

Alternative Funds – New opportunities

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IN A WORD:

Alternative Investments have proven in Q1 their ability to limit the downside. Since then, they continue to demonstrate their ability to benefit from volatile markets. The increase in volatility and the differentiated impact on companies of the COVID-19 crisis and the policy stimulus are a key positive driver for future performance. “Macro” and “Long-Short” are still among our preferred strategies. We decided to upgrade “Relative Value” to positive and downgrade “Event-Driven” to neutral.

What are alternative investment strategies?

Alternative Investment funds provide different sources of returns to traditional asset classes like equities and bonds, and thus, seek to render an investment portfolio less sensitive to the ups and downs of financial markets by optimizing the balance between risk and return, i.e. reducing volatility.

Whether markets are moving up or down, the alternative fund manager will employ specific investment techniques and strategies, often across the full range of financial instruments, in the pursuit of positive absolute returns (i.e. independent from a benchmark). An example being the “short” sell: whereby a manager will seek to partially hedge a long position or make a profit from a stock’s over-valued price.

Alternative funds are, however, also exposed to the same asset class and market liquidity issues as other investments, as well as other specific risks such as the use of leverage (debt), or key-

man risk that is associated with investment houses that rely on one or a few talented individuals to define and implement their investment strategies. Most of the time, these key people are invested significantly in their funds alongside external investors, thus aligning interests.

Alternative Investment Strategies

Type	Description	Key drivers
Long short equity	High levels of dispersion between stocks provide both "long" (profit from rising prices) and "short" (profit from falling prices) opportunities.	Volatility, gaps between market expectations and company fundamentals, disruption and structural changes that create winner and losers.
Event driven	Capture the value gap created when companies undergo transformative corporate events that have yet to be priced by markets but that are expected to have a significant impact on shareholder value.	M&A activity, tech disruption, tax reforms and sector consolidation. Other corporate events and restructuring such as spin-offs, share class exchanges etc.
Relative value fixed income	Managers focus on arbitraging mispriced fixed income assets, anomalies in yield spreads as well as mean-reversion of prices.	Volatility, mis-pricing, high level of yield spreads, increased issuance of bonds.
Global macro	Seek profits from changes in global economies brought about by changes in government policies that impact interest rate, currency, bond and stock markets. Some quantitative strategies follow trends in market pricing across a multitude of markets	Volatility, New structural trends. Government policies, market trends, macro-economic indicators.

Source: BNP Paribas WM

Performance overview

In March, the lockdown of almost half the world's population plunged the global economy into an unprecedented recession, and global stock markets followed suit, for example, the S&P500¹ shed 34% (in USD) in 30 days (from 19th Feb to 23rd March), despite the large "tech" bias (GAFAM) that has outperformed other sectors in the index.

Alternative investments, measured by the HFRI index¹ (Asset Weighted Composite Index): the average performance of a very broad aggregation of different alternative strategies, was down 9% in March (monthly data), whilst the HFRU index¹ (Composite EUR) (comprised of European

regulated funds that provides daily data) was down 12% over the same period (19th Feb to 23rd March).

By our own measures, we saw even less downside on alternative investments, albeit from a much smaller sample of funds pre-selected by our experts. Average performance of the selection was down 1% year-to-date in February and down just 6% YTD by the end of March¹. Within the selection, we saw some degree of dispersion in performances, with some funds producing positive absolute returns over the period; the large majority significantly reducing the downside risk with very low single digit negative performances; and other funds that lost some more. All in all, performances were largely in line with expectations, and in particular, in the most part, in line with their investment strategies and the inherent degree of market risk (volatility) that they take on.

Recent developments

Although markets have bounced back very strongly after the announcement of government and central bank measures (gradual exit from lockdown, economic stimulus policies, low rates for longer etc.), the short-term environment remains uncertain. It is likely that equity markets will witness a correction before moving higher. Renewed trade tensions between the United States and China, the challenges to finance the European reconstruction and the impact of 'deglobalisation' are likely to be key drivers of volatility but could also be sources of new opportunities. The search for yield will remain a structural driver in financial markets. Our central medium-term economic scenario involves a gradual recovery in the second half of the year, with growth accelerating into next year (a U-shaped recovery).

Alternative strategies have also benefited from the quick market recovery, and many managers are now running their strategies with lower levels of risk due to both the higher levels of market volatility as well as current market valuations. Our own selection of Alternative Investment funds (as mentioned earlier) is now in positive territory since the start of the year (average performance of the selection +0.3% on 16th June, net of fees, € share classes¹) whilst major indices continue to play catch up.

The flexibility of their investment strategies is a clear advantage in these conditions and instinctively, these managers are looking to preserve their investors' capital in the event of further market corrections and to then redeploy capital as new opportunities present themselves. In the meantime, they continue to find interesting opportunities from the current market dislocations.

The increase in volatility is a key positive driver for future performance of all strategies. **Macro strategies** are expected to benefit from new trends linked to monetary policy (low rates for longer and falling yield spreads, potential reversal in the dollar trend), fiscal policy (potential turnaround in commodities for example) and structural changes such as de-globalization or disruptive innovations.

The crisis will no doubt create dispersion among companies, offering attractive long/short opportunities for fundamental stock pickers. Restrictions regarding the use of "Short" strategies

¹ Source : Bloomberg Past performance is not a reliable indicator of future performance

in continental Europe have also been lifted. This should offer many opportunities for **“long-Short” managers**.

“Macro” and “Long-Short” are thus still among our preferred strategies. We made some changes in our other preferences, more precisely “Event-Driven” and “Relative Value” Strategies. Let’s have a closer look.

Opinion changes

Upgrading “Relative Value” to positive: The crisis will exacerbate the outcome in corporate bond markets between the survivors and those more likely to struggle, thus creating more attractive long/short opportunities in credit markets, in particular as “fallen angels” are requalified as high yield. Market anomalies will continue to present themselves as companies refinance, restructure and issue earnings revisions as revenue estimates are adjusted to the new reality. New issuances have increased dramatically, including in the Convertible Bond markets where we see further opportunities. We believe that nimble, actively managed long-short credit strategies should do well to capture the opportunities in these markets whilst providing some protection on the downside as uncertainty remains high.

Downgrading “Event-Driven” to Neutral: M&A deals that were under discussion before the COVID crisis were temporarily priced for failure as the global lockdown took hold. This market dislocation was a good opportunity for Event Driven managers who fully understand the legal covenants that underpin corporate activity, including in times of crisis. This pricing anomaly has significantly reduced since March as markets see most deals reach their conclusion. However, the remaining short-term economic uncertainty leaves many companies reluctant to pursue any new strategic external growth and M&A volumes (new deals) are currently falling.

In the medium term, however, it is clear that the full effects of the COVID crisis will sort the winners from the less successful and there will be some renewed interest in M&A and other corporate events as companies sell off assets and make strategic deals to consolidate and strengthen themselves either with competitors (horizontal) or supply-chains (vertical). Protectionism against foreign acquisition will distort the market somewhat, but this will likely change companies’ focus as opposed to dampen appetites.





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