UBS

Where do successful hedge fund strategies invest?

How hedge funds access unique market opportunities and megatrends

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Highlights

- Many of our investors have never invested in an inflationary regime, and they are coming to grips with the thought that they need strategies that can perform better in a structural inflationary regime.
- Investors have significant concerns about economic growth. We have potentially above trend inflation and below trend economic growth, that stagflation boogeyman that investors are so concerned about. We see a lot of disruptions in the market, when you look at the beta performance in long duration, fixed income and credit and equities. There have also been some pretty violent rotations within factors in the market.
- We're seeing pressure from investors to invest in the energy transition, which is driving demand for some assets, such as metals used in batteries.
- Many people invest in China on a beta basis, relying on massive economic growth and market appreciation. But China is more nuanced than that.
- There are some really compelling structural alpha trends in credit that we're excited about. The first is the ongoing disintermediation of banks. If it's complex loan, if there is a loan with urgency, the banks are just not there in the way that they used to be prior to financial reform. And subsequently, there's been a huge void that's been stepped into by hedge fund managers like us. We have the ability to extend credit and get really good covenants, really good collateral protections.

Summary

Investing in an inflationary regime

- Our investors are laser focused on diversification in their portfolios. Many are looking at hedge funds as a fixed income replacement. Hedge funds seek to provide returns of U.S. T-bill plus 3% to 4% returns over the cycle, with limited fixed income duration and limited equity beta.
- This is attractive in an environment where the equity/bond correlation is turning positive, with valuations moving in lockstep together.
- The transition from quantitative easing to quantitative tightening, which means that the central banks and the Fed are no longer dampening volatility with bond purchases. This should create a lot more volatility and illiquidity and the rate markets, which will likely drive opportunities in strategies like fixed income relative value.
- We think long/short equity and long/short credit will benefit from a much trickier earnings backdrop, as increased margin pressures, supply chain issues, and elevated funding costs start to create challenges for companies, creating dispersion and stock trading opportunities.

- For hedge funds, it's never about what changes are happening. It's about how discounted those changes are in the market. We're starting to see lots of opportunities open up in the credit and equity markets on an individual stock or bond basis.

Economic growth and volatility

- After you have a period of massive company creation, like we've seen over recent years, once you start to see tightening financial conditions on the back of that, that may set up the short side nicely. And so long-short strategies should benefit.
- A key risk indicator is interest rate volatility. Interest rates tell us everything we need to know about inflation and policy and growth expectations, and are central to how we value all financial assets, whether it's discounted cash flows, earnings streams or bond coupons. In 2022, we've seen an absolute explosion in realized and implied interest rate volatility and it's caused some aggressive moves within markets.
- I think we're entering a more dangerous space in the credit cycle in developed markets. We are already seeing the warning signs of trouble ahead with worsening liquidity and wider spreads. We're seeing some of the weaker credits really start to struggle, but we're still at the 50th percentile in spreads. so we have potentially further to go.
- Corporate fundamentals are still pretty strong right now. But when you look forward over the next six to 12 months, you're very likely to see the headwinds associated with higher funding costs, inflation, eroding earnings, and lower liquidity which are going to drive more volatility in credit markets.

Energy transition and sustainable investing

- We've been really focused on the energy transition, or specifically the move from oil, coal, and gas to renewables, battery storage, and electrification. Our perspective is that investors have been naive in terms of thinking that you can just avoid the carbon intensive industries.
- We never thought that was realistic. This transition will not be a magic, overnight, change. It's a decade-plus of heavy CapEx, changing behaviors, changing psychology.
- We're seeing investors start to take a more healthy approach to investing in the energy transition, respecting the need for oil and gas consumption on a short-term basis. In some ways, the disruption that we've seen in oil and gas prices is going to accelerate the energy transition, to doubling down on renewables and grid upgrades, for example.
- Later this year, or next year, it feels like a distinct possibility that increased spending is going into the energy transition. We have actually more conviction now than we did six months ago, even though we've seen this huge spike in oil and gas prices.

Investing in China

- There are big differences in performance based on what industry you're in. And there's a lot of repositioning and restructuring which is happening right now. We think China is a perfect market for an alpha-oriented strategy.

Private credit

- To our mind, it's probably one of, if not the most compelling, risk/reward profiles in the market. We try to keep it short duration, a three-year weighted average life.
- The second area is working capital finance. It is one of the biggest asset markets that nobody talks about. Specifically, it involves the financing of supply chains, largely for US and European corporates. As a result of financial reform, that financing has had to move off balance sheet and go into the balance sheets of investors. They're very operationally intensive to invest in. You see just incredibly compelling yield profiles.
- You can get the same credit exposures that you see in the high yield market or investment grade market, but you generally get them with a shorter duration and a higher yield. And historically this type of investment has had a lower default rate and higher recovery. We see this as better than investment grade or high yield bond beta in every way, shape, or form and we see this a secular alpha opportunity. This is a massive market by the way we're talking about. It's a USD2 trillion funding gap in our estimate, that will move to a securitization market over the next five years or so.

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AMT-2484 10/22
Review code: IS2203861
Expiration date: 7/31/23
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