Introduction

2012 represented a year of modest gains for hedge fund investors with the HFRI Fund weighted composite index recording a gain of 6.2% during 2012. This was another year when the aggregate return from hedge funds represented a disappointment to traditional investors in this asset class. It served to highlight the importance of astute manager selection – a number of managers produced very strong returns. In addition it was a reminder to investors that absolute return strategies targeting 5% over cash will produce just 5-6% when cash is at zero.

Across the different strategies unsurprisingly long biased credit approaches were the strongest performers as Central banks' purchases of government and government backed securities fuelled the rally across investment grade and high yield markets. By way of example the strongest performing hedge fund sector was the HFRI RV Fixed income asset-backed which was up 16.5%. Both the convertibles and corporate indices were not far behind recording near double digit gains.

Within the equity long/short spectrum, funds delivered mid-single digit gains in aggregate however there was a wide dispersion between different sectors as energy and basic materials focused strategies performed poorly as investors fretted about a possible slowdown in China. Technology and healthcare strategies in contrast performed well. More generally across equity markets the standout sectors were financials and consumer discretionary stocks helped by continued support from central banks. In contrast despite the interest from investors in high dividend yielding stocks utilities performed poorly.

Looking through the other hedge fund sectors multi-strategy and event driven managers generated above average returns during the year while the laggards were discretionary macro and trend following strategies. Macro managers struggled to deliver returns due to limited moves in both long and short term interest rates and the lack of meaningful moves in the major exchange rates. Managed Futures delivered negative returns due to a lack of sustainable trends in interest rate and currency markets.

Looking forward through 2013 an informed assessment of where the opportunities for hedge fund investors may arise has to be prefaced with an assessment of the likely overall investment environment. Will we see further risk on risk off within a rolling perception of crisis by investors as we did for the first 8 months of 2012 or instead a handover to fundamentals? Under the former scenario expectations of continued central bank action leads to sentiment driven markets hampering gains for stock-pickers, trend followers and discretionary macro strategies and favours those assets that are direct beneficiaries of such action. This scenario will not continue ad infinitum. The end of the so-called “central bank put”, when it comes, should witness significant opportunities for discretionary macro and trend followers as those asset classes, (short term interest rates, government bonds, asset-backed securities in particular) are repriced back to fundamentals. The timing of this “handover” is critical for investors and the reverberations will be significant. The markets have of course priced in “not any time soon” but investors may well be surprised and caught out on the near side in the US for example. In this new environment we would recommend discretionary macro and trend following and both market neutral and directional fundamentally focused equity strategies.
Strategies

Equity long/short

Equity long/short managers, that hedge fund investors ideally like to own, enjoy markets that are driven by the operating profits of listed businesses. In this environment comprehensive valuation work on individual shares is rewarded where the market has those shares miss-priced. Investors are currently focusing on the US fiscal situation, the European debt crisis, a possible slowdown in emerging markets and are nestled in the cradle of Central Bank support. Last year this continued support and a reduction in the perception of these risks led to markets rising sharply and financials in particular outperformed.  

This leaves equity markets in the US trading at slightly above average long term cyclically adjusted earnings multiples, European markets are trading cheaper and the larger markets in Asia such as China and Japan are arguably trading at good value. We favour equity allocations to Emerging markets on a selective basis where policy and/or macroeconomic conditions are supportive for valuations.

HSBC Risk on Risk off chart

We believe that during 2013 an investor should maintain a healthy allocation to equity long/short funds for 2 reasons. Firstly this would ensure that they not miss the possible “great rotation” into equities from sovereign debt. Secondly this strategy would benefit from the possible “handover” to fundamentals. Investors should also focus on sector specialists where there is greater stock dispersion and greater insulation from closet macro managers. Technology companies could benefit from higher corporate spend from cash rich companies. Financials after a strong 2012 will be subject to further regulatory pressure but are trading at a discount to long term averages. Materials and energy companies’ valuations will reflect the developing outlook for global growth. Opportunities within healthcare services and facilities are favoured under the Democratic administration. More generally longer term opportunities in sub sectors of healthcare reflect and ageing population prepared to pay any price to stay healthy for longer.

Discretionary macro

2012 was a difficult year for the traditional macro manager. There was very little movement in interest rates both at the short and the long end. Within the currency markets there were few opportunities. Why? The carry trade has not been popular since 2008. Secondly momentum trading in a risk on risk off environment has not paid off. For example the EUR/USD has range traded during 2012 buffered by developing investor perception of the outcome of the European debt crisis. Risk management therefore often stopped out positioning. Thirdly a fundamentals based approach seeking real currency appreciation in the faster growing Emerging economies has not been rewarded. Those macro managers that did make good money during the year did so by timing the Greek sovereign debt market to perfection or by venturing into credit markets.

Looking forward through 2013 macro managers would hope to generate better returns from currency markets. For example they may continue to trade Yen on the short side as the new government in Japan targets 2% inflation for the first time. Within Government bond markets there would be significant directional opportunities if central banks change course or if investors start to tire of receiving a negative real rate of return. Relative value opportunities could also avail themselves. Continued superior US economic growth or inflation in Japan could lead to short positioning in US Treasuries or JGBs versus long positioning in Bunds. Opportunities in equity markets driven by liquidity will avail themselves as the future becomes clearer. Volatility in commodity markets will also open up entry points for trades.

Managed Futures

It was a similar story for trend followers during 2012. There were no sustainable trends in the major government bond markets for the whole of the year leading to losses for the sector. Currency trading was loss making as a whole with the exception of USD/YEN towards the end of the year and in certain Emerging Markets. Some money was made in equity and credit strategies. Traditionally managed futures strategies will follow a period of poor performance with a period of strong performance. Predicting when this performance will happen is almost impossible as any CTA manager will tell you. However the sector over the long term exhibits a very low correlation of returns to other hedge fund strategies and also to a balanced portfolio of traditional asset classes. A change of policy direction by the Central Banks or investors wishing to invest in higher yielding assets (equities) would precipitate the kind of sustained moves in fixed income markets that would be beneficial for managed futures. It would also in all probability have a knock on effect on currencies.

© 2013 Allenbridge Investment Solutions LLP and/or its licensors, subsidiaries and affiliates (collectively, “AllenbridgeIS”). All rights reserved. For more information about AllenbridgeIS’s analytics and due diligence capabilities visit http://www.allenbridgeis.com/analytics
Long term performance of trend followers and correlation to equity markets

![Graph showing correlation between Managed Futures and S&P500 over 12 months.]

Global speculative-grade default rates

![Graph showing default rates over time with different scenarios.]

Credit long/short

2012 was a banner year for the majority of the credit spectrum with yields on the US high yield market touching all-time lows of 6.07% during the year prompting some observers to call for a renaming of the market. It was a similar story for investment grade debt which trades around 2% yield at the time of writing. The markets were supported by strong company fundamentals and a thirst for carry from investors receiving near record low yields from both major government bond markets and the highly rated asset backed sector.

Going forward much has been said about the possible overvaluations that may exist in this sector and comparisons continue to be made with higher yielding the equity markets. The easy money has been made from a directional perspective. For hedge fund managers in this sector we recommend a balanced approach to investing both long and short perhaps with managers who have demonstrated an ability to make money on the short side historically. Further to this relative value opportunities will continue to arise as companies adjust their means of financing.

Distressed

The distressed opportunity set is as much the domain of private equity as hedge funds. The latter, mindful of managing their potential calls on capital from investors, opportunistically invest in distressed assets for trading, buy and hold and work out purposes. 2012 represented a good year for distressed hedge fund managers with performance driven by re-pricing of credit instruments in particular and successful work-outs across a number of situations. With default rates at or near historic lows and forecast to rise only marginally over the coming 18 months the opportunity set for workouts looks to be more limited than the elevated levels of the last 4 years. However there will continue to be a number of interesting buy and hold situations as financials particularly in Europe sell down non-core assets at interesting prices to investors.

Multi-strategy/event driven

Multi-strategy managers finished the fourth year in a row ahead of the hedge fund median producing returns in aggregate of 7% for 2012. Investors have noticed and two thirds of net new money into hedge funds last year was subscribed to this sector. Managers in this sector made significant successful allocations to credit, well timed allocations to peripheral Europe government bond markets but very little in merger arbitrage.

We like this sector going into 2013 for a number of reasons. Firstly these managers have the ability to dynamically allocate capital to where opportunities lie. This replicates to a degree what proprietary trading desks used to be allowed to do. Secondly investors do not pay a fee for this strategy adjustment. Thirdly it is probable that there will be more mergers this year than last year because companies have large piles of cash and the risk of Euroland breakup appears to have dissipated. For institutional investors looking for stable returns from large hedge funds with high quality systems and infrastructure they may look like a suitable alternative investment solution.

Equity market neutral

This sector as a whole endured a relatively mundane year yielding 3.3% over the period. Hurdles to generating stronger returns were sentiment driven markets which left fundamental factors scoring companies unrewarded. Secondly volatility was crushed in equity markets which made performance more difficult for statistical arbitrage. In 2013 more fundamentally driven equity markets would drive returns. Significant asset allocation decisions by investors out of government bonds into equities would also throw up significant opportunities for statistical arbitrage. Therefore in conclusion the risk/return trade-off of investing in equity market neutral looks strong.

Conclusion

Underlying the top down strategic choices is the ever present necessity for thorough and effective due diligence and monitoring of individual managers. Why? Dispersion of manager returns within sectors can be elevated. In addition managers have a habit of moving capital to “where the trade is” which raises implications for actual diversification within hedge fund portfolios.

© 2013 Allenbridge Investment Solutions LLP and/or its licensors, subsidiaries and affiliates (collectively, “AllenbridgeIS”). All rights reserved.

For more information about AllenbridgeIS’s analytics and due diligence capabilities visit http://www.allenbridgeis.com/analytics
Below are our suggested allocations for 2013. These are based on our base case scenario where investors’ attention is focused on absolute and relative valuations across and within asset classes.

- Equity long/short - neutral/positive with bias to sector specialists
- Equity market neutral – positive
- Credit strategies - negative with a bias to market neutral strategies and special situations
- Multi-strategy/Event driven – neutral/positive
- Discretionary macro – neutral/positive
- Managed futures – neutral/positive
- Distressed – neutral

What are the risks to our thesis of a move back to fundamentals?

1. Investors continue to buy overvalued assets which in many cases offer negative real rates of return. This flattens the opportunity set for macro managers and further distorts the valuations of individual equities. Under this scenario the investment opportunity set for both macro managers and stock-pickers is naturally enhanced. Our view is better to be into the trade to early than too late.

2. Major unforeseen crisis – an “unknown unknown”. Given how many “known unknowns” are trading as information in markets – European sovereign crisis, US debt ceiling, Emerging market slowdown it’s hard to see another significant issue directing asset prices and sentiment but it’s not inconceivable. However from past experience unforeseen crisis play into the hands of discretionary macro and managed futures strategies both of which fared relatively well during 2008.

The table above highlights that we see a number of fertile opportunity sets for hedge fund strategies which builds a case to be positive overall on a diversified portfolio of well researched funds. The potential for change from sentiment driven to fundamentally driven markets supports an investment in fundamentally focused equity strategies. In addition significant allocation changes by institutional investors seeking to optimise the risk/return trade-off in the portfolios will, in our view yield substantial opportunities for macro and trend following strategies.

The information contained in this document is not an invitation, offer or agreement to subscribe, purchase or otherwise acquire any financial instrument.

© 2013 Allenbridge Investment Solutions LLP and/or its licensors, subsidiaries and affiliates (collectively, “AllenbridgeIS”). All rights reserved. ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY COPYRIGHT LAW AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT ALLENBRIDGE’S PRIOR WRITTEN CONSENT. All information contained herein is obtained by AllenbridgeIS from sources believed by it to be accurate and reliable. AllenbridgeIS does not independently verify any such information. Nor does AllenbridgeIS audit or otherwise undertake to determine that such information is complete. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided “AS IS” without warranty of any kind. Under no circumstances shall ALLENBRIDGE have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of AllenbridgeIS or any of its partners, directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if AllenbridgeIS is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. This report, any ratings, financial reporting analysis, projections, and other observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any fund vehicles, securities or any assets. NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINENESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY ALLENBRIDGE IN ANY FORM OR MANNER WHATSOEVER. Each opinion or rating must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information contained herein, and each such user must accordingly make its own study and evaluation of each fund or investment that it may consider purchasing, holding or selling.

Allenbridge Investment Solutions LLP is incorporated and registered in England and Wales. Registered number OC 373073. Registered office: 26th Floor, 125 Old Broad Street, London EC2N 1AR

© 2013 Allenbridge Investment Solutions LLP and/or its licensors, subsidiaries and affiliates (collectively, “AllenbridgeIS”). All rights reserved. For more information about AllenbridgeIS’s analytics and due diligence capabilities visit http://www.allenbridgeis.com/analytics