Prepared for an economic slowdown

- *The actions of political leaders and central bank governors on both sides of the Atlantic will determine risk appetite*
- *Strategies based on fundamentals are at a disadvantage*
- *Revenge for CTA and Global Macro/ Trading*

Since the last issue of *Investment Outlook* (June 2011), hedge fund performance has been weak. Measured as the HFRX Global Hedge Fund Index in EUR, this asset class lost 2.5 per cent during the second quarter of 2011.

Because of recent market turbulence, bottom-up analyses based on fundamentals are falling short. Assessments have been based more on interpretations of macroeconomic statistics and major political moves. Whether the focus has been on the debt problems of Europe and the US, inflation fears in China or – especially – general worries about American macro statistics, the result has been violent fluctuations in risk appetite. This is making life easier for some hedge funds and significantly more challenging for others.

Below we have chosen to divide the hedge fund market into four main strategies:
- Equity Long/Short
- Relative Value
- Event Driven and Distressed
- Macro and Trading

What these strategies have in common is that the shaky market climate has generally led hedge fund managers to balance their portfolios. These actions are aimed at improving their preparedness for an economic slowdown (in the worst case, a new recession).

Equity Long/Short

The world's stock markets have had a tough time recently. In Equity Long/Short, managers (most of them with long positions in equities) have turned in a weak performance: -5.4 per cent during the second quarter.

Volatility is historically high and will probably remain high in the foreseeable future. Managers are thus likely to reduce their total exposure, then gradually increase it as volatility falls again. Such a procedure carries the risk of missing out on a considerable proportion of the upturn once analysis based on fundamentals begins to work again.

In Equity L/S, sub-strategies whose managers act quickly in response to short-term market movements (trading) are likely to do relatively well, though at the moment they are somewhat hampered by low trading volume (common during summer months and at times of great turbulence, a "wait-and-see" market).

We have a cautious attitude towards Equity Long/Short and believe that strategies focusing on the fixed income market have better potential during the coming quarter.

Relative Value

Relative Value managers in fixed income performed somewhat better than their equity-oriented colleagues in the second quarter, since worries about the global macro scenario did not affect sentiment in corporate bond markets until June.

In June, large outflows and lower issues of new bonds hurt the High Yield segment, resulting in major sell-offs. Those managers who acted quickly in response to short-term market movements were nevertheless able to benefit from the flight to safer government securities and thus performed better than more long-term-oriented managers.

Meanwhile we reached the end of America's QE2 stimulus package, removing a large buy-side player in US financial markets. This withdrawal will create disruptions in liquidity and in flows, which Relative Value managers can take advantage of.

Many observers believe that the recession risk in the OECD countries is 50 per cent (SEB's estimate is 30 per cent). If these more pessimistic market players should prove correct in their forecasts, strategies with a degree of built-in protection will probably benefit. For example, such protection consists of rising effective yields, which act as a buffer against a possible continued decline in bond prices.

For the Credit Long/Short sub-strategy, major fluctuations in market risk appetite create opportunities to identify undervalued fixed income securities that are undeservedly pulled into downturns that are more or less caused by poorer liquidity. Speculation about further quantitative easing measures from the Federal Reserve (and possibly from other central banks) is propping up volume at a somewhat artificial level, and thus the opportunity to find fixed income securities that are suitable short-sale candidates. The risk-adjusted returns of these strategies should be capable of surpassing risk-free interest in the coming quarters.

We prefer Relative Value to Equity Long/Short and are cautiously positive towards this strategy during the next quarter.

Event Driven and Distressed

Event Driven strategies such as Merger Arbitrage and Broad Event Driven had a tough second quarter. The number of acquisitions and mergers decreased, even companies still have large cash reserves and generally healthy balance sheets.

The cost of capital remains at comfortable levels, and in some sectors such as pharmaceuticals it will thus be possible for consolidation to continue. But in our assessment, poorer risk appetite in the market will adversely affect the number of deals, and managers will probably reduce their total exposure.

Because of continued low interest rates, forecasts defaults on American loans and corporate bonds will remain below 2 per cent until 2013. Distressed strategies will thus focus on very few, complex situations that require high specialised knowledge (and are often very time-consuming). The returns are there for those with patience, but liquidity and trading cycles may be difficult for many investors to manage.

Event Driven and Distressed are not strategies we recommend at present.

Macro and Trading

Global Macro strategies have generally found it difficult to deliver good earnings throughout 2011, but there are major differences between managers and their specific working areas. Some earned good money on the April rebound but failed to take profits before the turbulence of May and June.

Macro/Trading strategies in the fixed income area, which have not delivered good earnings this year either, succeeded in turning around this trend and showing double-digit positive earnings this summer until early August. However, the choice of manager is still a crucial factor, even if we choose the "right" strategy. Today's market climate has a little "wait-and-see" feeling. As the phase that we are in matures, managers are preparing to act. The most proficient, experienced managers will probably make more correct impact assessments of major political moves and benefit from the violent fluctuations in risk appetite and asset prices that these events may lead to.

CTA has shown tendencies similar to Macro/Trading. Over a two-year period, many managers have shown zero earnings, but during the worst turbulence in July and August, this strategy delivered earnings equivalent to our return ambition for 12 months. There have been large movements in currencies, commodities, equities and bonds, and some managers have occasionally held aggressive positions. We have witnessed significant portfolio turnover aimed at balancing assets.

Holdings of bonds as well as short-term securities (such as Treasury bills) have been built up. Equity positions have been reduced, and in some cases even shorted. Commodities remain in portfolios but no longer have the same clear focus on energy. Currency positions in portfolios have not changed to any great extent, but remain focused on emerging market and commodity-producer currencies plus short USD positions. On the whole, this results in more balanced portfolios and better potential to navigate through still-volatile, uncertain markets.

Macro and Trading are our first choices among hedge fund strategies in the near future.

Conclusion:

Compared to 2008-2009, hedge funds are generally in a much more stable situation, with substantially better portfolio balance and preparedness to face an economic slowdown (or at worst, a new recession). Solutions to the unusually large sovereign debt problems must be devised. This may naturally lead to weaker global GDP growth, but for high-quality hedge funds, the outcome is likely to be "business as usual".

STRATEGY	INDEX	PERFORMANCE %			
		Jul-Aug	Q2	2011 YTD (Aug 26)	2010
Global Hedge	HFRX Global Hedge Fund	-4.15	-2.51	-6.18	5.19
Equity Hedge	HFRX Equity Hedge	-7.49	-5.42	-15.19	8.92
Relative Value	HFRX Relative Value Arbitrage	-3.85	0.09	-2.51	7.65
Event Driven	HFRX Event Driven	-5.26	-0.95	-3.89	1.98
Macro	HFRX Macro	1.24	-3.56	-0.93	-1.73