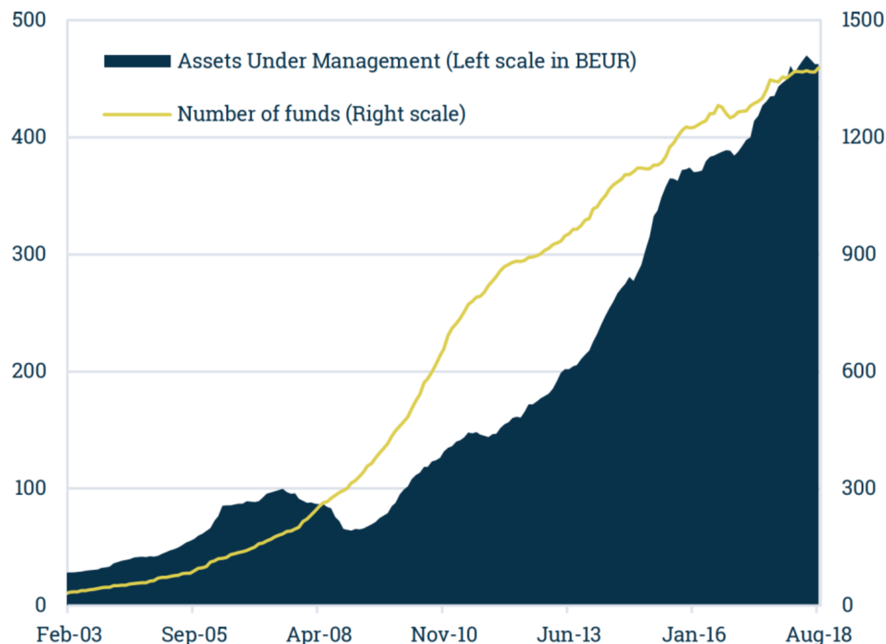
Ayaltis INSIGHT – April 2019

Topic of the Month: Liquid Alternatives

Liquid Alternatives or Alternative UCITS are a segment of growth in the hedge funds area that have gained popularity in the last few years. It's time to assess this area of the hedge fund industry with an expert. We talked to Andrea Luzzi, Chief Risk Officer at Ayaltis.

Chart 1: Evolution of UCITS funds



Source: LuxHedge

What has led to the strong growth on the Liquid Alternatives side?

I believe that the main aspect has been the transformation of "Risk Management" into a commodity. Investors are desperately looking for solutions which may give them a "false" sense of security. Liquidity, regulatory supervision, Value-At-Risk, leverage limits, diversification and price stability are the Holy Grail for all types of investors, both professional and retail.

Not only did regulated Liquid Alternative strategies gain traction, but also strategies where valuation is more of an "art than science", such as; private debt, private equity and real estate.

Most of the "magic words" I just mentioned are in fact false idols.

Francis Bacon, in his most famous work, Novum Organum, classified 4 types of idols and they apply quite well to the way some investors look at risk.

Chart 2: Francis Bacon "Four Idols"

Source: PiktoCharts

<u>Idol of the Tribe:</u> Human beings grow with the false impression that the true nature of things comes from how we perceive them. A false mirror separates the measure of the universe and our perception of objects. Plato came to a similar conclusion. If we apply this observation to our world and to our mental process of making investment decisions, we immediately realize that we overestimate or underestimate risks filtering the light rays with our false (sometimes broken) mirror. That's why people fear daily marked-to-market while rarely-valued investments are dramatically over-weighted. The massive inflows in private equity and private debt are a clear sign that the first idol is at work.

<u>Idol of the Cave:</u> Man's decisions are usually driven by passions and emotions. Therefore, a man's decision process is frequently perturbated, if not obstructed, by his peculiar nature. Likewise, people tend to enter and exit investments at the wrong time: excited by bubbles and scared by sell-offs.

<u>Idol of the Marketplace:</u> People use words to mislead other people. Words can be taken out of context. Volatility is used as the main measure of risk, but does it really represent the actual risk run by an investment? The misuse of poor risk measures forces investors into concave strategies, prone to big losses and fat-tail events.

<u>Idol of the Theater:</u> Dogma and abused rules-of-thumb make investors believe in laws that no longer apply. Keeping an open mind and being keen to review an investment process, even against the old well-known and apparently safe trading style, is a paramount requirement.

Everybody should keep these four idols in mind when it comes to making an investment decision. Good liquidity terms, highly-regulated frameworks or absence of marked-to-market, cannot replace either risk management or sound investment processes.

In what respect does the universe of hedge funds differ from the Liquid Alternatives space?

At the beginning, UCITS funds tended to have a significant European bias as UCITS funds are born and designed for the European market. But in the last few years, more and more US managers launched UCITS structures to gain attraction from EU-investors and diversify their investor base.

On the hedge fund side (offshore) investors have access to a large variety of strategies, which are extremely difficult to replicate in a liquid alternative format. Besides, the best hedge funds managers have no interest in relaxing the purse strings. On the contrary, some of them have made the decision to move on without external investors, preserving the rich golden mine they found for themselves.

The Liquid Alternative space provides investors access to certain types of hedge funds strategies, focussed on liquid assets. The challenge for a fund manager selector is to avoid getting trapped into low quality hedge fund managers, repackaged in UCITS format. To separate the wheat from the chaff in Liquid Alternatives is more challenging than ever, due to the narrower range of opportunity sets that can be exported from the UCITS universe.

An important point to be prudent: When illiquid strategies get repackaged in liquid formats, we must become more cautious. The recent appearance of CLO-focused UCITS troubles me. The financial industry is always keen to refurbish unsellable assets and put them in new boxes, with shiny and colourful labels. The real nature of the objects inside does not change but investors are attracted by the light of stable returns in liquid format, like mosquitos that fly around lamps in a dim night.

When asking investors what defines a hedge fund, one of their instant replies is likely "They can go short." Apparently Liquid Alternative funds can also go short. Could you provide us with some colour on where the differences are in shorting?

"Hedge fund" is a term abused by many commentators. Anything that invests in the market with a non-long-only approach is today considered to be a hedge fund. The world, as always, has many shades of grey.

Shorting financial assets is a way of expressing market views that is available to traditional hedge funds and Liquid Alternatives, although the latter have to find ways to circumvent the hurdles imposed by inconsistent legislations. UCITS can go short, although in certain circumstances they have no access to the most efficient assets available to offshore funds. Within the alternative UCITS framework covered short selling is not permitted. However, it is allowed to express views

through synthetic shorting via the use of derivatives. Instruments used are swaps, options, stock futures and CFDs (contract for difference). A contract for difference (CFD) is an agreement between two parties – the investor and the CFD provider – to pay each other the change in the price of an underlying asset. The recent clarifications by the European authorities open a new frontier for Alternative UCITS and their ways of replicating typical "hedge fund" techniques. "Shorting" is certainly one of them.

The goal of the UCITS initiative was to create a "safer" place for investors. Are investors on the UCITS side safer and happier after all?

The introduction of the UCITS structure for certain hedge funds strategies, proves that the regulator acknowledges the importance of active asset management such as hedge funds and the importance of regulatory protection and accessibility for EU investors. But what do we mean with the term "safer"? UCITS are certainly less exposed to certain bad surprises on the operational side of the asset management business. Investors may never sleep in peace, but at least some of their worst nightmares are averted. Operational risk, administrative risk, valuation risk and every risk not directly related to the trading activity are more and more under control and somehow curtailed. This is a massive result that helped the creation of a safer investment space.

However, the recent disappointing results, especially in 2018, in terms of performance, of the UCITS sector are not making investors happier. In a world of low interest rates and fewer opportunities, manager selection is more important than ever.

Has due diligence on hedge funds become any easier when selecting from alternative UCITS?

Partially. On the other hand, the hunt for liquidity has increased the risk of a mismatch between very loose prospectus terms and the actual liquidity of the underlying assets. For this reason, every UCITS-compliant investment cannot only rely on the Regulator capacity of monitoring risks. The recent failure of GAM UCITS fund is a perfect example of the insufficient protection offered to investors by the regulators.

Liquidity risk is a sneaky enemy: it seems under control until it is not, and it does not quite matter how many layers of compliance and risk management are set up. Like the burning ashes underneath, liquidity droughts (driven by redemptions or market sell-offs) are still a serious concern.

What are the reasons for the differences in performance between offshore/main vehicles and UCITS funds which apply the same strategy?

There are various factors explaining the performance difference of offshore versus UCITS vehicles. For the most diversified strategies, the differences are minimal. For more concentrated

portfolios, the manager has to apply a risk management overlay to be compliant with the UCITS diversification factor, which forces the manager to trim large positions. As a second aspect, the limitation of shorting and the usage of leverage explain most of the performance difference. In short, if you limit the degree of freedom in hedge funds investment management, the price is the uncorrelated performance.

What are the paramount pillars of success when composing a fund-of-funds in the alternative UCITS space?

UCITS is a way for certain investor to have access into liquid alternatives. The growth has been enormous in UCITS hedge funds space with various of platforms and strategies increasing the heterogeneity of attractive hedge funds and UCITS hedge funds strategies. In addition, the performance dispersion within the UCITS hedge funds space is wide, as we have seen in 2018. This offers a value proposition for UCITS fund-of-hedge funds which may give investors the opportunity to access the hedge fund market without having to give up their needs for liquidity and diversification.

I am convinced that the alternative UCITS space still requires a high level of discipline and market insight. The attractive liquidity terms of the investments and the sound regulatory framework give a vague sense of complacency to investors. A fund-of-funds will move a simple portfolio of UCITS funds close to the efficient frontier, by dynamically selecting only managers of high quality and by tactically adjusting the allocations to market conditions.

Thank you for taking the time to share your thoughts with us.

Thoughts and News

Hedge Funds Performance in Q1 2019

Hedge funds performance has followed a clear trend so far in 2019, which remained prevalent throughout both, January and February 2019: Equity focussed took the lead and emerging markets fund came in second. The strong risk-on mood is reflected in these results. At the other end of the spectrum, macro hedge funds also returned positive results over the same time period, but to a lesser degree.

Chart 3: HFRI Indices Overview 2019

Jan-19	HFRI Equity Hedge 5.16%	HFRI Emerging Markets 4.25%	HFRI Fund Weighted Comp. 3.50%	HFRI Event-Driven 3.19%	HFRI FoF Comp. 2.56%	HFRI Relative Value 2.45%	HFRI Macro 0.28%
Feb-19	HFRI Equity Hedge 1.94%	HFRI Emerging Markets 1.89%	HFRI Fund Weighted Comp. 1.37%	HFRI Event-Driven 1.28%	HFRI FoF Comp. 1.12%	HFRI Relative Value 0.93%	HFRI Macro 0.32%

Source: HFR, Ayaltis Proprietary Database

Merger & Acquisitions: Is Asset Management Next in Line?

Overall the M&A space had a rather difficult start going in to 2019. In general, the end of cycle proves to be not the easiest territory for this space. In addition, political and economic uncertainties weigh on the segment. But increasing activism, too, has made a difference. While mega deals seem to slow down, it looks like the asset management space is just ramping up on the M&A side. In an interview with the Financial Times, Invesco CEO Martin Flanagan mentioned that one third of the asset management industry might disappear in the next five years. While "disappear" seems to be an odd choice of words, changes appear to come up on the horizon: Only recently Brookfield Asset Management announced the acquisition of a controlling stake in Oaktree Capital, a renowned hedge fund manager in the distressed and high yield space.

Read on at:

https://www.ft.com/content/c4ff2a92-4508-11e9-a965-23d669740bfb

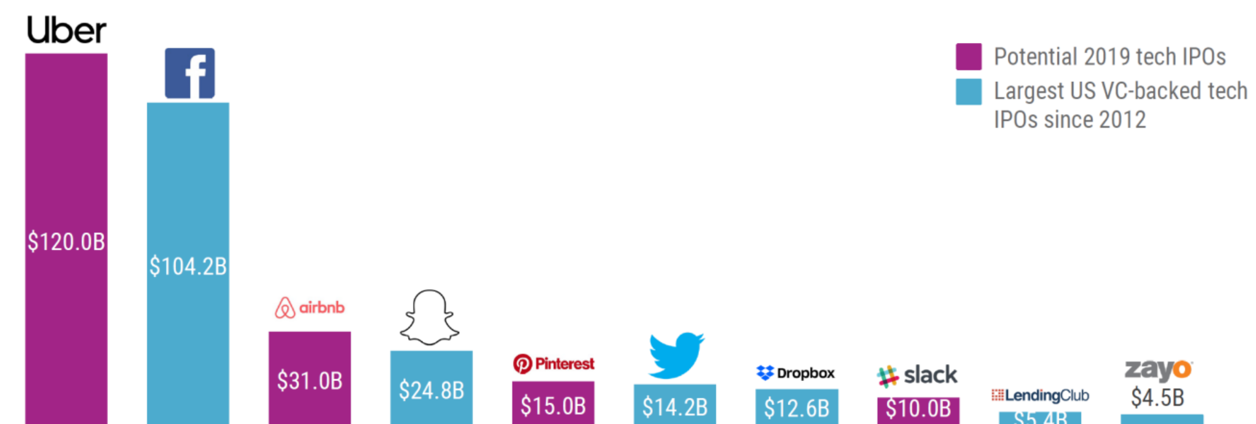
https://www.bloomberg.com/news/articles/2019-03-13/brookfield-to-buy-62-of-oaktree-capital-management-jt78y0i7

https://www.wsj.com/articles/brookfield-asset-management-to-buy-62-of-oaktree-capital-11552488375

IPO comeback?

It may well be the year of IPOs among tech companies. Lyft, the ride hailing company, decided to go first and started trading on the exchange last week. Uber, the main player in the segment, is expected to follow shortly thereafter. However, Uber has faced a decline in bookings in the last quarter. If you had bought Spotify during its IPO in 2018 and missed selling it, you would now hold it at a loss. But not only tech related companies are lining up for IPOs. Levi's returned to the stock exchange. Virgin Trains USA also intended to go for an IPO, started the roadshow and then unexpectedly halted plans as they were able to raise funds on the private side. Well, maybe investor appetite was not quite there? Or is private funding a cheaper way to finance?

Chart 4: Potential Tech IPOs Versus Realised Tech IPOs



Source: CB Insights

Read on at

https://www.businessinsider.com/tech-startups-going-public-2019-rumored-ipos-2019-2?r=US&IR=T

https://www.cnbc.com/2019/02/04/a-giant-ipo-wave-is-coming-as-unicorns-whet-investor-appetite.html

Credit Default Swaps: Need for Reforms

Despite the overall decrease in CDS volume, credit default swaps have remained a popular hedging instrument. But they are not unimpeachable. So called "manufactured defaults", where companies are offered a perk in their financing if they breach one of their covenants and therefore

trigger a payment. You might have come across headlines related to the US housebuilder Hovnanian in this respect. Now Wall Street is finally ready to take action to stop this abuse.

Read on at

https://www.bloomberg.com/news/articles/2019-03-05/wall-street-titans-said-to-cut-deal-to-clean-up-shady-cds-trades

https://www.ft.com/content/efab718a-40c9-11e9-b896-fe36ec32aece

Hedge Fund Manager Wisdom

In case you would like to take a different perspective on hedge fund managers and learn from their experience, you should consider reading Ray Dalio's book "Principles". The founder of Bridgewater decided to share with us what worked best for him in terms of decision making. It's a very interesting read. In case you want to take the short cut, Ray Dalio also published a 30-minute YouTube video, for those who would rather absorb wisdom in an animated fashion. Should you have a little more time, there is a 90-minute Google talk available.

Take a look at:

https://www.youtube.com/watch?v=B9XGUpQZY38

https://www.youtube.com/watch?v=c1OoWdqbKdg

Digging Deeper: Hedge Fund Index Construction

Sometimes things that are supposed to make your everyday life a little more comfortable, end up making your life more complicated. Wasn't life easy, when there was only one remote control for the TV? But "Things have changed on Waltson's Mountain".

This theme is perfectly applicable for the financial world in many aspects. Indices were invented to facilitate analysis and to act as a reference point for investors. If the universe of indices rapidly expands, finding a reference point becomes trickier than ever. Therefore, we like to take the opportunity to highlight the difference and similarities among hedge fund indices.

First of all, hedge fund indices face issues, which do not apply to equity indices. To start with, hedge fund indices can only track hedge funds, which continuously report to them. Hedge funds are not forced to report, it remains at the hedge fund's discretion to do so or not. Some hedge funds may not feel the need to provide their performance numbers to a database anymore (e.g. closed funds). Others cease to exist and cannot report anymore. The latter is referred to as "survivorship bias". Depending on their construction hedge fund indices may suffer a "retroactivity bias". This means, when a new fund is included into an index, the historical data of the index is changed as the performance history of the new component is also now reflected in the index. Moreover, index construction differentiates between asset weighted and equal weighted indices.

Chart 5: HFR Indices Comparison I

Index	Performance 2018
HFRI Asset Weighted Composite Index	-0.67%
HFRI Fund Weighted Composite Index	-4.64%

Source: HFR

Let's take a look at a real-life example: In 2018, the HFRI fund weighted composite index returned -4.74% while the HFRI asset weighted composite index posted a return of -0.67% over the same period. The constituents of the two indices are the same. This leads to the conclusion that at least certain hedge funds, which are bigger in size, contributed more than funds smaller in size. Looking at the performance on a monthly basis, it turns out that October 2018 and December 2018 were the two months, where divergence was most significant. If you look at 2016 and 2017 the fund weighted index actually outperformed the asset weighted one.

One of the most noticeable difference in hedge fund indices is the split between investable and non-investable benchmarks. In this respect "investable" refers to the components of the index being open to investors. Whereas non-investable indices account for open as well as closed funds. As a result, the non-investable indices reflect a wider spectrum of the hedge fund industry and is less prone to suffer from database biases.

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Chart 6: HFR Indices Comparison II

Index	Performance 2018
HFRI Asset Weighted Composite Index	-0.67%
HFRX Global Hedge Fund Index	-6.72%

Source: HFR, Ayaltis Proprietary Database

Looking at the HFR database, the non-investable index family is referred to as HFRI (yes, the "I" at the end is a trap) whereas the investable index family is called HFRX. The "flagship" index on the investable side is the HFRX Global Hedge Fund Index (asset weighted). It returned -6.72% in 2018 compare to -0.67% of the HFRI Asset Weighted Composite Index. A major discrepancy! Therefore, closed funds must have been a significant return driver for the HFRI asset weighted index. From a monthly return perspective, the investable index also materially lagged in October 2018 and December 2018, but also reported minor negative performance in June 2018 and July 2018 while the non-investable counterpart was able to show low positive performance figures.

To make things worse, we could also investigate the HFRI Fund of Funds index, which is definitely subject to certain degree double counting on the level of constituents of the fund-of-funds, or the strategy weighted HFR index.

"Mea culpa".

Probably we failed in our attempt to provide clarity and have to conclude that there is more than one truth when it comes to a benchmark for hedge fund performance. It depends on which angle you prefer to take. No matter which one you believe is best for you, remember to be aware of its benefits and its drawbacks.

We are looking forward to your feedback. Please feel free to share your ideas with us and continue the dialogue.

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