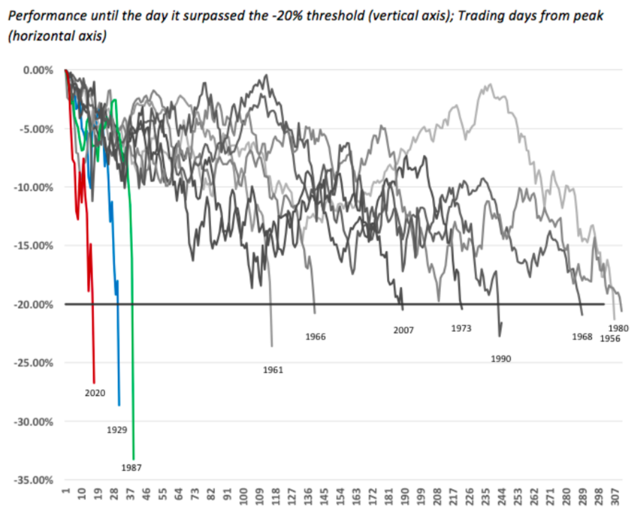
FLASH UPDATE #2

THE FINANCIAL MELTDOWN WORST DAYS SINCE 1987

The Covid-19 continued to shudder financial markets during the second week of March, taking them down at a speed that has never been seen before. Last Thursday, March 12th, was the worst single day equity drop since the Black Monday stock crash of 1987. And on Monday 16th, markets were down again, beating the previous worst single day with declines greater than 12%. Market volatility was very elevated in the past weeks as exhibited by the S&P500 that was up or down more than 4.5% in every trading session last week. These moves were also exacerbated by investors' margin calls, passive ETF selling, forced selling and redemptions. Furthermore, there were no safe-havens to hide from the current market sell-off as correlations went all to one.

Many equity markets entered "Bear Market" territory with drawdowns of 20% since the highs reached in February. Investors saw liquidity drying up considerably in major asset classes and more notably in fixed income as there were no counterparties to trade with. Central Banks and governments acted with bold monetary and fiscal responses and especially during the week-end to stem this crisis. Their actions seem appropriate but it will take some time before their effects will reach the real economy.

Fastest 20% decline from peak ever for the S&P 500



Source: Banque Pâris Bertrand

Since the severe financial breakout that started last month, we are in close contact with all our hedge fund managers. Business continuity programs have entered into action and many if not most of the hedge fund staffs are working remotely since a few days already. Generally, teams are split in order to manage the contagion and limit disruptions in their trading and risk management activities.

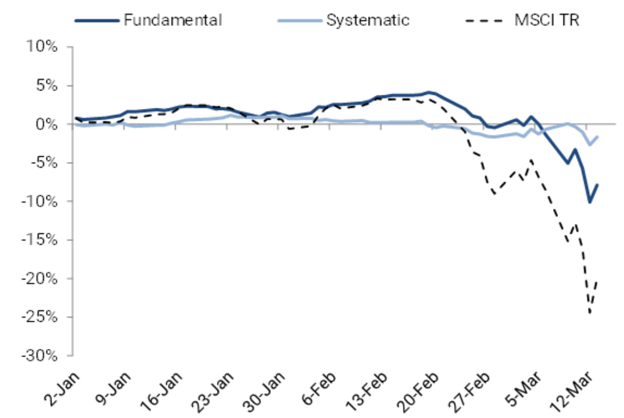
HEDGE FUNDS PROTECTING ON THE DOWNSIDE

Hedge Funds are delivering on their promise by being a good portfolio diversification and value tool beyond the traditional equity/bond allocation in today's market environment. The current trading environment for some hedge fund strategies has become very interesting as the volatility in all asset classes has come back and creates unique idiosyncratic opportunities.

Trading activity in managers' portfolios has been very high and some hedge funds' strategies have proven to be more resilient than others in this market meltdown.

Fundamental long and short equity managers were more impacted than other alternative strategies as they generally have higher equity beta exposure. On average managers we follow have a net exposure of 40%-70% and were able to contain somewhat the market equity selloff. They are actively managing their portfolios and reduced exposures gradually. Their gross exposure has also lowered mechanically as long market positions reduced in value and profitable short positions exposure decreased. Managers were more active in beta hedging portfolios and adding selectively to some beaten down stocks.

Total performance estimate: LS equity managers



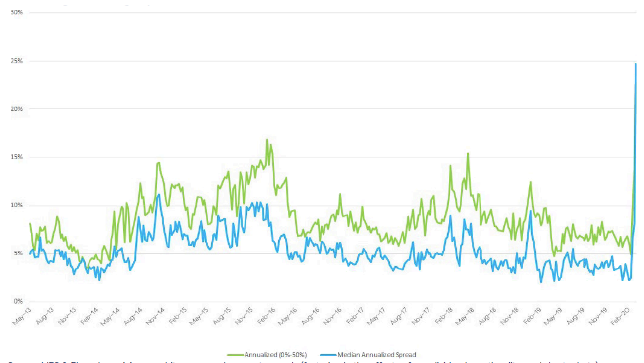
Source: Goldman Sachs

Global Macro managers are holding up well in the current market turmoil apart from some EM focused managers. We saw one Macro manager completely winding down his portfolio as he witnessed significant stress in cash instruments (IG, HY, EMD and corporate bonds). As the manager still had a positive performance entering March, he decided to completely unwind his book and protect capital. An EM manager had a very tough week due to a complete unwind of all positions even those considered safe assets. Correlations broke down and there was a giant rush to the exit in markets where liquidity had disappeared. The dislocations were very important in a market that behaved irrationally (i.e: some safe sovereign bonds are trading as if they were to default in the coming year). The manager is staying the course and plans to remain invested. He thinks that it is not the right time to remain on the sidelines.

CTA/Managed futures strategies' performance vary greatly depending on their time horizon and models. Trend followers had a tough week as most models were still long equities and could not be offset by long fixed income and short commodities exposure. A systematic and quantitative manager made several human interventions in its systems as markets started to behave irrationally. They introduced higher penalties, added hedge overlays and reduced the margin to equity. These measures contributed to save some P&L.

Merger arbitrage managers were able to contain, to a certain degree, the large equity drawdowns, but we are noticing some dispersion across managers, even though the announced deals/transactions are normally set to materialize in the short-term. Merger arbitrage spreads widened across the board and are now disconnected from arbitrage fundamentals due to the equity market selloff. Managers remain confident that almost all merger transactions should complete successfully, as they did in 2008. It is also worth noting how adaptive the M&A community is to adjusts to new circumstances as a number of the newer contracts already include a pandemic clause, which explicitly excludes the Covid-19 outbreak as a basis for ending the deal.

US Merger Arbitrage Spreads



Source: UBS & Bloomberg. Merger arbitrage spreads are net spreads (factoring in the effects of any dividends, optionality, and short rebate) on a LIBOR-adjusted basis. In calculating average and median annualized spreads, only definitive deals with more than 5 days to expected closing are used, subject to a 50% annualized spread cap.

Source: PSAM

Fixed Income RV had a challenging start of the month as credit markets saw an unprecedented move with spreads widening by 200% since mid-February and with intraday moves being 50% wider than the worst days of 2008. Cash future basis trades suffered as erratic spikes made it a difficult trading environment for some fixed income arbitrageurs.

Large multi-strategy firms navigated decently well in the first two weeks of the sell-off. However, the third week has been more challenging for them. As most strategies are based on a RV approach with some equity beta exposure, these will tend to be impacted at the margin when larger than normal equity drawdowns occur. Other strategies such as index arbitrage, merger arbitrage or basis trades were all strategies that had small negative contributions.

A NEW DAWN FOR ALTERNATIVES

To conclude, the velocity of the market decline and the numerous uncertainties that lie ahead, makes alternative investments and especially Hedge Funds a well needed toolkit for investors.

With many financial capital markets collapsing in unison, having an allocation to an active portfolio of heterogeneous hedge funds with distinctive risk-return profiles and performance drivers can greatly help stabilize returns (e.g. graph below). Portfolios of hedge funds shall be seen as a good diversifier in times of higher volatility and irrational market behavior as they reduce the impact of specific factors. Finally, Hedge Funds have historically been able to mitigate losses during market downturns and experienced faster recoveries.

MtD and YtD Performance of major indices vs. active FoHF portfolios (as of 13.03.20)

Source: Bloomberg as of March 13th 2020.

DISCLAIMER