The Early View

The Role of Discipline in Navigating Uncertainty

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All market data sourced to Bloomberg unless otherwise indicated. All manager data sourced to Solutions internal database.

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Dealing with uncertainty is nothing new for hedge funds. They constantly evaluate their portfolios, making decisions based on incomplete information and imperfect observations. However, when discussing the current outlook, most we speak to point to elevated uncertainty.

Many questions loom over markets and, with that, investors need to consider a wider set of outcomes when selecting and sizing positions. There aren't many parallels that can be drawn from personal experience either, with calls for rate cuts after aggressive monetary tightening despite ongoing inflation concerns, growing geopolitical tensions, and major equity markets trading at or near their highs. Economic activity data has beat most economists' expectations too, leading investors to question whether current policy rates in some regions are even set at restrictive levels.

When faced with uncertainty, traders are prone to changing their approach. Their behaviour may succumb to biases in search of short-term solutions, and mistakes can follow over the long-term. We think this is a good time to reflect and remind ourselves why as allocators, when trying to determine the likelihood of a manager's success continuing, we spend time evaluating the framework they use to make investment decisions. Considering *why and how* such difficult decisions were and will be made is usually at least as insightful to us as analysing the returns.

Sticking to the process during uncertainty?

A common quality we observe among the strongest hedge funds is a staunch commitment to their process. When returns are at the higher or lower extremes of their expectations, they limit the influence that recent performance can have on their approach

When they do make changes, as is necessary for survival in this industry, they tend to be carefully considered and logical rather than knee jerk reactions to outlier events. They are adept at preventing fear and emotion from jeopardising their trading behaviour, and often the investment and risk management decisions they make under uncertainty rhyme with those made in calmer times.

Lots of people will tell you what they think will happen to markets, but it's more important to analyse behaviour in the face of uncertainty, than to take a bet on the markets' path from here. A plethora of macroeconomic and geopolitical crosscurrents lie ahead for markets and the uncertainty that brings can forge mistakes for some, thus alpha opportunities for others. While hedge funds are not immune to the unwanted effects of uncertainty, process discipline may be the difference in determining those making mistakes as dislocations emerge and those well-placed to exploit them.

Key Drivers of Hedge Funds Performance: An Early April Snapshot

Equity Long-Short:

- After an especially strong first quarter, returns for directional and market neutral discretionary Equity Long-Short strategies moderated in April as equity markets experienced some turbulence. Shorting activity picked up during the first half of the month, especially in broad index and/or ETF products, amid some market turbulence as managers sought additional downside protection. In the second half of the month, managers re-engaged on the long side as equity strength reemerged.
- Regionally, positive flows to the Asia Pacific region were accompanied by outperformance of Asia-focused, particularly China focused, Equity Long- Short funds. Net buying and overall increase in gross exposure was exhibited across managers in the region.
- By sector, defensive sectors and info tech stocks were the most net bought industries, with the latter in focus ahead of the Q1 earnings season. By factor, elevated exposure to momentum remains while an increase in exposure to both profitability and size suggests managers are emphasising quality in their portfolios.
- Performance appears slightly more mixed for quant equity market neutral strategies. Faster machine learning models look to have outperformed slower implementations, while strategies which are less aggressive in penalising common factor exposures have posted stronger numbers.

Credit:

- A volatile and risk-off month for the broader markets led to muted returns in corporate and structured credit strategies, the latter's performance largely driven by carry.
- Idiosyncratic, event-driven opportunities generated positive performance in convertible arbitrage. However, returns have moderated after the strategy's strong Q1 performance.
- Capital structure arbitrage and high yield long-short strategies also produced modest positive returns. Portfolio level rate and credit hedges produced positive returns and countered losses experienced from various sub trades and reorg positions.
- Financial preferreds experienced modest spread widening. Longer durations names underperformed while floating rate securities outperformed, and there was ongoing call activity in the sector.

Event Driven:

- Event-Driven strategies were hurt by spread widening in April, despite an uptick in new deal activity.
- The widely-held DS Smith / International Paper reversed March gains after a competing bidder, Mondi, walked from the process unexpectedly early, which curtailed the optionality upside. Spreads across the industry widened more broadly due to the general risk-off sentiment, while several deals with higher levels of complexity/uncertainty were impacted by regulatory delays. Positive offsets came from deals like, Hess / Chevron tightening, and the closure of Japan's JIC acquiring JSR Corp.
- Activity on the new deals front was led by the $39bn bid for Anglo American by BHP – although initially rejected, as well as Shockwave / J&J ($13bn) which was rumored in March and confirmed in April, similarly the already speculated Endeavour / Silverlake ($6bn) transaction, and several other $5-7bn deals in energy, software/tech and real estate.
- Event Special Situations were hit by mark-to-market and general unwinding pressure, with notable exceptions like contrarian Japan, as well as soft catalyst China positions, also backdropped by recent regulatory developments in China, emphasizing "supervision to prevent risks" and "high-quality development".

Macro:

- Discretionary Macro strategies added in April. US exceptionalism themes helped performance as investors dialed back their expectations for Fed rate cuts this year. Longs in USD gained, notably versus JPY, while a more modest sell-off in European rates benefitted relative value positions versus Treasuries. Long gold positions also contributed, as fears over persistent inflation and safe-haven demand both increased following an escalation of geopolitical tensions in the Middle East. While the reversal in global equity markets proved challenging, its impact on performance will have been mitigated somewhat by the broad reduction in long positions we saw from managers towards the end of March.
- Trend-following strategies were up despite some pullback in the latter stage of the month. Traditional approaches benefited from short bond positioning, notably in the US, alongside bullish USD positions versus G10. Longs in oil and precious metals have boosted commodity returns, however price action in equities worked against Trend. Alternative styles endured a more challenging month, with short exposure to European energy and carbon emissions weighing on returns and some reversals in emerging market currencies proving problematic.
- Diversified systematic macro strategies were positive. Trend-following exposure helped performance, though carry models continue to prosper with both styles prompting long USD positions and a net short stance in fixed income. Equities detracted, though most strategies held a mixture of longs and shorts across regions, limiting losses in the sector.

On the radar:

- Many major central banks are priced to begin their easing cycles in June. The narrative of imminent policy easing has been supportive for risk assets, however strong growth and inflation data in April may create a dilemma for policymakers who find themselves in a difficult position to deliver rate cuts. The next month of economic data releases will be key in determining the outlook, and surprises in either direction will likely induce shifts in investor sentiment.
- Geopolitical tensions remain in focus, particularly developments in the Middle East following Iran's direct attack on Israel. Further escalation or spillover can impact markets through various channels, notably energy prices and inflation expectations.
- Beyond this, a busy political calendar ahead may see attention turn towards the sustainability of public finances. The recent debt ceiling scare will mean fiscal plans in the United States come under greater scrutiny as news around the presidential election gathers pace.

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