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Alternative View
November 2017

For professional investors only

Pictet Alternative Advisors

THE MARKET CAN REMAIN IRRATIONAL ... BEFORE HISTORY RHYMES

A blend of two quotes… "The market can remain irrational longer than you can remain solvent" by John Maynard Keynes, and "History doesn't repeat itself but it often rhymes" attributed to Mark Twain. After all, explaining the state of the markets today can't be summed up in a one-liner.

The current bull market has so far been the second longest in history but might just be on track to become the longest one. Who knows? While valuations are reaching new highs and the probabilities for strong returns are growing slimmer, the cost of being un-invested or underinvested is too great to ignore.

What options do we have for navigating in the current environment?

Experience points to three steps:

› *Understand the risks.* Be aware of the downside of your investments (and the lack of upside). Don't forget about asset and liability management. Be conscious of left tails, and remember that leverage combined with illiquidity can be a deadly proposition. Diversify your investments and be contrarian. Some strategies have fallen out of favour; you may want to reconsider them.

› *Build a margin of safety.* Understand how value is created. When the market is unlikely to bail you out, invest in strategies where skills such as operational expertise have been the major source of performance. Look for new niches – they may be as large as China!

› *Work harder.* There are no free lunches and hope is not a strategy.

Finally, be realistic about your expectations and continue to invest; cash is not an option!

Nicolas Campiche
CEO Pictet Alternative Advisors

HEDGE FUNDS

A NEW DAWN FOR HEDGE FUNDS?

While passive allocations keep rising, hedge funds have reinvented themselves. As yield curves steepen, a regime change may be around the corner. There is no instruction manual on how to navigate this transitional period, but what we do know is that alpha does exist, cannot be replicated, and a robust manager selection process is crucial in its production.

Our approach to hedge fund investing is built on a set of strong beliefs regarding the way in which we may best serve our clients' needs. These convictions include the following:

Skillful persistent active management exists

From a longer-term perspective, the current trend toward passive or semi-passive alternative beta contains the (eventual) seeds of its own destruction at an aggregate market level. A market dominated by passive participants yields an unstable equilibrium where the reward to being amongst the (smaller) pool of contrarian fundamental investors becomes greater over time.

In addition, the current market regime - in which monetary easing has supressed volatility across asset classes and pushed up valuations over the last 10 years – has exacerbated underlying economic distortions and masked substantial deviations from fundamental intrinsic value, often leading to broad capital misallocation. Passive indices provide no corrective mechanism, simply mirroring the current market.

> *"A market dominated by passive participants yields an unstable equilibrium where the reward to being amongst the pool of contrarian fund-amental investors becomes greater over time"*

Manager selection adds value

Identifying managers that outperform and, especially, those that underperform (including frauds or those with tail risk) is possible. When it comes to hedge funds, the idiosyncratic nature of (high quality) individual hedge funds means that they are the exception to the general rule that 'asset allocation beats stock selection' in explaining the bulk of an alternative portfolio's performance. Said more quantitatively, the spread between hedge fund managers within a strategy is greater than that between strategies.

Certain hedge fund strategies cannot be replicated

Although some strategies clearly can be replicated in aggregate, many strategies cannot be replicated through alternative ETFs or risk premia strategies in practice ex-ante. In fact, efforts at replication remove precisely the idiosyncratic element of hedge funds' performance which is the core of the value-added.

PRIVATE EQUITY

CHINA HARD TO IGNORE IN PRIVATE EQUITY

In the past, despite sustained economic regional growth, Asian private equity funds have not typically outperformed their European or North American peers – returns have often suffered higher volatility and the pace of distributions has generally lagged while teams themselves faced frequent churn. Today, however, it is hard to ignore Asia's largest player, China.

In today's China, a more local brand of private equity is thriving and venture capital is playing an important part. Some key takeaways:

› China is rapidly shedding its reputation as the poster child for copy-pasting; real Chinese innovation has prevailed. In particular, this innovation can be seen in the mobile technology space, which is redesigning the way many industries work. TMT has been a catalyst for transformation in other sectors as a flourishing, relatively unregulated part of the economy.

› In contrast to the US, where most mobile technology has provided an important complement to highly developed industries, in China it provides an alternative to traditional retail and consumer industries. A payment, fintech, and logistics ecosystem has developed around mobile so that in most major Chinese cities, a smartphone can provide virtually all staple needs (food, clothes, housing, and transport) to entertainment, travel or luxury goods.

› Healthcare is also a sector poised for growth thanks to China's aging population and higher disposable incomes.

What is there to bear in mind amidst all this excitement? For one thing, herding of capital around de rigeur investment themes as abundant funds pour into Healthcare and TMT sectors, hiking asset valuations. Concern about distribution multiples also remains a pressing topic, although distributions seem to be on a trajectory of catching up with capital calls since 2013. Ultimately, investors would be wise to remain disciplined in their selection process, maintaining a clear focus on managers both keen and able to deliver distributions on investments.

"China is rapidly shedding its reputation as the poster child for copy-pasting; real Chinese innovation has prevailed - in particular in the mobile technology space"

REAL ESTATE

MEGATRENDS AND NICHE OPPORTUNITIES

While investor demand for property remains strong as an asset class, global uncertainty, the risk of rising interest rates and general economic headwinds could be beginning to suppress investors' demand for real estate. To date, easy money may be one reason market multiples have been so high and volatility is so low, but as this trend reverses how will interest rates influence core investments?

On the whole, one might expect real estate and other real assets to gain in popularity thanks to what is often touted as these asset classes' inflation protection properties. But then where to focus?

Unsurprisingly, the risk-off sentiment has fixed investor focus on prime properties and perceived quality income. However, this sort of "core" real estate, i.e. working properties with vacancy rates below 10% or with long-term leases, is for the moment hard for many investors to stomach. If making it past the intense competition to secure an attractive vanilla "core" opportunity were not enough to deal with, core properties today are often unequivocally expensive with a potentially disproportionate exposure to geopolitical and macro/ economic risk.

Strategically for investors, one potential solution to this conundrum may therefore be to focus their investment activities on assets set to benefit from key transformational trends reshaping the property markets. These are segments in which we are seeing relative amounts of volatility today – volatility which may be exploited provided access to the relevant skills. These so-called "megatrends" include urbanization; demographic shifts; ecommerce and disruptive technologies that are changing the way properties are used or constructed. Megatrends have encouraged the emergence of niche real estate segments. Urbanization has encouraged the emergence of coworking/ co-living spaces and student housing; demographics in developed markets are spurring senior housing opportunities; and the increasing penetration of e-commerce is reshaping our high streets and logistics hubs. All these trends are calling out for new developments or remodelling in these sectors.

Tactically, investors may also wish to leverage structural imbalances in the market. For example, the continued lack of available financing has driven the emergence of alternative lenders. Investing in the debt side of a property's capital structure may, within today's context, be a useful way to achieve core-esque returns of yore but without the price tag and risk accompanying core assets today. In the US and Northern Europe where transparent legal jurisdictions favour creditors, the comfort of an equity cushion and regular income in the form of coupons may provide a potential substitute for standard core opportunities. The caveat? The requirement of carefully vetted expert skillsets to both evaluate and structure debt as well as to price and manage real estate assets.

Pictet Alternative Advisors (PAA) is a leading European alternative investment specialist with expertise in manager selection and portfolio management in liquid alternatives, private equity and real estate. PAA is an independent unit of the Pictet Group. Founded in 1991, we currently manage over USD 20 billion and our team is composed of more than 50 people.

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