4TH QUARTER ▪ 2018

HEDGE FUND UPDATE

Global equities ended 2018 with their worst calendar quarter decline (-12.8% for the MSCI All Country World Index in USD terms) since third quarter 2011. Volatility spiked with an initial sharp sell-off beginning in early October and remained elevated throughout the quarter as markets were hit in December by a second meaningful correction to book-end the period, with markets volatile but range-bound during November. Among the reasons cited by market pundits for the initial October sell-off were concerns regarding rising inflation, central bank tightening, slowing growth (particularly outside the United States), European political stresses, potential escalation in the US-China trade war, and a possible cyclical earnings peak for US companies as the benefits of tax cuts and fiscal stimulus begin to fade. In December, these ongoing issues were exacerbated by plummeting oil prices and news of a partial US government shutdown.

Emerging markets stocks outperformed developed markets equivalents in fourth quarter thanks, in large part, to significant outperformance in November and December. For the full quarter in USD terms, the MSCI Emerging Markets Index declined by 7.5% relative to a -13.4% return for the MSCI World Index of developed markets equities. US large caps (-13.5% for the S&P 500 Index) slightly underperformed the MSCI World Index last quarter, though the former's full year result (-4.4%) outperformed global peers. There were very few places to hide last quarter, as 10 of 11 Global Industry Classification Standard (GICS) sectors in the S&P 500 Index finished in the red, with energy, information technology, industrials, and consumer discretionary declining the most and underperforming the broader US market. Utilities (1.4%) were the lone sector to finish the quarter in the black. Smaller-capitalization US equities fared even worse than large caps, with the Russell 2000® Index declining by 20.2% in fourth quarter, entering a technical bear market, and returning -11.0% for the full calendar year. Meanwhile, value equities outperformed growth counterparts by several hundred basis points (bps) for the quarter, but still meaningfully lagged on a calendar year basis.

Hedge funds held up reasonably well last quarter on a relative basis but were not immune from the selling pressure as the Hedge Fund Research (HFR) Fund of Funds Composite Index declined 4.8% to finish the year down 3.9%. In terms of underlying hedge fund strategy performance, the HFR Macro (Total) Index declined by 1.9% in fourth quarter to finish 2018 down 3.6%; meanwhile, indexes reflecting fundamental-oriented strategies, such as the HFR Equity Hedge (Total) Index and the HFR Event-Driven (Total) Index, declined by 8.3% and 5.0% last quarter, ending the year in negative territory at -6.9% and -2.3%, respectively.

In this quarter's update, we look at the market pressure long/short equity managers experienced in October as technical selling by some tightly risk-controlled multi-manager platforms and other volatility-targeting strategies, combined with a deleveraging effect stemming from ongoing redemption activity (including announcements of several high-profile fund closures) created major headwinds for the strategy. December's additional market turbulence yielded further negative results among equity hedge funds, although alpha generation improved as long/short managers performed reasonably well, capturing less of the downside as a group amidst the broader sell-off.

LONG/SHORT EQUITY MARKET UPDATE

To begin, we explore how programmatic selling and short covering by statistical arbitrage and quant funds, as well as deleveraging by large multi-manager platforms, may have contributed to the trouncing experienced by many fundamental long/short equity managers during the first month of the quarter. As evidence of the challenging technical environment, October 18 was reportedly the largest day of exchange-traded fund selling since September 2016. Long/short equity managers suffered one of their worst calendar months since the global financial crisis, although there were already signs in late September that higher-beta momentum stocks were starting to underperform. The HFR Equity Hedge (Total) Index returned -4.6% in October, capturing more than 60% of the MSCI ACWI's 7.5% decline (in USD) for the month as many managers generated negative alpha on both sides of their trading books; that is, most hedge funds' long portfolios sold off more than the broader market indexes, while most short portfolios declined by less than the overall market. For comparison, the S&P 500 Index declined 6.8% in October, the smaller-cap Russell 2000® Index experienced a 10.9% correction, and the MSCI Emerging Markets Index returned -8.7% in USD terms.

Non-US equity long/short managers were not spared from October's carnage as the MSCI Europe Index and the MSCI All Country Asia Pacific Index returned -7.6% and -9.6% in USD terms, respectively. In Europe, the average directional equity long/short manager was down approximately in line with the global hedge fund universe as a whole, though more underperformed than outperformed, and Europe-focused managers fared worse than the region's equity markets in local currency terms. Much like their global- and US-focused counterparts, non-US managers with meaningful mid- and small-cap exposure suffered to a greater extent. Those that fared better had proactively reduced gross and beta exposures in prior quarters; however, most lower-net strategies still ended the month in negative territory. The story was similar

among pan-Asian long/short managers but involved wider performance dispersion, depending on geographic focus. Performance was driven by broad-based losses in these managers' long books—both good-quality, high-growth businesses and attractively priced value opportunities were hit hard, while gains generated on the short side did not provide sufficient protection to offset losses on the long side.

One fundamental equity hedge fund practitioner we recently interviewed remarked that his team had already factored the prospects of rising interest rates, higher transportation costs, higher raw materials prices, and rising wage inflation into its models by the time the market decided to begin worrying about these issues in October. The portfolio manager lamented that many long holdings had still declined significantly for the month, despite reporting earnings in line with his team's expectations. Meanwhile, shorts that were more likely to be affected by the aforementioned cost pressures reported disappointing earnings results as expected, yet barely declined. This manager noted that October represented the most volatile month in its history (which includes 2008), based on the number of days when the fund finished up or down by more than 100 bps. Similarly, the majority of long/short equity managers we cover reported little evidence of stock-picking mistakes during the period and, with few exceptions, did not aggressively reshape their portfolios or de-lever to the extent that some broader peers may have. Instead, many used the weakness in October to incrementally add to high-conviction positions, funding these top-up allocations largely by culling lower-conviction positions with less favorable risk/reward profiles.

While it is difficult to know for sure what caused the sell-off in October or how great a role each of the convergent factors played, we would not be surprised if large multi-manager platforms, statistical arbitrage, and quant funds made nontrivial contributions to the deleveraging and technical-selling pressure observed throughout the period. Given the large balance sheets multi-manager platforms use and the tight risk limits they place on each underlying trading team (or "pod"), it would be reasonable to assume that some portions of the underlying platforms were breaching risk limits and unwinding portfolios in the weeks following Federal Reserve Chairman Jerome Powell's seemingly hawkish comments on October 3, which caught the markets by surprise. While many platforms held up reasonably well in October, others did not. Furthermore, November proved to be more challenging for the group as a whole. As the losses mounted, the deleveraging activity may have broadened to include those multi-manager platforms with wider, less stringent risk parameters.

Crowded hedge fund longs suffered disproportionately amid the technical-selling pressure in October. Though at one point in July the ten most crowded long positions among equity long/short hedge funds had outperformed the ten most crowded shorts by a magnitude of 26% year-to-date, by October 29 that spread had compressed to zero, further indicating that popular longs were being sold and favored shorts were being covered. Then on October 29 alone, the ten most crowded long positions underperformed the S&P 500 Index by nearly 300 bps, while the ten most crowded shorts outperformed the index by more than 100 bps. Comparative results for the 50 most crowded long and 50 most crowded short positions were similar in direction, though not in magnitude.

As the selling continued, news of several high-profile fund closures likely added to the pressure on crowded hedge fund long positions. While most of the liquidating managers were largely in cash by the time of their announcements, it's reasonable to assume that other practitioners, nervous about potential year-end redemption pressures, cut risk in anticipation of the potential fallout. Aside from day-to-day gyrations, net exposures largely drifted downward throughout October, along with gross exposures.

Markets were mostly range-bound in November, but then in December global equities suffered another leg down on further evidence of a global economic slowdown, another rate hike by the Fed, shrinking liquidity, a partial shutdown of the US government, and continued political uncertainty in Europe. As a result, hedge fund performance was broadly negative during the last calendar month. However, long/short equity managers held up marginally better than they had in October, as the HFR Equity Hedge (Total) Index declined 3.7%, capturing just over 50% of the MSCI ACWI Index's 7.0% decline (in USD) in December. Although October's sell-off could be attributed to deleveraging and technical-selling pressures, December felt more like a broader risk-off move among global investors. While crowded longs declined, crowded shorts fell by an even greater amount, somewhat cushioning the blow for fundamental long/short equity managers. ■

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