Perspectives

JAN 2019

2019 Market Preview: Hedge Funds

IS MARKET VOLATILITY HERE TO STAY?

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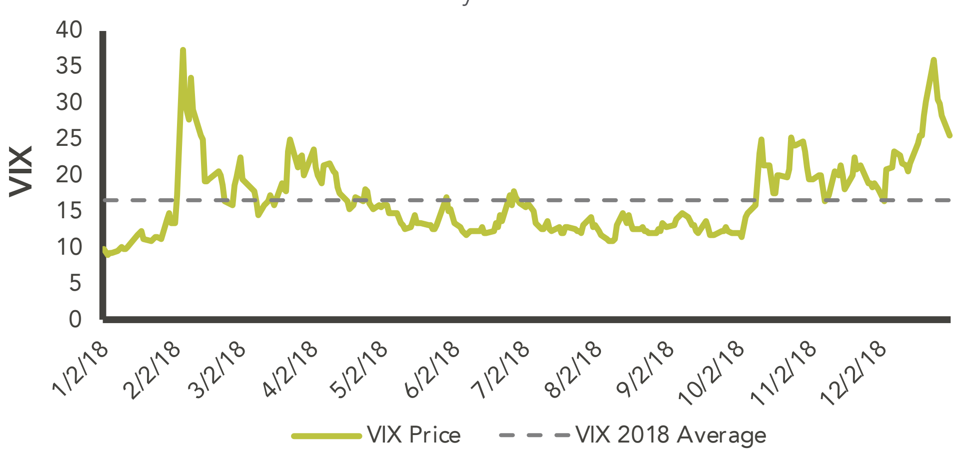
Hedge funds finally got what they have been waiting for over the past few years: volatility and dispersion across asset classes. 2018 will be remembered for two stock market corrections (February and October), a trade war between the U.S. and China, rising interest rates, and fears of slowing economic global growth. Despite the arrival of heightened volatility many hedge funds were ill prepared to profit from this increase in dispersion, leading to the worst year for hedge fund performance since 2011. Funds that were high flyers in 2017 experienced disappointing performance as their long-biased portfolios suffered a setback during the second half of 2018.

Equity hedge strategies finished the year down 6.9%, as market volatility returned in the second half of 2018, causing a collection of hedge funds' top holdings to underperform the broader equity market. The below chart shows the daily VIX index price movements throughout 2018. The average price of the index was 16.64, which saw periods in February and the fourth quarter where volatility spiked.

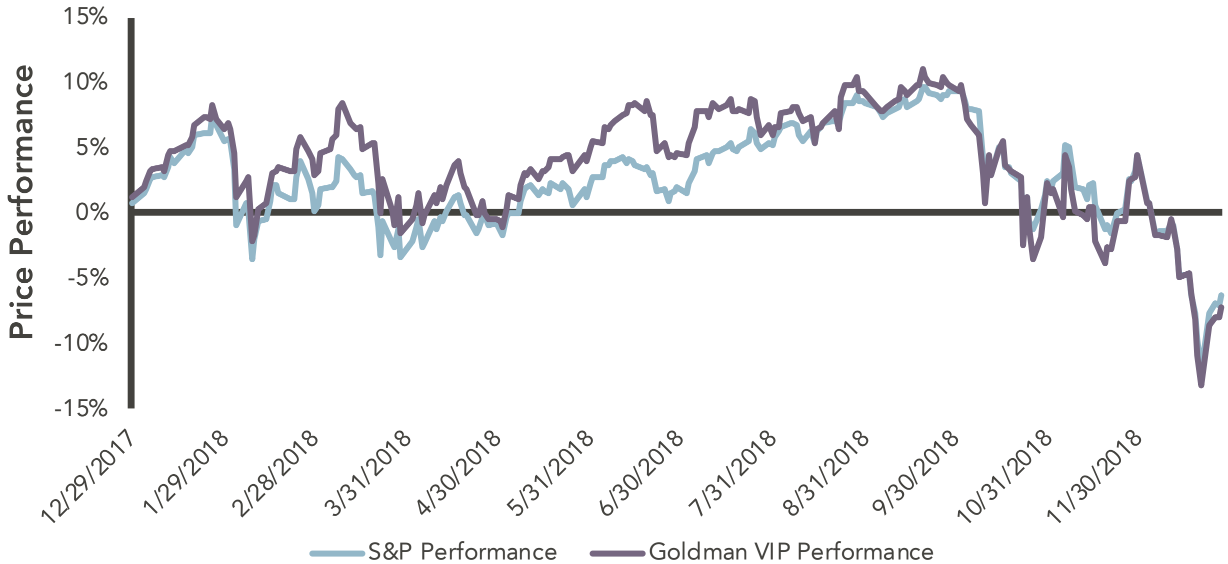
Exhibit 1: Return of Market Volatility



Source: Bloomberg

Among the most commonly held names at hedge funds were the "FAANG" stocks, which include Facebook, Amazon, Apple, Netflix, and Alphabet. All fell sharply causing funds to underperform the broader market indices. The below chart shows the price performance of the Goldman VIP Index, which consists of stocks that appear most frequently among the top 10 long equity holdings in equity hedge mangers.

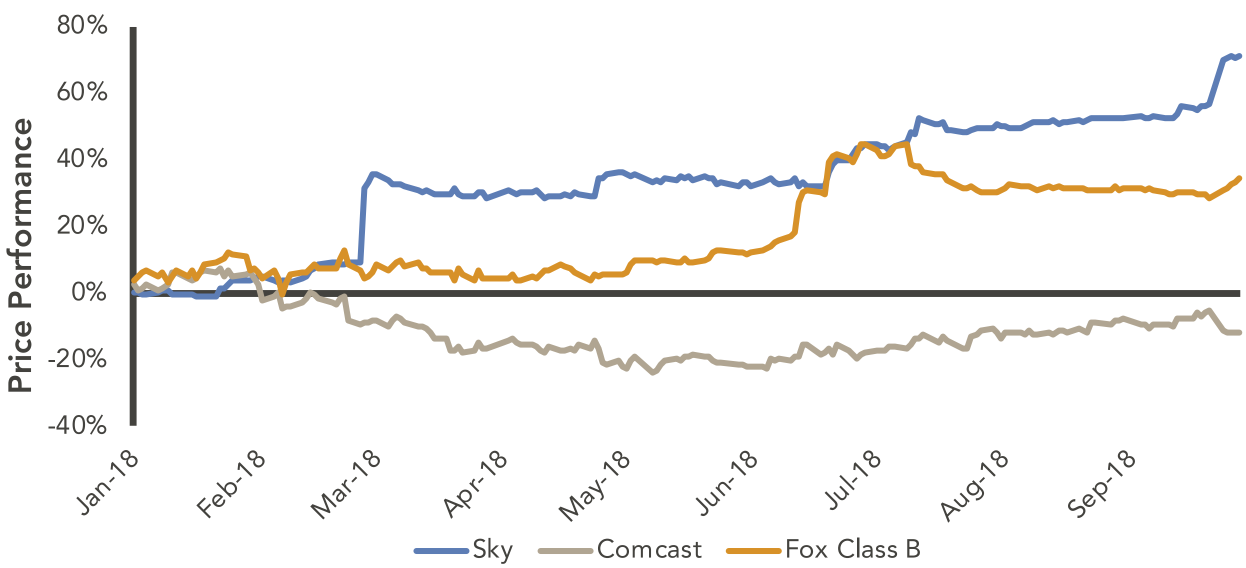
Exhibit 2: Hedge Fund Favorites Had a Difficult Second Half



Source: Bloomberg

The bidding war for broadcaster Sky provided hedge funds with one of their best trades of the year. A 21-month sales process culminated in a dramatic auction at the end of September which saw Comcast defeat Fox with a $38.8B, £17.28-a-share bid to buy the network, which represents a 71% uptick in Sky price this year. Major hedge funds accumulated sizable positions in Sky at the beginning of the year following Fox's original offer to buy the rest of the firm at £10.75-a-share. Even if no new bids had emerged shares would have only fallen back to Comcast's original offer of £14.75-a-share, still resulting in a successful trade.

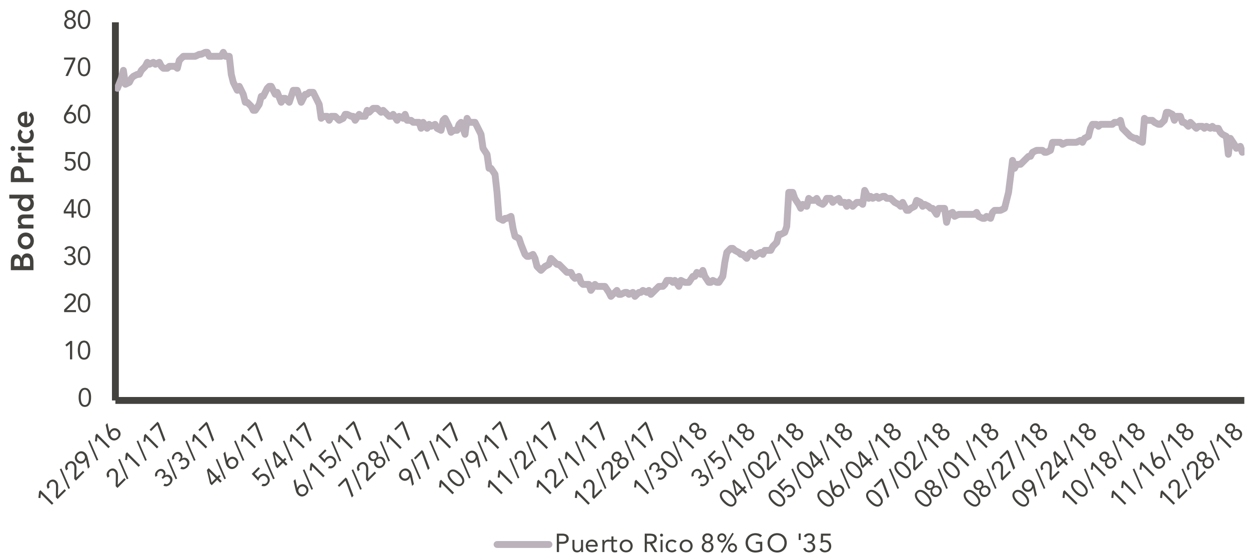
Exhibit 3: Sky Takeover Top Trade for Hedge Funds in 2018



Source: Bloomberg

Relative value credit focused hedge funds ended the year up 0.7%, as managers who pursued more complex sectors of the market generated a higher rate of return as opposed to managers who were just trading in corporate credit. One of the most profitable positions for hedge funds in the credit space has been the public debt of Puerto Rico. Credit hedge fund managers became involved with this U.S. territory due to its misunderstood fiscal story, bondholder protections, and a credit situation better than many stressed sovereigns. This chart shows the price action of Puerto Rico's 8% general obligation bonds due in 2035, a benchmark for the island's debt. Following the devastation left from Hurricane Maria and President Trump's comments on wiping out Puerto Rico's debt, bondholders endured a volatile ride in prices at the end of 2017. The bonds rebounded over 100% in 2018, as settlements in Puerto Rico Sales Tax bonds (COFINA) drove the whole bond complex to trade higher.

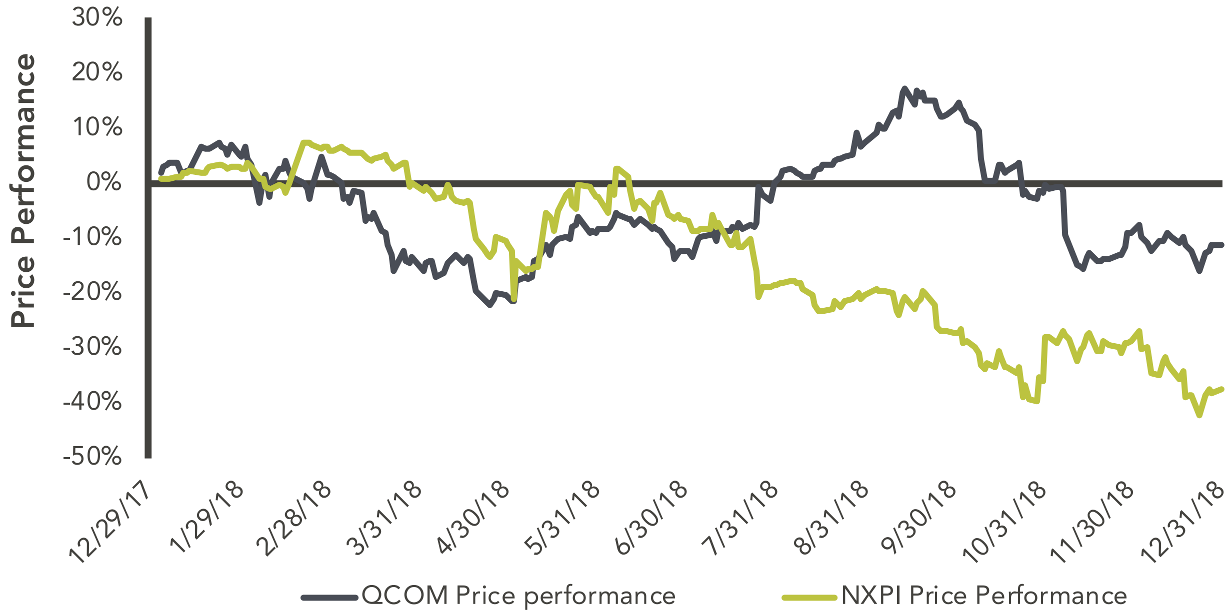
Exhibit 4: Puerto Rico Bonds, Top Distressed Trade in 2018



Source: Bloomberg

Merger arbitrage was a top performing strategy on the year up 3.2%, as 2018 saw large and healthy deal flow throughout the year. Deal spreads were notably wide, largely due to elevated uncertainty on anti-trust challenges as a result of size and insufficient merger arbitrage capital. One of the largest and most closely followed deals during the year was AT&T's $85 billion acquisition of Time Warner which the U.S. government said violated antitrust law. After a six-week trial, a federal judge ruled the government failed to prove the deal was in violation. One of the worst trades for hedge funds during 2018 was Qualcomm's failed attempt to buy NXP Semiconductors for $44B. *(See Exhibit 5 on the following page.)* First agreed to in late 2016, it was scrapped in July after a company deadline passed for China to approve the deal. Many viewed the deal breakup related to the back and forth of the U.S.-China trade tensions.

Exhibit 5: NXP/Qualcomm Trade One of the Worst M&A Trades in 2018



Source: Bloomberg

Macro strategies finished the year down 3.2% with performance mixed across discretionary, systematic and trend following managers. Large reversals in European market rates and emerging market risk assets led to significant dispersions in performance. Performance differentials were further driven by positioning in U.S. equity markets and the U.S. dollar.

2019 OUTLOOK

Looking ahead to 2019, we believe market volatility is here to stay, as growing geopolitical risks related to the trade front will continue to cause market jitters. As equity markets digest an environment of rising interest rates, equities that have been trading at elevated premiums with stretched valuations are likely to see multiple compression. If the Fed continues to move towards interest rate normalization, equities could have another tough year in front of them.

In the equity hedge space, we believe managers who are hedged as opposed to long biased will be better suited to withstand the elevated market volatility. Managers who focus on one sector or very few should be able to identify opportunities in those sectors where they are likely to have more expertise than funds that are more generalists. We are also positive on equity hedge mangers who are focused on Asia, as China is slowing the opening of its markets to foreign participants which will be a positive for those active in the markets. Merger arbitrage funds were the top performers in 2018 due to healthy deal flow and wide spreads. If the U.S. and global economies continue to weaken in 2019, we suspect merger arbitrage funds will find fewer compelling deals to invest in.

We continue to believe that opportunistic hedged credit will be positioned to profit even if the current credit cycle is coming to an end. Based on fundamental credit analysis, on-the-run credit spreads are at all time tights sending managers into off-the-run areas to find attractive opportunities. With the possibility of more rate hikes in 2019, focusing on shorter duration investments is a must. Furthermore, funds that are moving up the capital structure will be better prepared in the event cracks in the economy appear.

Relative value strategies will be positioned to allocate capital in 2019 if meaningful dislocations occur across asset classes and geographies. Ongoing trade tensions, emerging market softness and ongoing Brexit discussions should be an attractive environment for relative value funds to excel.

Market volatility and greater dispersion will remain across developed and emerging markets, along with changing global risk factors, which should create compelling investment opportunities for macro hedge fund managers. Macro managers should be the best positioned hedge fund strategy to identify new areas of market dislocation as central bank policy continues to evolve. Implementation of these trades will of course be the key for successful managers.

As hedge fund returns for 2018 were less than stellar, we expect to see an increase in fund closures during the first quarter of 2019. Investor skepticism will only increase about the value of paying high fees for lackluster alpha generation. Despite a difficult 2018, Marquette believes hedge funds are still a valuable part of client's portfolios given the diversification they provide. We will be vigilant in tracking managers' alpha generation in changing market environments.

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