JULY 2024

ALTERNATIVE INVESTMENT SOLUTIONS: QUARTERLY STRATEGY REVIEW & OUTLOOK

Marketing communication

Key points

- The second quarter of 2024 saw a continuation of the positive investor sentiment since the beginning of the year. The quarter started with strong economic data in the US which dialled back expectations for central banks interest rate cuts. This was tempered by improvements in inflation data later in the quarter. Equity markets rallied as a result, led by Emerging Markets (EM) and, to some extent, the US. The economic developments mentioned above continued to weigh on Developed Markets (DM) fixed income, which were flat –to-down. High Yield and EM debt were positive. Credit spreads, which reflect a healthy economy, remain tight and should also be the focus of investors going forward.
- At the industry level, performance was positive for the period All strategies bar Systematic and Merger Arbitrage were positive. The strongest performers were Discretionary Macro as well as Corporate Credit managers. Dispersion between markets and companies had a positive impact on those strategies.
- At the strategy level, our outlook remains consistent with previous quarterly reports. Within Equity L/S, our preference is with less directional low net exposure managers, as well as sector specialists that have been out of favour. For diversifying strategies, if rates easing begins, this should be supportive for Macro and EM through bond and FX opportunities. In Relative Value, a number of strategies are set up to outperform cash in 2024.

UNION BANCAIRE PRIVÉE

Markets Review

The second quarter of 2024 saw a continuation of the positive investor sentiment since the beginning of the year. The quarter started with strong economic data in the US which dialled back expectations for central banks interest rate cuts, even questioning whether rate hikes were possible. Improvements in inflation data later in the quarter helped temper those concerns. Equity markets rallied as a result, led by Emerging Markets (EM). In Developed Markets (DM), the US dominated the field (+4.3% for the S&P 500 Index). In Europe, multiple elections generated uncertainty and volatility in some markets (+0.6% for the MSCI Europe ex-UK). In terms of styles, Growth saw strong positive returns during the quarter, while other styles were negative. Commodities continued their recovery, posting positive returns once again in Q2 (+2.9%).

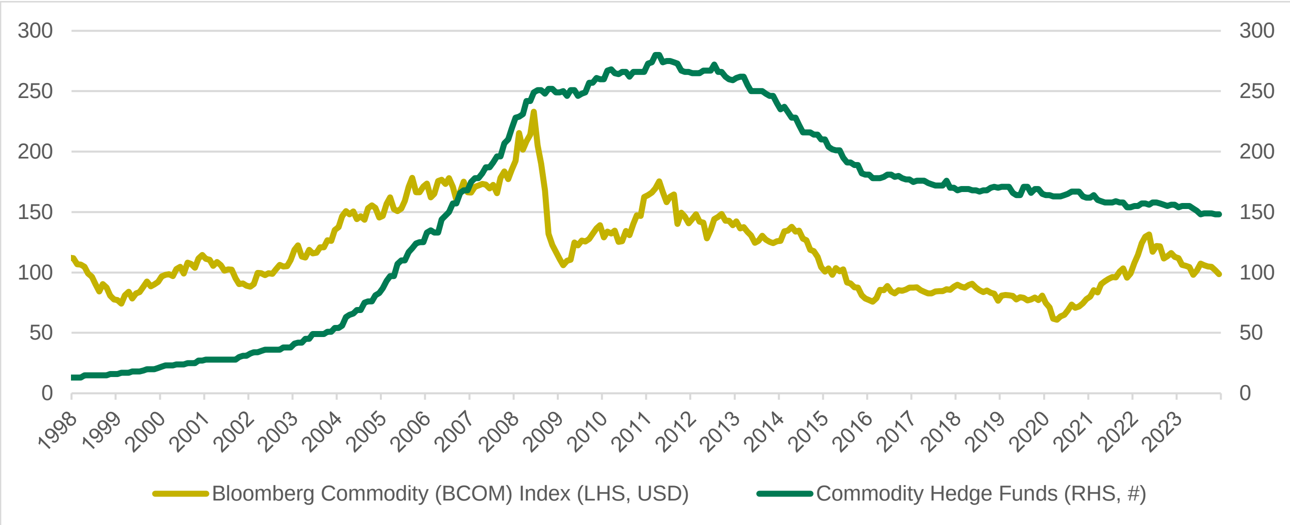
On the fixed income side, the picture was more mixed. The economic developments mentioned above continued to weigh on DM interest rates markets, with only US treasuries ending slightly up (+0.1%). European government bonds were down (-1.3%) despite the widely anticipated first interest rates cut by the ECB. In credit markets, global investment grade (IG) bonds were down, while global high yield (HY), and Emerging Market (EM) debt, which are both less sensitive to interest rates, were positive. On the economic front, data has remained resilient which has positively impacted corporate earnings and limited any material increase in default rates. In the short term, investors will continue to be guided by economic growth and inflation. Credit spreads, which reflect a healthy economy, remain tight and should also be the focus of investors going forward.

Hedge Fund Insights

Outlook for hedge funds' commodities allocation

Commodity hedge funds have seen an increase in interest after a decade of relative inactivity. A core premise of hedge funds is to profit from price action in markets and in the commodity space we note the correlation between prices and the number of dedicated hedge funds (Figure 1). In the early-2000s, an emerging China's increasing demand growth resulted in a significant increase in prices across the commodity complex and hedge funds took advantage, as seen by a rapid pace of new launches. Interest peaked pre-2008 but the decade long bear market from 2010 to 2020 reduced the opportunity set and resulted in hedge fund closures. However, from 2020 onwards there has been an increase in price moves and volatility, driven by energy transition themes and macro political events, both of which we expect to continue.

Figure 1: Bloomberg Commodity Index vs Active Commodity Hedge Funds



Source: Bloomberg Finance L.P., UBP. Past performance does not predict future returns

Commodities speculation is made up of three broad participants: Systematic, Fundamental and Merchants Trading Houses ("Merchants"). Systematic managers are typically associated with trend following, so profit from sustained price moves up or down. Fundamental players look for value in specific market and mispricing relative to fundamentals. Finally, Merchants trade to either hedge physical exposure or use this information to take market views. Historically, Fundamental funds faced headwinds in trading compared to Merchants as most hedge funds trade only financial products (such as futures and derivatives), whilst Merchants trade primarily in physicals markets with trading in financial instruments only acting as an additional source of revenue. By viewing the physical flows, Merchants have insights into commodities demand and therefore pricing that gave them an informational advantage which contributed to their robust profits which have been sharply rising recently.

However, the market ecosystem has been changing which improves the outlook for commodity speculation but may also see some Merchant advantage diminish. Firstly, pricing dynamics have become more unstable. The impact of the energy transition, new demand from sources such as AI and electric vehicles and change in supply from geopolitical issues caused a re-think on sourcing, redrawn supply routes and substitutability across energy supply. This has led to changing correlations and higher volatility across the commodity complex. Secondly, growing capabilities in data storage and capture has also meant a better mapping of demand and supply networks. This has contributed to greater use of quantitative tools in price forecasting and greater emphasis on an analytical edge, where hedge funds can compete well. Thirdly, the type of market where physicals information is important may be changing. Demand and micro-driven markets favour physical traders who observe flows, but if supply fundamentals and macro themes drive price, then a wider range of market participants can be profitable.

As a result, we have seen an increase in allocation to commodity strategies from multiple sources: Multi-PM Platforms have been increasing their allocations and hired teams as expected returns have increased, and the asset class acts as an attractive diversifier to traditional asset class exposure given a different set of underlying price drivers. Secondly, we have seen a growing number of standalone launches attempting to take advantage of strong opportunities in specific markets. Finally, systematic strategies have also increased exposures as they have broadened their exposure from only the most liquid commodities contracts into more esoteric commodities.

Conclusion

The commodity opportunity set for hedge funds has improved strongly in the past few years. This is due to changes to the market ecosystem and what factors are important for forecasting prices, all whilst the overall profitability of the space has improved dramatically. As a result, returns have been strong in commodities even whilst more hedge funds have been deploying capital to the space. As these market changes are structural, we expect the commodity hedge fund opportunity set to remain attractive going forward, acting as both a source of absolute returns and as a diversifier.

Please contact us for more information on the study and to discuss the findings.

Hedge Fund Strategy Reviews

Table 1: Hedge fund strategy indices performance

Strategy Indices (in USD)	2024 Q2	2024 YTD	2023 FY	5 Year Ann.
HFRI Fund Weighted Composite Index	0.51%	4.97%	8.12%	6.66%
HFRI Equity Hedge (Total) Index	1.11%	6.29%	11.36%	7.83%
HFRI Event-Driven (Total) Index	0.31%	2.65%	10.43%	6.19%
HFRI Relative Value (Total) Index	1.21%	3.79%	6.96%	4.56%
HFRI Macro: Discretionary Thematic Index	1.60%	3.33%	5.02%	5.68%
HFRI Macro: Systematic Diversified Index	-2.00%	7.48%	-3.78%	5.12%
HFRI ED: Merger Arbitrage Index	-0.06%	0.20%	5.06%	5.46%
HFRI RV: Fixed Income-Corporate Index	1.59%	4.84%	8.35%	4.78%
HFRI RV: Fixed Income-Convertible Arbitrage Index	1.04%	5.35%	4.82%	6.55%

Source: Hedge Fund Research, Inc,. As of 30.06.2024.
Past performance is not a guide for current or future results.

Equity Long Short

Equity L/S managers, as represented by HFRI Equity Hedge (Total) Index, gained +1.1% during the second quarter of 2024. Returns were driven predominantly by stock dispersion rather than by the rallying equity markets that characterised the months of May and June. In continuation of the first quarter, stock dispersion stayed at higher levels as markets remain very sensitive to earnings announcements/outlooks and company fundamentals. This is well illustrated by the HFRI EH Equity Market Neutral Index that gained +2.9% during the quarter versus the HFRI EH Directional Index that rose only +0.9% (notwithstanding that the MSCI World rose +3.2%). The HFRI EH Fundamental Growth Index and the HFRI EH Fundamental Value Index gained +2.2% and +0.1%, respectively. This is reflective of the strong outperformance of the MSCI World Growth Index versus the MSCI Value Index during the quarter (+6.1% versus -1.9%, respectively). The HFRI EH Sector Healthcare Index was the poorest performer, losing -1.5% (driven by the strong sell-off in the biotech sector during the month of April). The HFRI EH Sector Technology Index was the strongest performer, increasing +3.7%, closely followed by the HFRI EH Sector Energy & Basic Materials Index that made +3.5%.

Macro

Discretionary Macro strategies, represented by HFRI Macro Discretionary Thematic Index, posted a gain of +1.6%. Funds saw a strong start to the quarter but weakness into quarter end. Manager performance continued to be widely spread depending on their natural trading style with EM orientated managers outperforming DM as rates stabilised and carry performed, whilst those managers with breadth to trade long risk assets in equities and commodities did better than fixed income and FX focused managers. Overall there was a continued focus on tactical trading with lighter risk than usual. They were generally positioned short fixed income which benefited the strategy at the start of the period but cost into quarter end. The largest positions were paid positions in Japanese rates across the curve (expecting increasing rates), and US rate steepeners, which PMs continued to like due to potential for cuts in H2 whilst longer dated rates could move up due to the high fiscal deficit and a higher neutral rate. Cross market rates trades were also popular in Europe. However rates conviction and sizing was lower than earlier in year ahead of summer lull and US elections. In commodities PMs were generally long energies and precious metals, particularly gold as a macro and inflation trade whilst new energy theme in copper and uranium remains popular.

Systematic

Systematic strategies were negative for the quarter with the HFRI Macro Systematic Diversified Index returning -2.0%, although remain the top returning strategy YTD, up +7.5%. The strategy started on a positive footing before losses accelerated into quarter end. Gains from short rates and long USD earlier in the period were more than offset by losses into quarter end as rates rallied and USD strength faded. Positioning was short fixed income globally throughout most the period though positions reduced in June, to a greater extent in faster models. The strategy was long equity positions globally which was sustained through the period. In FX, long USD positioning was broadly against low yielding currencies (including JPY) and losses led by underperformance vs majors including CHF, CAD, EUR. Positioning in FX was reduced in the period. Commodities positioning was mixed with funds mainly long precious metals, long energy but mixed industrial metals and short aggs. Reversals in precious metals and energies was costly in June. Overall by strategy type, Short-term models fared better in the longer-term reversal, and reduced positioning faster to flat positioning in rates and FX. Statistical arbitrage strategies continued to perform well for the quarter and year, especially non-US markets.

Event Driven

Event Driven managers posted mixed returns through Q2, with the HFRI Event Driven Total Index up +0.3% overall. The index's losses in April were more than offset in May, but gave back slightly in June, so performance for the quarter was only modestly positive. As equity markets saw declines in April and there was a reversal in the risk-on environment, Merger Arbitrage strategies were challenged and Special Situations funds were hurt by their exposure to catalyst-driven fundamental value equities. However, it was notable that Distressed Event Driven managers were less negatively affected in the month given their less correlated and idiosyncratic positioning. As a generally directional strategy, Event-Driven made gains in May as broader equity markets recovered. June performance was dragged down most significantly by Activist and Special Situations sub-strategies.

Relative Value

Relative Value (RV) managers, as measured by the HFRI RV (Total) Index, returned +1.2% in Q2 2024. The strongest performing strategy over the quarter was Asset Backed (+2.2%), seeing both high interest income and total return opportunities. The funds are seeing plenty of opportunities to find mis-understood and cheap bonds as consumer trends change (credit card, autos, student loans), and uncertainty looms in Commercial RE. Other areas such as Corporate and Convertible Arbitrage were positive but muted as new issuance, particularly in Convertible Bonds, was extremely high (reaching historical records), which forces the prices of existing bonds to temporarily fall as paper is digested by the markets. Managers trading RV sovereign bond strategies were also positive but muted, seeing some opportunities to trade government bond RV, but more limited opportunities in bond futures RV as curves remained stable (outside of the France election volatility) with no massive flows. All other strategies posted small positives; RV Multi-Strategy, Volatility and Yield Alternatives.

Hedge Fund Strategy Outlook

Table 2: AIS' strategy conviction

	Low Conviction	Cautious	Neutral	Positive	High Conviction
Equity Long/Short			Long biased	Moderate/low net - fundamental Sector specialist fundamental Regional specialist fundamental	
Macro		Pure FX		Macro G10 Commodities Macro - EM Macro Systematic	
Systematic			Systematic Trend	Quant Equity Market Neutral	Systematic Multi-Strategy Systematic short term
Event Driven		Activist	Special Situations Distressed M&A		
Relative Value			Volatility	Platform ABS	Convertible Arbitrage Credit Long/Short Fixed Income Relative Value

Source : UBP. As of 30.06.2024

Our outlook is determined by our forecast of the expected return for the hedge fund strategy over the next 12 to 24 months. The attractiveness of the expected return is measured both in absolute return compared to its historic range of returns and relative to the current expected return of traditional assets. Hedge fund strategies' total return is influenced by a number of factors, some are stable whilst others are more cyclical in nature. For example, for equity long short managers what are the factors that have an impact on capturing alpha such as stock dispersion and number of competitors executing similar approaches? What are the style factors within the investment approach? How stable is the market beta within portfolio construction? The strategy colouring reflects a change in the rating from the previous quarter- green represents an upgrade in our conviction whilst blue is a downgrade in our conviction.

Equity Long Short

In general, Equity L/S strategies are running with close to historical average exposure levels both on a gross and net basis. At large, managers have no marked positive or negative outlook on overall equity markets for the near future. However, there is an agreement among managers that stock dispersion will remain at elevated levels, driven by the market's focus on company fundamentals. This generates convincing opportunity sets for L/S strategies on both the long and short sides. In continuation of the first quarter, this was reflected by the solid returns of many moderate/low net long and market neutral strategies during the second quarter. We also continue to observe that many managers are generating strong positive alpha (and often positive absolute returns, notwithstanding the rallying equity indices) on their short books. On the other hand, many long-biased strategies continue to have a more difficult run. The biggest contributory factor to their relatively disappointing returns has been their low exposure to the small number of mega-cap stocks that have accounted for a clear majority of year-to-date equity index returns (Nvidia on its own added multiple points to both US and global index returns).

In the medium- to longer-term, returns and alpha generation of moderate net Equity L/S are strongly correlated with equity market dispersion. Given the major macro shifts of the past years, we believe that stock dispersion levels will continue evolving back towards levels seen in the "pre zero interest rate and quantitative easing" period. As shown in Figure 2 (on page 9), for the top managers within the strategy we expect a significant move upwards in alpha generation at both strategy level and manager level leading to returns at the top end of their historic range. At the sub-strategy level, moderate/low net long and market neutral strategies should be strong beneficiaries of this. In addition, specialist strategies focused on equity segments that have been characterised by indiscriminate selling in the past years should also benefit (such as small- and mid-cap stocks or UK stocks).

Macro

In Discretionary Macro, over the short-term managers continue to focus on tactical trading with risk lighter than usual. Many run with a risk-on leaning portfolio across equities, credit and commodities which means that returns should remain strong given the Fed's signal that it will look to ease rates whilst the US economy continues to grow steadily and steepening yield curve trade remains a popular trade which should drive performance. Rates sizing is lower than earlier in year ahead of a summer lull and US elections however managers are excited on the prospect of adding risk aggressively as volatility is likely to increase and the opportunity set opens up. As for all HF strategies, the main issue remains stretched asset price valuations which is likely to result in a pull back at some stage.

For the medium to long-term, our expected return for the top tier macro managers over the next 18 months is 10 to 12% p.a. net – this is shown in Figure 2. This is significantly above the 5 year HF Index trend return and is driven by a combination of unencumbered cash earning the risk free rate for the fund and a good opportunity set. The opportunity set for the managers has expanded by a divergence in economic trends globally. The US continues to shift to pro-cyclical monetary and fiscal policy and this is likely to create an inflationary boom environment which will mean large repricing moves across fixed income, FX and equities. Outside of the US, slower growth should create additional relative value opportunities. The top tier managers should also be able to outperform their peers 3-4%. This is driven by internal factors that differentiate the manager and provides them with a barrier to entry to protect their excess return and is identified by our internal fund research process. The differentiating factors that we currently see with the top managers are; a tactical approach which results in higher portfolio turnover to take advantage of sharp market moves, and highly sophisticated portfolio execution.

At the sub-strategy level, we remain constructive on both DM and EM focused Discretionary Macro managers as government bond markets and FX remain core asset classes for the strategy, and the underlying managers thrive when central banks pursue differing policy objectives which creates large swings in prices and increases volatility.

Systematic

As highlighted in our last outlook, after a strong start to the year, Q2 2024 saw a pullback in performance for longer term strategies as trends in rates, FX and commodities markets reversed. However this means positioning is much lighter and managers can start to rebuild. Statistical Arbitrage continued to perform well YTD as equity market volatility was low but dispersion high and opportunities outside the US were notably rich. Strong performance could continue but if we see crowding or increased leverage, then there is a greater likelihood of an unwind around factor reversals or an equity market pullback.

For the medium to long-term, our expected return for the strategy over the next 18 months is 9 to 11% p.a net, this is shown in Figure 2. This is above the 5 year average and the forecast is predicated on high levels of unencumbered cash earning the risk free rate for the funds and a continued compelling opportunity set. Trend/CTAs are the largest sub-strategy so will dominate performance of the overall group. This group have demonstrated diversification benefits in periods of macro uncertainty. There are multiple longer term themes which could cause significant sustained price moves, including political uncertainty, inflation uncertainty, monetary policy divergence, and green energy transition. These themes all suggest increasing market volatility and a breakdown of market correlations, which in turn could see uncorrelated profitable trades. Systematic Macro and Short-Term trading can also profit from these market dynamics in shorter time frames and incorporating wider range of styles. The best quality managers can add further value by adding new markets to further diversify and more effective execution can allow faster speeds of trades at a lower cost. In the single stock equity space, statistical arbitrage benefits from higher dispersion and liquidity, with moderate to higher volatility levels, and equity markets have could continue to trade in this environment as their price patterns better reflect underlying fundamentals.

At the sub-strategy level we remain constructive on Multi-Strategy Quant managers that can benefit from a wide range of underlying styles including longer-term trades that profit from more sustained regimes shifts, whilst also benefiting from shorter term volatility in markets. In the equities space, we are most positive on equity market neutral managers that can use advanced statistical methods such as machine learning to deploy risk across a more diversified set of alphas.

Event Driven

There has been marked optimism for a recovery in capital market deal activity, a driving factor for the opportunity set for Event Driven hedge funds. Since the record low transaction numbers in 2023, regulatory headwinds seem to have calmed and vast amounts of private equity dry powder have continued to accumulate. Furthermore, higher valuations and increasing CEO confidence on the economy are supportive of a pick-up in M&A activity, but interest rates remain elevated, posing a challenge to corporates considering financing for deals. In spite of clear signposting for a Fed rate cut later in the year, the pace of cuts in 2024 YTD has been much slower than initially anticipated as inflation remains sticky. IPO windows are gradually reopening and M&A numbers indeed saw an uptick in Q1 compared to the previous year, but global deal counts in Q2 fell quarter-on-quarter for the first time since 2020. The rebound in deal activity that was hotly anticipated earlier in 2024 has not materialised in much strength – though there have been some green shoots. Several notable deals were announced and completed in H1 2024, with activity driven by strategic acquisitions across the US and Europe. This included an increase in mega-deals ($10bn or larger), particularly in the US, which contributed to attractive merger spreads. Deals have been across various sectors, with Tech and Healthcare standing out.

All in all, we are mindful that deal volumes are still relatively soft compared to the broader history, and the supposed recovery is from a very low base. We believe it will still be a few months before transactions significantly increase and so, performance expectations for Event Driven strategies remain muted for those market neutral approaches more dependent on deal flow. Interesting opportunities have expanded beyond the traditional Merger Arbitrage strategies given the subdued deal flow, and there is diversification of managers into Special Situation, Credit Arbitrage, Distressed investing, for example. Multi-strategy Event Driven funds are currently preferred given their ability to pivot between sub-strategies depending on the most compelling deal opportunities, rather than concentrating on just one strategy.

Relative Value

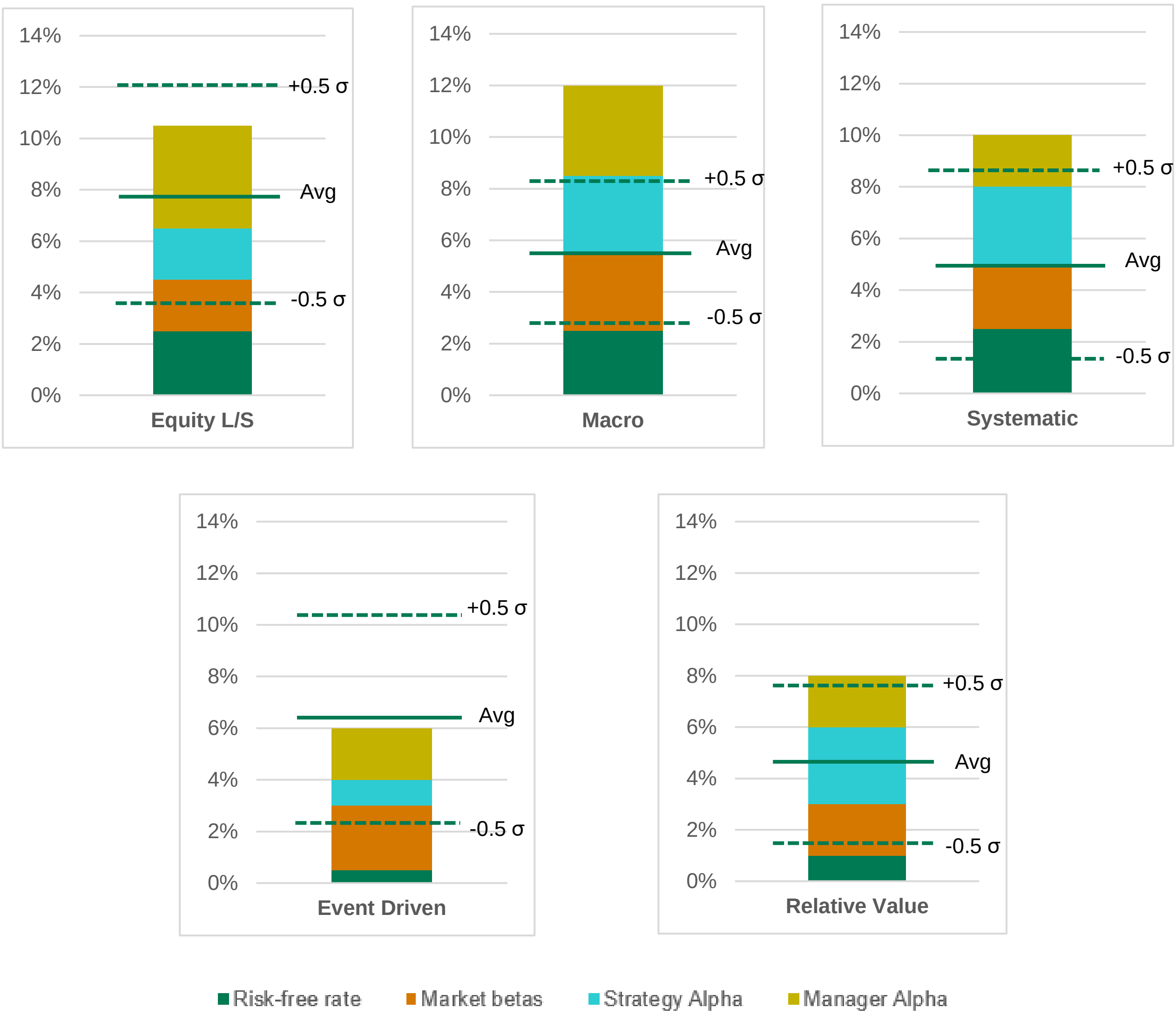
Relative Value managers are expected to perform in line with long term averages in 2024. Given the current elevated interest rate environment and volatility across different corporate and structured credit instruments, there are many attractive RV trading opportunities. Over the next 2-6 months, we expect Convertible Arbitrage strategies to benefit from high issuance (already evidenced by strong numbers in Q1) and Credit Long/Short managers should continue to profit from dispersion and high rates of carry as they did through 2023.

In the medium to long term, we anticipate returns around 7-9% (net) across RV strategies, mostly driven by strategy alpha in the form of deep fundamental analysis and specialist knowledge. Rates-focused fixed income arbitrage managers can take advantage from tug-of-war between quantitative tightening and fiscal spending, and central banks globally moving in different directions will keep interest rate volatility structurally higher. That said, we remain cautious about potential crowding in this space as capital floods into multi-strategy funds, and specifically this strategy. Again, Convertible Arbitrage stands out as a strategy we anticipate above average returns due to high expected issuance, especially as the notional amount of debt coming due is significantly greater than historical averages. Some corporate issuers are expected to finance themselves via converts rather than conventional high yield bonds due to the cost savings available, as high as 250-300bps. Corporate credit remains an area of interest, as noted above with high carry and decent dispersion between companies which can survive in a higher interest rate environment and those that can't. We believe dynamic positioning in all weather-type strategies will likely be most effective in uncertain market conditions. An area which may see a resurgence in the coming year could be asset-backed securities. The impact of higher rates is starting to be seen across the US consumer with higher delinquencies in both consumer asset-backed assets and certain commercial mortgage-backed securities, and greater volatility in mortgage-backed securities. These worsening metrics will present interesting, high yielding opportunities to the specialist funds with deep granular understanding of the space.

Appendix 1: AIS Medium Term Strategy Expected Returns

The below chart illustrate our teams' expected return for each of the main hedge fund strategies. This forward looking target is measured against the 5 year historic return of the strategy with +-0.5 standard deviation range. We look to decompose the performance of alternative strategies in a similar way as you can decompose equity returns. The valuation of equities can be decomposed between changes in multiples, projected earnings growth and dividend yields. Similarly, alternative strategies can be split between Pure Alpha, where you find managers with high barriers to entry, Strategy Alpha, which include models and strategies which provide added value and the last piece is composed of Market Beta, depending on the exposure to equities or bonds that the strategy provides. Over time these components can expand or decrease for various factors identified in our manager research, and therefore has an impact on whether returns are expected to be above or below long term trends.

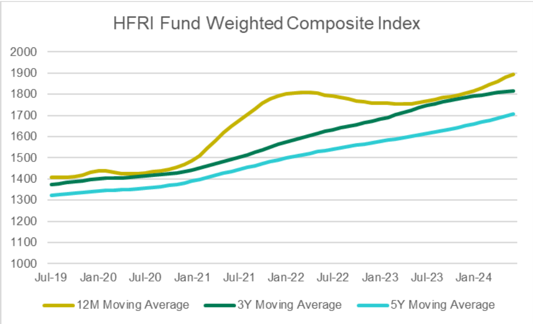
Figure 2: Expected return and volatility range over 12-18 months

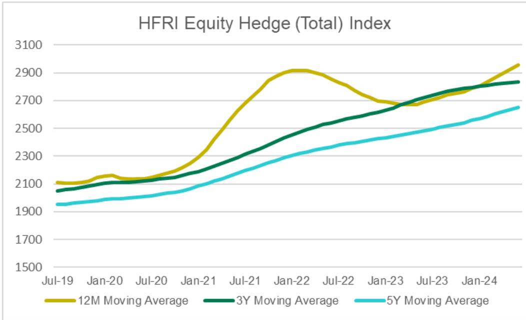


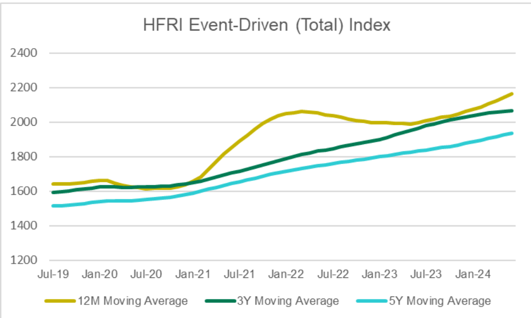
Source: UBP: Target returns are targets only and may not be achieved. The potential for profit is accompanied by the possibility of loss. Unexpected factors may dominate the market at certain periods and adverse market conditions may limit investment opportunities. Avg= 5 year annualised return; +0.5 σ= 5 year annualised return +0.5 standard deviation; -0.5 σ= 5 year annualised return -0.5 standard deviation;

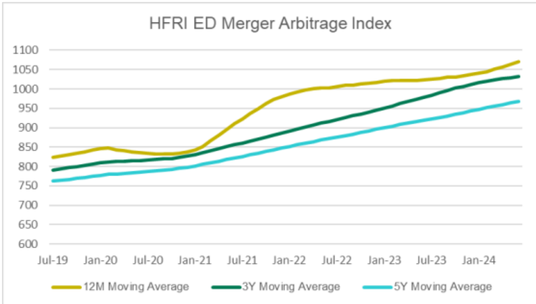
Appendix 2: Long-term Performance of Hedge Fund Strategies

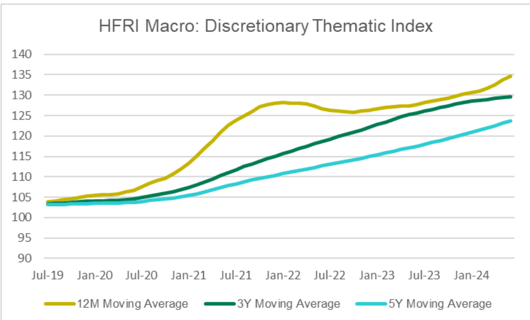
Performance is measured by moving averages of the HFR strategy indices. The interesting point for an investor is identifying inflection points, especially strategies which have been underperforming for a sustained period of time, that potentially demonstrate some bottoming out. We, as an investment team, then look to identify the fundamentals that drive total return and whether this performance pattern is supported. If so, it triggers a review of the peer group.

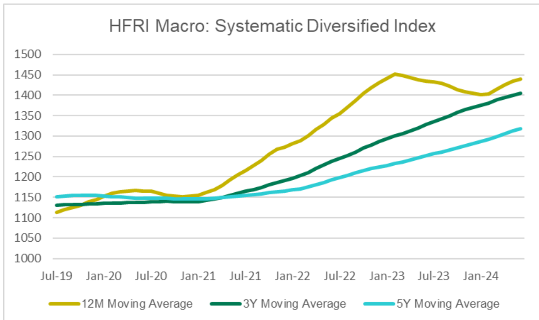


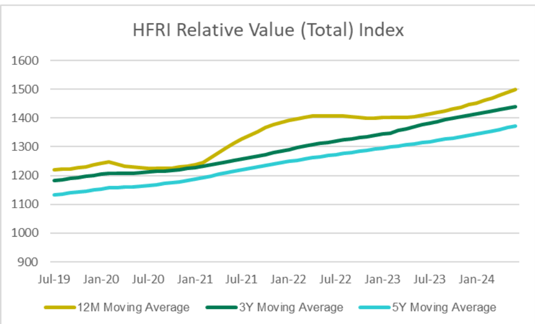


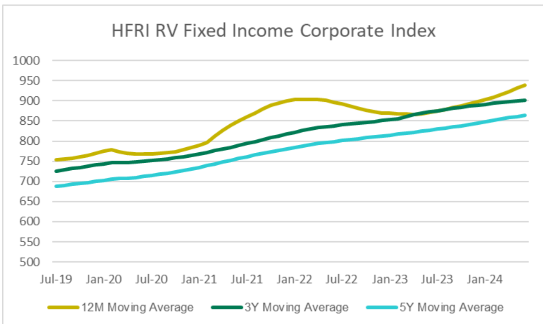


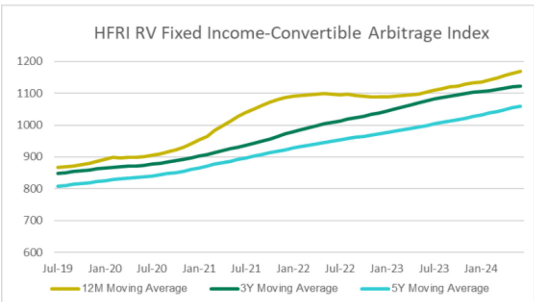












Source: Hedge Fund Research, Inc

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