The first two months of the year left most equity strategies down significantly; those who maintained exposure were rewarded by a rapid rebound but those with significant short books were even more negatively impacted as the "most shorted" stocks positively outperformed; crowding was a surprise tailwind.
- Long-biased and more beta-directional strategies clawed back their initial losses while low net strategies continue to struggle.
- Short borrow rates have come down over the past 12-18 months as more funds use ETFs and futures baskets to hedge portfolios. We still prefer managers who focus on individual short alpha rather than broad beta hedging, but acknowledge the cost savings of the apparent evolution.
- Given the large number of managers and assets competing for opportunities in North America, clients should consider more geographic diversity.

#### LONG/SHORT EQUITY PERFORMANCE

Index	2014	2015	2016 YTD
HFRI Equity Hedge (Total)	1.8	(1.0)	4.2
HFRI EH: Fundamental Growth	(0.2)	(2.8)	4.8
HFRI EH: Fundamental Value	1.9	(1.4)	3.7
HFRI EH: Equity Market Neutral	3.1	4.3	0.9
HFRI EH: Short Bias	(3.9)	(1.6)	2.7
HFRI EH: Quantitative Directional	4.2	1.4	2.1
HFRI EH: Energy/Basic Materials	(6.5)	(13.7)	19.1
HFRI EH: Technology/Healthcare	9.4	5.6	3.0

Source: MPI, HFR, as of 9/30/15

#### FACTOR PERFORMANCE VS. MSCI USA INDEX



Source: MPI, MSCI, as of 9/30/16. MSCI USA factor indices minus MSCI USA Index.



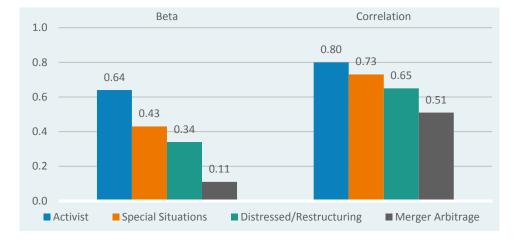
## Event driven

#### Market sensitivity continues to obscure idiosyncratic returns

- Event Driven strategies target equity or debt securities involved in mergers, acquisitions, corporate events, spinouts and debt refinancing as well as distressed, bankruptcy and capital 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. Commodity price volatility is expected to contribute to an uptick in distress and defaults, although plenty of capital exists on sidelines.
- Merger deal closures, Lehman Brothers and Icelandic bank liquidations as well as Argentina's debt settlement contributed significantly this year.

- M&A activity has lightened up from past few years, but credit markets remain supportive, especially as central banks wade into investment grade credit markets; on the other hand, the healthcare sector has been negatively affected by regulatory challenges, especially related to inversions.
- Headline grabbing stumbles and high beta-sensitivity have contributed to this sector of strategies suffering the most capital withdrawal yearto-date. This in turn provides investors an opportunity to negotiate more favorable fee concessions on a go-forward basis with these managers.

#### SENSITIVITY TO S&P 500 OVER LAST THREE YEARS



Source: MPI, Verus, HFR

#### REBOUND IN COMMODITIES FUELED EVENT DRIVEN RECOVERY



Source: MPI, HFR. Daily returns from 8/17/15 through 10/20/16.



# CTA and global macro

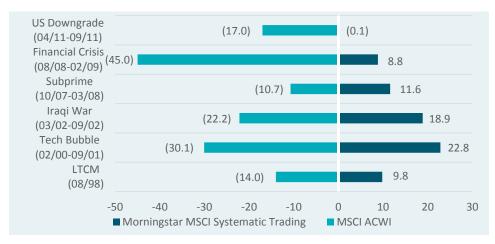
#### Low risk-taking resulting in low returns; few sustained trends to ride

- 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.
- Japanese yen strength has been a common refrain; in addition, continued accommodative policies from developed central banks are credited with supporting emerging markets' surprising strength despite significant geopolitical risks to the contrary; Chinese yuan continues to steadily weaken.
- Anecdotally, managers have been hesitant to invest with any conviction this year as exhibited by low VaR exposure across many of the discretionary macro managers we follow. This has also led to increased redemptions and fee concessions from otherwise "premium brand name" managers.
- The systematic sub-sector has garnered more recent attention from investors as they seek strategies expected to exhibit much lower correlation and less market directionality during equity and credit market drawdowns. We believe these managers will continue to serve that role in portfolios.

#### REDUCE RISK IN ENVIRONMENTS WITH FEW OPPORTUNITIES, NO TRENDS



#### MANAGED FUTURES PERFORMANCE DURING CRISIS PERIODS



Source: Bloomberg, as of 10/2/15

Source: MPI, Morningstar



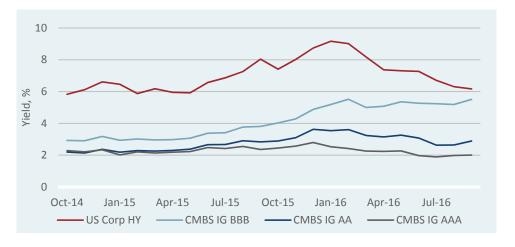
## Relative value

#### Factor volatility increases, structured fundamentals improve

- 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.
- High yield remains relatively attractive in low yield environment despite a 40% spread tightening since late-February's deleveraging concerns.

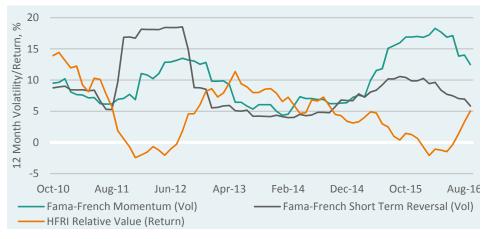
- Structured MBS credit benefitted from settlement payouts and strong fundamentals; mezzanine CLO bonds were negatively impacted by credit price sensitivity, although upcoming call optionality suggests strong technical support in this area; high retail CMBS appear ripe for rising defaults.
- The low volatility environment and low equity dispersion, further complicated by heightened factor volatility, has negatively affected statistical arbitrage and fundamental market neutral trading strategies that require stable relationships among signals and pairs.

#### CREDIT SPREADS RE-TIGHTENED DRAMATICALLY SINCE FEBRUARY



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

#### HFRI RELATIVE VALUE RETURNS VS. FACTOR VOLATILITY



Source: MPI, HFR

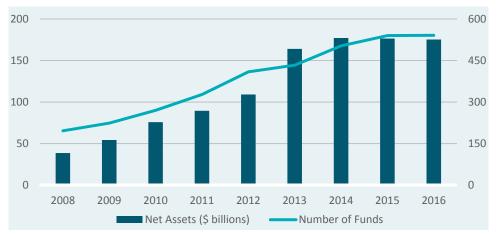


# Multi-strategy and alternative beta

#### Headline risks take front page and fortune reversals in momentum

- 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 than through "2 and 20" vehicles.
- Examples of "naïve" strategy or factor replication include merger arbitrage, delta hedged convertible bond trading, and cross-asset momentum.
- Style factors have demonstrated persistent ability to explain significant proportions of active hedge fund manager returns, providing support for active risk benchmarks and explicit fee reductions.
- Principal-Agent problems, covered aggressively by the media in recent months, persist in the competitive arena of multi-PM, multi-strategy firms so a focus on operational due diligence and the culture of compliance is an important step in the underwriting and evaluation process.
- Significant AUM growth among high quality risk premia strategies raises potential concerns about crowding which in turn can lead to increased volatility and rapid reversals and, at the same time, mute return potential; we continue to monitor performance and risk drivers in this space.

#### **GROWTH OF "LIQUID ALT" AUM AND FUND COUNT SINCE 2008**



Comprises all US Open End Funds (excluding FOF) included in the "Alternative" US Category group. Source: Morningstar

#### ALT BETA INDEX PERFORMANCE - LAST TWO YEARS



Credit Suisse LAB (Liquid Alternative Beta) Indices

Source: Morningstar, MPI



# Summary



# Forward-looking views across styles

We recognize that 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	<ul> <li>Strong ability to access multiple styles, diversify factor exposures, risk management and capital efficient infrastructure may allow access to less liquid opportunities.</li> <li>Concern over rapid increase in AUM for liquid alternatives, varying product quality and skill.</li> </ul>	Favorable
Event Driven	Return Enhancing	<ul> <li>M&amp;A volume remains robust, illiquid credit volatility hints at coming distress which would benefit those with more process-driven or restructuring approach; prefer nimble operators.</li> <li>Significant alignment with beta dampens enthusiasm for most managers' approaches.</li> </ul>	Negative
Long/Short Equity	Lower Volatility Higher Sharpe	<ul> <li>Continued expectation of the victory of fundamentals over factor rotations; longer-biased strategies have posted better absolute returns at the risk of exposure to beta.</li> <li>Ability to preserve capital during drawdowns and capture long-short spread are attractive.</li> </ul>	Neutral
CTA / Macro	Countercyclical Diversifier	<ul> <li>Hints that unconventional monetary policy may be on the wane suggest an improving opportunity set lies on the horizon, but most managers have little conviction yet.</li> <li>Anticipate longer-term bond and currency trends; emerging markets offer good volatility.</li> </ul>	Favorable
Relative Value	Diversifier	<ul> <li>Tight spreads across all assets remains a headwind to relative value strategies trying to capture fundamental, sentiment, technical and flow-driven mispricing across securities.</li> <li>Returns from convergence of mispriced fundamentals and limited exposure to broad equity, credit or rate factors remains one of the purest expressions of hedging despite low absolute returns and required levels of financing to implement these strategies.</li> </ul>	Favorable



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