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First Quarter 2017

Hedge Fund Update

Global equity markets notched their sixth consecutive quarter of positive performance in first quarter 2017.[1] Leadership among markets, sectors, and factors rotated relative to fourth quarter 2016: after trailing by 600 basis points (bps) in fourth quarter, emerging markets equities trounced developed counterparts by 500 bps in first quarter; energy and financials underperformed information technology, health care, and consumer sectors; growth outperformed value; and large caps outperformed small caps.

Many long/short hedge fund managers we follow navigated these rotations more successfully than they had the shifts in market leadership over 2016. The HFRI Equity Hedge Index returned 3.8% for the first quarter, compared to 2.2% for the HFRI Event-Driven Index and -0.2% for the HFRI Macro Index. Yet, investor sentiment toward the strategy is historically low. Hedged equity products collectively experienced outflows of approximately $21 billion in 2016, according to Morgan Stanley. Furthermore, according to a recent investor survey by Credit Suisse, demand for fundamental long/short equity strategies declined year-over-year.

All investment strategies and styles exhibit some degree of cyclicality, providing opportunities for investors to profit when they cycle back into favor. When a strategy as broad as long/short equity underperforms expectations and prompts investors to effectively "give up" altogether (the "baby with the bathwater" phenomenon), re-underwriting individual managers to identify those that can weather the storm and resume producing attractive returns is critical.

In any strategy, and especially a more volatile one, a stable capital base is a true competitive advantage. The permanence of a manager's capital base can be measured by the length of lock-up, the degree to which investors' time horizons match the manager's, and other metrics. Managers that are confident in their investor bases are able to apply more discipline and a longer time horizon in their process, which presents a competitive advantage for fundamental investors. Short-term investors generally find it nearly impossible to compete with quantitative managers and high-frequency traders, given how quickly information is now disseminated and processed. Managers must have stable capital and a long-term perspective to buck the cycle and capitalize on forced selling in a particular sector or stock.

Understanding individual managers' performance holistically, not just in terms of basis points, is another key evaluative factor. Was a given manager's underperformance consistent with its investment style and investor expectations in light of market conditions? If not, did the manager drift? Did the team make research or procedural errors? Have the key decision makers remained engaged? Did the manager capitulate at the bottom, or, looking at the portfolio today, is there more value waiting to be realized? For example, it would have been

[1] All returns are total returns in USD terms unless otherwise noted. Global equity return represented by the MSCI All Country World Index.

difficult for a value-biased manager to generate positive returns in 2015, but patient value investors were likely rewarded in 2016.

Beyond understanding the manager-specific considerations, the outlook for the strategy is also important. In this regard, some headwinds are turning into tailwinds. The outflows from long/short equity mentioned earlier may ease crowding in widely owned names, which Goldman Sachs data suggest was already turning around mid-2016. Modest, controlled increases in interest rates should put a spotlight on companies with poor capital structures and better enable markets to penalize them. A positive short rebate and low cost of stock borrow will help, too. Continued capital inflows to passive options should create greater inefficiencies for long/short equity managers to exploit; passive equity products saw inflows of approximately $337 billion in 2016. Finally, stock dispersion has been trending upward, while correlations have been trending downward. A high dispersion, low correlation environment presents the broadest opportunity for active managers to add value, and leads to the highest dispersion of manager returns—creating larger rewards for investors who can select managers well. ■

—Eric Costa, Managing Director

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