



LIQUID ALTERNATIVES INVESTMENT INSIGHTS

JANUARY TO APRIL 2020

HIGHLIGHTS

- Hedge funds are in an ideal situation to outperform in this environment
- They are structurally stronger than in 2008
- They will benefit from important dislocations across asset classes
- Higher volatility should remain which is the fuel for various strategies
- A new distressed debt cycle is bringing large opportunities

HEDGE FUNDS HAVE NOT BEEN IN THIS SITUATION FOR A LONG TIME

Into 2020, markets were quite muted with low volatility overall as illustrated by a VIX index contained below 20 points for quite some time.

The first reported case of Covid-19 occurred in late 2019. It took 3 months for the fear to spread globally and impact financial markets, bringing indices back to levels not seen for 5 years. The particularity of this market crash is its velocity, causing the S&P 500 to fall into a bear market at the fastest pace ever, the VIX to top its highest level since its launch in 1990 and the US 10-year rate to sink to its lowest level ever.

Risk parity suffered because the historic negative correlation between bond and equity prices began to reverse. This in turn hurt fixed income arbitrageurs, who saw liquidity dry up, causing the spreads between cash instruments and their derivatives to widen. Managers then started to hit their risk limits, triggering deleveraging and magnifying the adverse effects on markets. Huge money outflows from Gulf Sovereign States due to record-low oil prices did not help either.

Throughout March, with about half of the world population locked at home, governments deployed fiscal and monetary stimulus, bringing real rates below zero in the developed world. This surge of optimism helped the S&P 500 record its quickest three-day advance in nine decades.

In this context, hedge funds fared these markets better than other traded asset classes. Even if a few hedge fund strategies may have disappointed, the hedge fund universe is completely different from what it was back in 2008. Hedge fund volatility is lower today because managers use less leverage, their investor bases have changed, banks are healthier and counterparties more diversified. Important dislocations have brought many opportunities, in particular in credit and arbitrage strategies. Hedge funds have not been in this situation for a long time. They are in the best position to profit from them. We could already see this in their strong April performance.

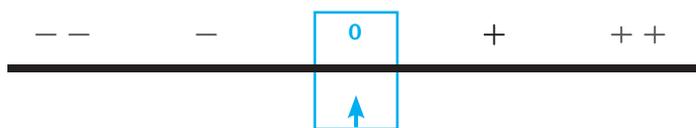
EQUITY HEDGE

The first few weeks of 2020 for equity markets were a continuation of the rally in 2019. The calm before the storm. Thereafter and within just a few days, as Covid-19 expanded across the world, equity markets saw a succession of historical daily losses and gains with swings in the likes of 2008, 1987 and 1929's most extreme trading sessions.

Most Equity Hedge strategies experienced rough times but outperformed the market. In this extreme volatility environment, equity managers lowered their net and gross exposures. Generally speaking, strategies with lower beta exposures preserved capital better than others. Some sector specialists like TMT and healthcare fared the turmoil relatively well.

Market neutral funds also suffered from factor rotations and their short books' gains failed to cover longs' losses as some names were also aggressively sold off irrespective of fundamentals.

STRATEGY OUTLOOK



After over two volatile months, equity markets have somewhat recovered from their respective trough but as the impact of the spread of the virus on the global economy may continue to be reluctant for a while. It would be no surprise to see secondary shocks. On the other hand, the COVID-19 crisis will make winners and losers arise and equity managers will be in the best position to make successful trades. In this context, we favor managers with a low net exposure.

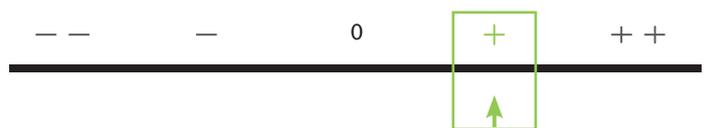
EVENT DRIVEN

Over the first two months of 2020, M&A spreads were volatile but tightened overall. Mid-March in the midst of the market selloff, spreads widened to levels last seen during the 2008 financial crisis. Pressure on spreads intensified due to margin requirements, deleveraging and platforms closing books irrespective of the situation of the underlying deals.

Generally speaking, the value-embedded nature of event strategies did not help on a relative basis as growth outperformed value by close to double digits.

In the trough, strategies with lower beta components such as merger and credit arbitrage as well as distressed/restructuring showed more resilience than others, namely activist and special situations.

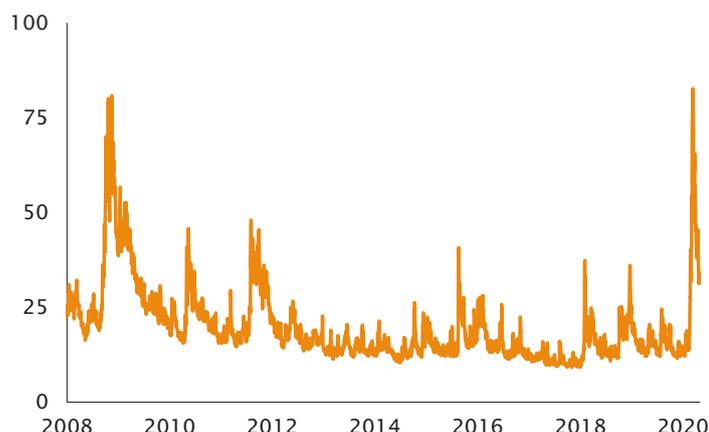
STRATEGY OUTLOOK



Higher equity beta strategies will rely highly on future better news regarding the virus. Merger spreads got crushed but recovered partially since then. Although the current uncertainty could bring less corporate activity, experienced managers may find good opportunities to make money in this larger spread environment. We are also positive in Distressed (see Our Conviction).

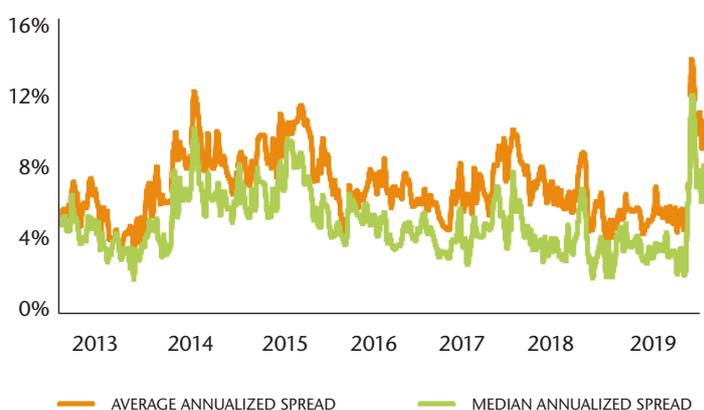
VIX INDEX

S&P500 IMPLIED VOLATILITY TOPPED 2008 LEVELS IN 2020.



SOURCE: BLOOMBERG

M&A SPREADS



SOURCE: UBS

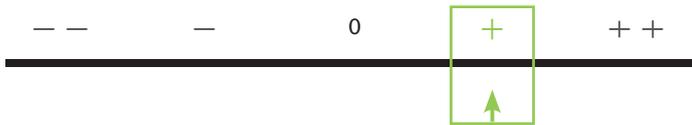
MACRO

The period under review saw large dispersion across the different sub-strategies. While some discretionary macro funds had a strong start in 2020, systematic managers suffered. In January, there had already been discussions about a potential pandemic. Therefore, discretionary managers had some time to move the portfolio with the evolution of the new information that they were receiving from their contacts and consultants in China and from epidemiologists. Most of them were positioned for a decrease in US interest rates. Volatility strategies hoping for a spike did very well. Short equity and commodities were also profitable trades.

Mid-February, most trend followers still held long equity and bond positions fueled by 2019's rally. Shorter-term CTAs managed to preserve capital in the equity sell-off better than longer-term ones. Investors fled risky assets to buy safe havens like US government bonds, bringing the 10-year US rate at a historical 0.3% low. CTAs made money from that but not enough to offset equity trading losses.

Generally speaking, larger funds were outperformed by smaller ones as higher volatility and lower liquidity made it harder to execute large trades.

STRATEGY OUTLOOK



We expect markets to remain volatile over the medium term which should again be supportive for discretionary macro and short-term systematic macro managers. Choppier markets may be harder to navigate for medium to long term trend followers.

US 10-YEAR YIELD

US 10-YEAR YIELD HIT LOWEST LEVEL EVER.



SOURCE: BLOOMBERG

RELATIVE VALUE

Mid-March, fixed income arbitrageurs were extremely affected by their basis trade and the adverse movements of US Treasury instruments. These important volumes dried up market liquidity, a situation last seen in 2008, sending most funds down double digits. Since the massive cash inflows from the Federal Reserve, losses have been somewhat recovered.

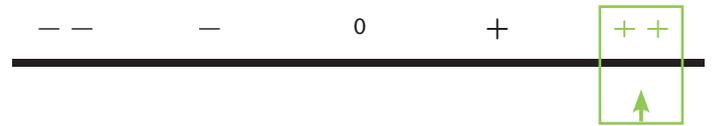
Volatility arbitrage performance dispersion was wide, from positive double digit to liquidating and shutting down the business. Managers who struggled were mainly hurt by the reversal and then a lack of liquidity in a crowded trade: long volatility Asia against US.

Convertible bond managers were resilient but in general they were down as their equity shorts did not compensate the sell off on the credit side of the trade. They were also hit by deleveraging from large multi-strategy funds.

Structured finance strategies were the largest losers. At some point in March, they lost almost half of their value as participants struggled to raise adequate funding before retracting a bit.

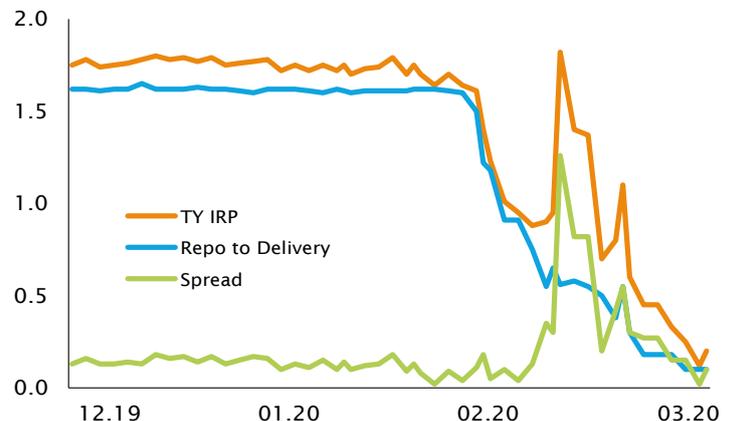
Quantitative managers were also hurt as their trading models were dealing with up to multiple-sigma events. Put another way, those models were designed with historical market data which did not contain such extreme trading events, largely preventing them from being well positioned to profit.

STRATEGY OUTLOOK



We continue to favor convertible arbitrageurs as they may take advantage of volatile environments while maintaining positions in the equity market. Huge cash injections by the Federal Reserve are also supportive of a normalization of the important dislocations seen in March.

TY IMPLIED REPO VERSUS GC FUNDING TO DELIVERY



SOURCE: BLOOMBERG AND LMR PARTNERS

OUR CONVICTIONS

We see interesting things in the credit market. We have just entered in a new distressed debt cycle with opportunities for the next 18 to 24 months. However, in order to make a good investment, investors must beware of timing, instruments (HY, IG, CLO,...) and the companies' credit quality. In a distressed cycle, there are generally three phases (see the graph below).

In the first phase, there is high uncertainty with irrational markets due to forced selling and asset liquidations, often driven by leveraged positions. Liquidity in the market can dry up significantly and quickly. It is what we experienced in March 2020, when phase one started. At that moment, there were significant mispricings and dislocations across asset classes (e.g. equity, credit, CDS and cash markets) and within companies' capital structure.

At this stage, it makes sense to invest in high quality credit instruments at very attractive prices. Distressed managers will focus on the largest companies trading at stressed levels. There is very little restructuring work to do, as the complex distressed situations risk reward is less appealing due to a low downside protection, as we are still within an environment of stress, i.e., in the current COVID-19 situation there is still too much uncertainty. Phase 1 is short, lasting from a few months up to 6 months. Managers mainly focus on 3 elements:

1. companies with the highest credit qualities and lowest LTV, which are more likely to survive,
2. finding arbitrage in large capital structures with important dislocations (high quality part of the high yield),
3. towards the end of the phase when liquidity is back, high quality credit but with more stress in the LTV.

The second phase begins when certainty arises around a range of economic and industry outcomes. Managers will focus on stressed but surviving large capital structures which are expected to have faster corporate restructuring, e.g. CMBS, MBS, NPL, structured products, private debt, real estate, aircrafts, junior tranches of CLO structures. They will take on leading active restructuring, lending in special situations and rescue financing. In the current COVID-19 situation, this phase is likely to start as soon as there is more clarity around the treatment of the virus and a vaccine. This phase will last a few quarters, depending on the shape of the recovery.

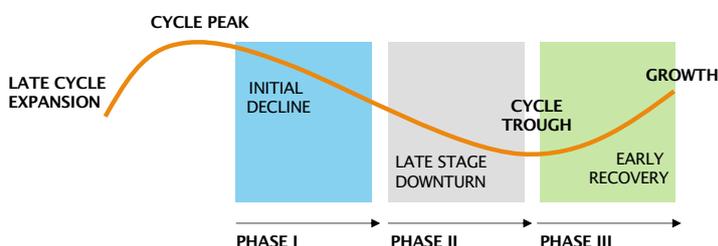
The last phase is initiated when the crisis ends. Managers are starting to reap the benefits from investments made in the previous phases. In terms of new investments, they will

look at opportunities in special situation lending, cross over investments combining deep knowledge of restructuring and knowledge of the underlying assets. They might have a special interest in shipping and aircrafts. The third phase generally lasts anywhere from a few years to a decade.

Since March of this year, we at SYZ Capital have been looking at the distressed market investments on both liquid and illiquid sides, from hedge funds with quarterly to yearly liquidity to closed-end recovery funds. In our view, today, the sweet spot is in yearly to four-year investment vehicles. We are still in an uncertain environment with the risk of a second wave of COVID-19 infections which could hurt in the short term. Therefore, in this adverse scenario, forced sellers in more liquid products could damage one's investment. If better liquidity terms are desired, there is the possibility to allocate capital to credit specialists hedge funds, which could play phases 1 and 2, but with smaller allocations to pure distressed situations. However, we are really focusing on higher quality names with 15- to 20-year track records that have fared previous distressed cycles and have low toxic legacy position exposure or are already marked down.

At the prices at which these managers are buying these distressed opportunities there is no need for a full recovery to make good money. A normalization is enough.

NEW DISTRESSED DEBT CYCLE



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