4TH QUARTER ▪ 2017

HEDGE FUND UPDATE

Global risk assets appreciated materially in fourth quarter 2017 and for the year as a whole. US equity indexes once again ended both the quarter and calendar year near historic highs. The S&P 500 Index returned 6.6% in fourth quarter and 21.8% in 2017, whereas the Russell 2000® Index returned 3.3% and 14.6% for the respective periods. All US equity sectors defined by the Global Investment Classification Standard (GICS) were positive for fourth quarter, and most experienced strong gains for the year; the S&P 500 energy and telecommunications sectors were the only two to experience modest losses for 2017.

Global ex US equity markets achieved strong gains as well, outperforming US equities in USD terms. The Stoxx Europe 600 Index returned 2.2% (in USD) for fourth quarter and 25.9% for 2017, and equity indexes in the United Kingdom and Japan also returned more than 20% for the year. Meanwhile, the MSCI Emerging Markets Index outperformed its developed markets counterpart for both fourth quarter and 2017, gaining 7.4% and 37.3%, respectively.

The corporate credit market, as represented by the J.P. Morgan Global High Yield Index, performed solidly for fourth quarter and 2017, returning 0.9% and 8.3% (in USD terms) for the respective periods. Major hedge fund strategies also produced strong results over both time spans, with the 2017 annual return reported by Hedge Fund Research, Inc., the highest since 2013. The HFRI Fund Weighted Composite Index returned 2.7% for the quarter and 8.7% for the year. According to Morgan Stanley, hedge funds produced positive returns for 14 consecutive months and for 17 of the last 18—a welcome statistic, considering that these strategies' performance over the previous 24 months had been subdued. This quarter, we examine the cyclicality of recent performance trends and consider what the future may hold for event-driven strategies.

CA research publications aim to present you with insights from a variety of different viewpoints. The views of our Chief Investment Strategist can be found each quarter in *VantagePoint*.

FUNDAMENTAL AND DIVERSIFYING HEDGE FUND STRATEGIES: 2017 YEAR IN REVIEW

Fundamental strategies led the way in the hedge fund space, particularly long/short equity and event-driven—two strategies that, interestingly, many hedge fund investors had declared obsolete two years ago. Whereas event-driven strategies outperformed all other major hedge fund strategies in 2016, they played second fiddle to long/short equity in 2017: the HFRI Equity Hedge (Total) Index returned 3.5% for fourth quarter and 13.5% for the year, compared with 2.0% and 7.7%, respectively, for the HFRI Event-Driven Index.

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Diversifying strategies also turned in positive performance. The HFRI Macro (Total) Index returned 2.4% for fourth quarter and 2.2% for 2017, and the HFRI Relative Value (Total) Index returned 1.1% for the quarter and 5.1% for the year.

Overall, 2017 results should serve as a reminder to remain patient and invest with a long-term, countercyclical orientation. Despite routinely challenging our own assumptions, we continue to consider this approach critical to producing outstanding results. Consider the recent pattern: in our fourth quarter 2015 letter, we correctly posited that event-driven strategies were poised for a rebound and that the patient investor potentially stood to benefit from the capital outflows the space was weathering. Then, in our fourth quarter 2016 letter, we noted the likelihood that headwinds to long/short equity—such as investor redemptions, deleveraging, and historically low interest rates—would exhaust themselves in 2017 and boost the strategy as a whole. Indeed, investor redemptions have subsided and interest rates have edged upward, aiding long/short equity managers as anticipated. Current stock market index levels and valuations should present opportunities for managers skilled in shorting equities.

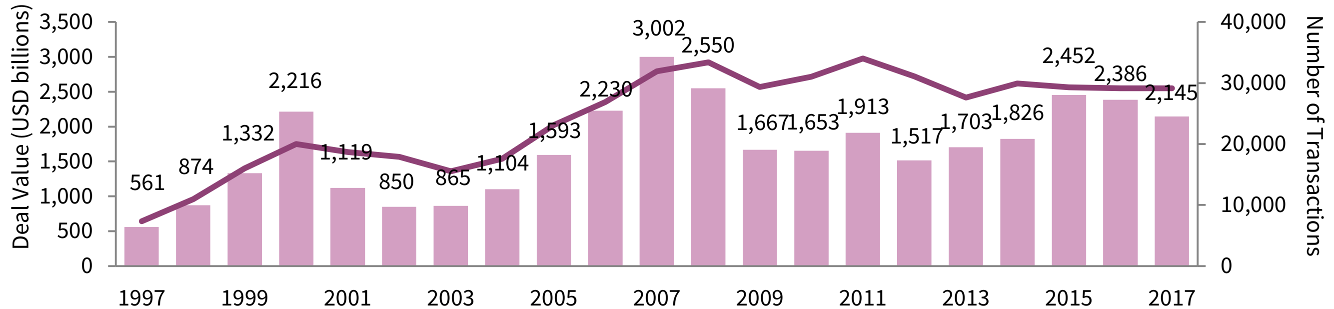
EVENT-DRIVEN STRATEGIES: LOOKING AHEAD

Event-driven strategies have the potential to provide more interesting opportunities for investors in 2018. Merger activity (in terms of aggregate deal value) was muted in 2017 relative to the prior two years, and many saw the uncertainty surrounding US tax reform as the primary reason. Going forward, a more favorable regulatory environment

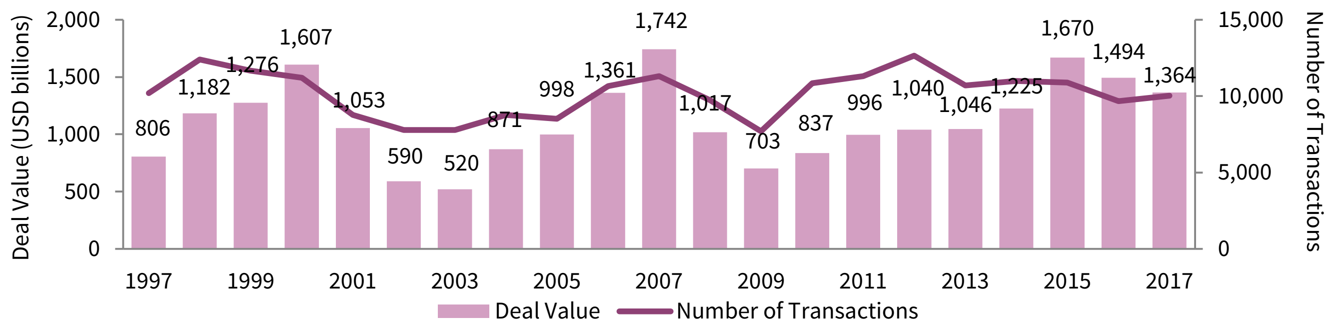
COMPLETED GLOBAL MERGER & ACQUISITION ACTIVITY

1997–2017

Global ex US



US



Source: Dealogic.

Notes: The above figures include cross-border activity. Dealogic updates its database on a regular basis; therefore, historical data may change. Data for 2017 are as of December 31.

and the US corporate tax overhaul passed by Congress in December 2017 could prompt management teams to initiate more corporate events—such as mergers, spin-offs, special dividends, and stock buybacks—as a means to create value. In turn, this wave of corporate activity would offer event-driven managers a more meaningful opportunity set to exploit.

Investor sentiment toward event-driven strategies remains subdued; the strategy has not received significant new capital in the last couple of years and has seen no new launch activity. Interest rates have trended upward, but credit remains attractive and available, and corporate balance sheets strengthened by repatriated cash would provide greater buying power. Less capital chasing more events could lead to attractive returns for the strategy as a whole in 2018. Any rotation in sentiment from growth investing to value investing would only enhance event-driven returns, given that many event-driven substrategies are value-oriented.

With global risk assets seemingly reaching daily historic highs, the value that hedge funds can add to a portfolio has never been more relevant. Eventually this race to the top will morph into a period of sustained lackluster or negative performance, and those who maintain or add to their hedge fund portfolios in the current environment may appear prescient when the landscape shifts. ■

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