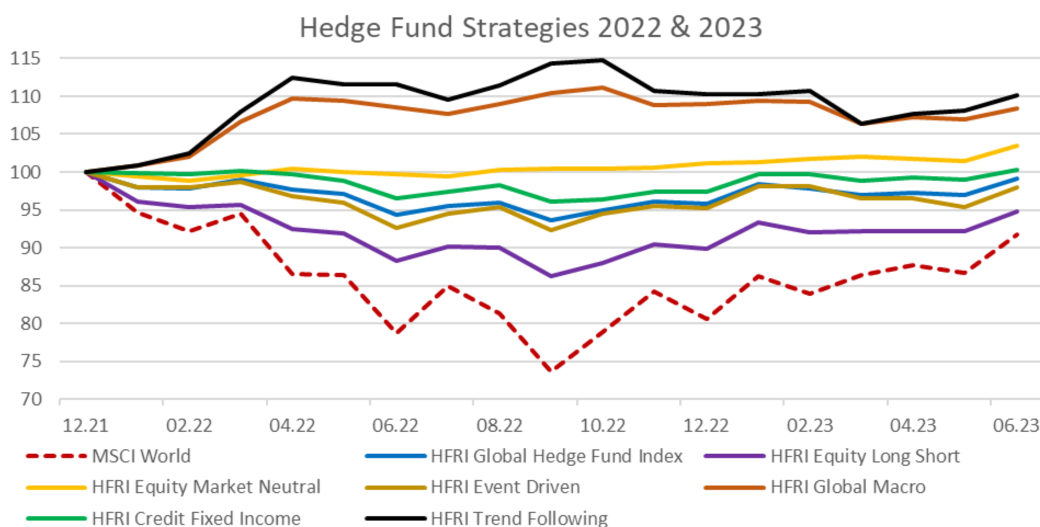
Hedge Funds Review & Outlook

1 Hedge Fund Outlook H2 2023, Performance Charts & Tables

Global equity and bond markets closed the first months of the year on a positive note. A real trend reversal could be observed: Asset classes which were severely punished last year returned above average so far in 2023 (e.g., growth stocks). The broad Hedge Fund Index was up +3.0% (HFRI Fund Weighted Composite Index as per June 2023), while traditional asset classes such as equities gained +15.4% (MSCI World) or bonds +1.4% (Bloomberg Global-Aggregate TR Index Value Unhedged). However, considering only the period 2023, the result is rather sobering for hedge funds. Looking at the last 18 months, the performance of alternative investments is still well above traditional investments, despite their significant catch-up in 2023. This again illustrates the absolute return concept of hedge funds well: smaller losses during periods of price corrections, keeping pace in the upward path.

Chart 1: Hedge Fund Strategy: A real trend reversal (data as per June 2023)

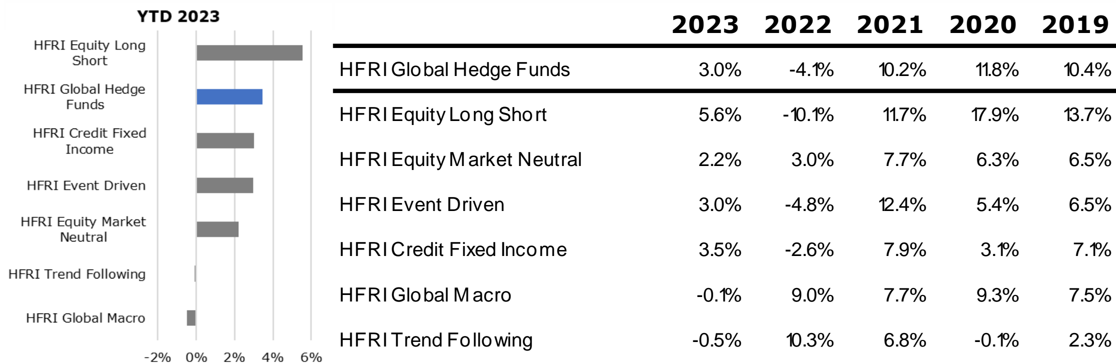


Source: Bloomberg Finance L.P., HFR

The trend reversal in the markets was also evident in hedge fund strategies. Last year's winners (macro and trend following funds) are the current losers and vice versa. Macro and trend following managers could not cope with the striking directional

changes in interest rates and the associated currency fluctuations. On the one hand, strategies with market beta (e.g., "long-biased" equity long short) worked well; on the other hand, strategies in the fixed income area (fixed income long short, arbitrage, relative value) also performed positively.

Chart 2: Performance main strategies (as per June 2023)



	2023	2022	2021	2020	2019
HFRI Global Hedge Funds	3.0%	-4.1%	10.2%	11.8%	10.4%
HFRI Equity Long Short	5.6%	-10.1%	11.7%	17.9%	13.7%
HFRI Equity Market Neutral	2.2%	3.0%	7.7%	6.3%	6.5%
HFRI Event Driven	3.0%	-4.8%	12.4%	5.4%	6.5%
HFRI Credit Fixed Income	3.5%	-2.6%	7.9%	3.1%	7.1%
HFRI Global Macro	-0.1%	9.0%	7.7%	9.3%	7.5%
HFRI Trend Following	-0.5%	10.3%	6.8%	-0.1%	2.3%

Source: Bloomberg Finance L.P., HFR

2 Negative Factors for Hedge Funds in H1 2023

Compared to traditional equity and fixed income markets, hedge funds have lagged somewhat in terms of returns. Several factors can explain this development.

1) Equities (MSCI World) had a phenomenal start into the year with a plus of +7.1% in January. After that, they corrected again, but recovered by May. In June, the market was again boosted with +6.1%. Looking back, most hedge funds were still very conservatively positioned at the beginning of the year. The trend reversal was rapid and pushed index prices up very quickly. In such an environment, qualitative and fundamental facts and analyses count for little, i.e., everything is pushed upwards, regardless of whether the company is in a "good or bad" position. An enormously difficult environment, especially for market-neutral hedge fund strategies, as the short positions are pulled up at a loss (short squeeze).

2) Central banks have indicated that the fight against inflation is bearing fruit and that interest rate hikes may be coming to an end soon (primarily in the USA), and possible recession scenarios have been and are being digested in the market. As a result, there are strong directional changes in interest rates, currencies, but also sector- or style-wise. A very fragile environment, which requires an enormously agile approach. Under these circumstances, fundamentally oriented managers may be right with their

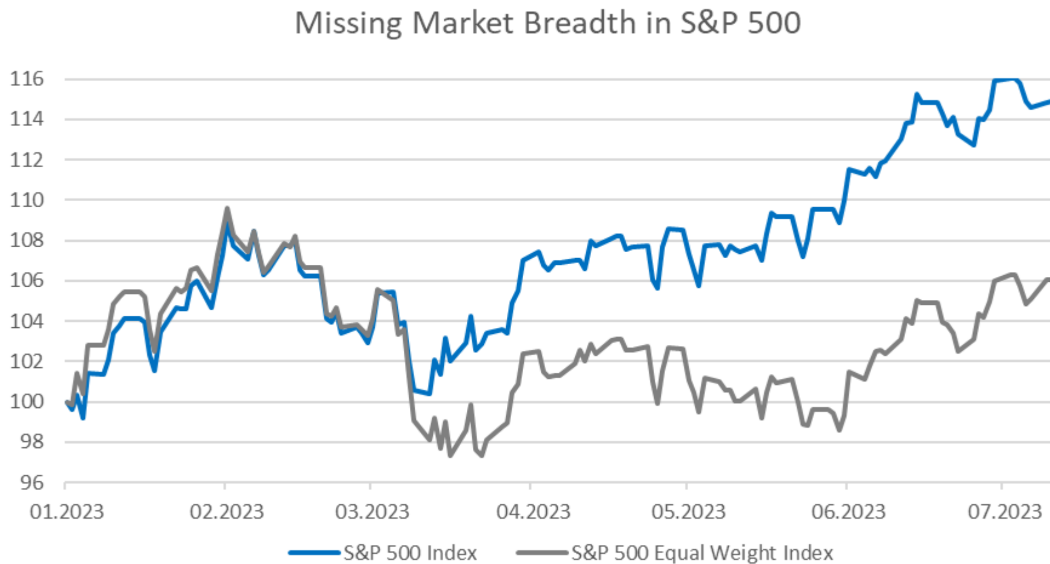
analyses in the long-term, but in the short-term the market turns against them. The rapid changes in direction in a relatively narrow band make profitable positioning difficult.

3) At the strategy level, macro and trend followers showed great difficulty and weighed on the Global Hedge Fund Index. Managers were unable to cope with the marked directional changes in interest rates and the associated currency fluctuations. In 2022, "short duration" was the trade of the decade for macro managers - those days are over, fluctuations in interest rates demand a more agile approach. In addition, some managers held on to shorts in equity markets for too long.

4) Market stress indicators show a mixed picture. A good example is the US equity market volatility index VIX, which fell by an average of about one-third from 26 to 18 in 2023, i.e., it lost volatility, despite the numerous uncertainties in the first half of the year in the United States. The US Treasury volatility index MOVE, however, maintained the high level (from 120 to 126), nearly double as much as it was in the years before.

5) Since March, it has been observed that the large indices (e.g., S&P 500 or European indices) are supported by a small number of stocks - i.e., the generally positive stock market is not broadly based, but is mainly supported by a very small number of large-cap stocks, as illustrated in Chart 3. It shows the S&P 500 and the S&P 500 Equal Weight Index. In the conventional S&P 500, for example, Apple has a weighting of 7.4% - in the Equal Weight Index, however, only 0.2%. Right now, "mega-cap" stocks are trading as if they were "staples" and are considered safe havens. Since March, the cap-weighted index has been moving upwards. This does not bode well for active hedge fund managers - they tend to get involved in smaller and not overvalued names. This is because, under normal circumstances, the information advantage provided by forensic analysis tends to be small for index heavyweights; here, the market is too efficient and alpha that differentiates from the market is harder to materialize.

Chart 3: Market breadth

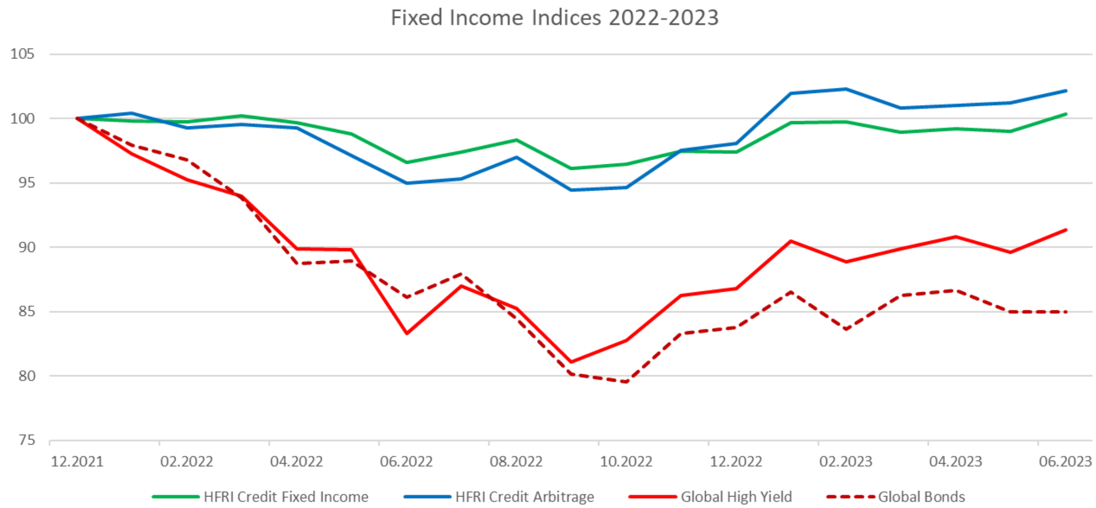


Source: Bloomberg Finance L.P

3 Hedge Fund Focus: Fixed Income Strategies

On the fixed income side, we see great opportunities for success - the new interest rate environment represents a paradigm shift for these strategies. For hedge funds across the whole fixed income space, an opportunity window is now opening that has not been so attractive for a long time. Good quality credits at attractive discounts, and newer bond issues are also benefiting from high coupons. This allows managers on the long book to get paid for waiting. On the short side, companies are coming under increasing pressure because they can no longer refinance themselves reasonably at such high interest rates. Quite a few companies see themselves forced to catch up on their financing needs after a refinancing pause in 2022. Not all are prepared for this, ideal for active hedge funds. Managers in the stressed & distressed space can take advantage of these opportunities. These strategies have been seeing net inflows for the first time since 2014. However, loan defaults and forced restructurings are still at comparatively low levels, and the distressed cycle has not yet begun. This is why flexible managers are needed who can adapt their portfolios agilely. Apart from fixed income long short, opportunities in relative value or arbitrage are very attractive, dislocations are numerous, spreads (credit spreads, capital structures, yield curves, maturities, convertibles, etc.) can be traded profitably and market neutral in this environment. Returns on fixed income strategies have already picked up significantly in recent months, as Chart 4 below illustrates.

Chart 4: Fixed income indices



Source: Bloomberg Finance L.P., HFR

4 Outlook: Hedge Fund Strategies

The macroeconomic picture remains uncertain, and central banks are hoping for a soft landing. Their inflation-fighting measures are creating winners and losers. A good environment for hedge funds to trade long, short or via relative value and arbitrage strategies - decoupled from market direction – whether on the equity or bond side.

	Underweight		Neutral	Overweight	
	heavily	slightly		slightly	heavily
HFRI Global Hedge Funds				■	
HFRI Equity Long Short				■	
HFRI Equity Market Neutral			■		
HFRI Event Driven				■	
HFRI Credit Fixed Income					■
HFRI Global Macro			■ ←		
HFRI Trend Following		■			

Source: Alpinum IM

Hedge funds will retain their purpose as a diversifying and stabilizing component in the portfolio. The focus, as in the first half of 2023, will be on trading-oriented and exceedingly agile managers. In the absence of very clear trends, the portfolio will have to be managed enormously active.

On the strategy side, Alpinum favours allocations to credit fixed income. As explained above, the environment following the significant interest rate hikes by the national

banks offers a wide range of opportunities. The equity long-short managers could also find their way back into the market in the second half of the year. The previously described market anomalies (lack of market depth, mediocre volatility levels) suggest that fundamental analysis may be in demand again sooner rather than later, in which case both sides of the ledger will materialize positively, long and short. We continue to hold the event driven strategy slightly overweighted, the announced mergers are numerous, the merger spreads attractive after some burst takeovers.

Our assumption on macro managers remains neutral. There are no «free lunch» trades this year (short duration), but we currently prefer managers with expertise in emerging markets. We are also neutral on trend followers. While we don't deny the portfolio protection qualities in stress phases of some managers in this strategy, the painful ups and downs in market indices, interest rates and currencies could continue and burden trend followers.

We recommend that hedge fund investors focus on broad diversification, especially in this challenging environment. However, active management and maximum proximity to the manager remain important. With access to non-traditional sources of return with low correlation to equities and fixed income markets, alternative investments will continue to serve as a valuable stabilizer in your portfolio as 2023 progresses.

Equity Long Short: Positive environment

The macro-driven markets are now providing an ideal environment for active equity long short managers, with winners and losers crystallizing among companies due to the higher interest rate environment. After the big losses in the equity markets last year, the "catch-up" took place within a few months (pronounced in January and June). These, for fundamental-oriented managers, challenging phases may be over, which is why they can profitably exploit their selection qualities again. We expect increased dispersion, accompanied by trend changes, which will provide a benign environment for trading-oriented managers who can profit on both sides, long and short.

«Long biased» Long Short Strategies strongly depend on the performance of the equity markets. New sector and style trends could manifest in H2 2023 (cyclicals), where "long biased" specialists could benefit after a difficult 2022. By nature, an investor should be able to sustain larger fluctuations in these strategies.

Equity Market Neutral: Neutral outlook

Many market neutral managers or even large multi-PM funds struggled in H1 2023. On the one hand, they suffered from heavy index rotations, on the other hand, as previously described, the strong half-year performance in equity markets was pushed by only a few mega-caps and not by the broader market. We keep the outlook for the strategy at neutral.

Event Driven (Merger Arbitrage): Attractive environment for merger arbitrage and special situations strategies

In recent months, several prominent deals (e.g., Horizon/Amgen) bust, causing merger spreads to widen sharply overall. The coming months now offer attractive opportunities for active managers. For investors in event driven strategies, the opportunity to profit from uncorrelated returns unveils. "Special situations managers" are benefiting from corporate restructuring and increasing asset sales to reduce debt on the balance sheet. Firms are feeling the burden of investor pressure for a merger, as the need to increase cost efficiencies in a "low growth" and inflationary environment rises.

Credit Fixed Income: Very positive environment

The completely new interest rate environment led to a total paradigm shift. For hedge funds across the fixed income space, a large window of opportunity has opened that has not been seen for a long time. On the long side, good quality credits at attractive levels, including high coupons, are tempting. Should the market nevertheless become difficult, the high yields will compensate for part of possible losses (yield buffer). The refinancing of many companies becomes difficult at high interest rates - again interesting for the short side. This creates large dispersion in the market, which is exploited by active hedge funds. Apart from fixed income long short, opportunities in relative value or arbitrage remain very attractive.

Global Macro: Neutral assessment

Global Macro can still serve as a helpful diversification in a portfolio. The ideal market environment with large movements in all asset classes cannot be found anymore ("once in a decade short duration trade"). We note that managers with specific know-how on the currency side or expertise in emerging markets were able to post gains in 2023. We continue to favour discretionary managers in this area.

Trend Following: Slight underweight

We maintain a slight underweight of trend followers. The strong movements in the equity, bond, interest rate, commodity and currency markets, as in 2022, are no longer consistent. In some asset classes and indices, volatility levels are at comparatively low levels.