Favoring equity hedge strategies

Hedge Funds
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CIO WM Research
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2015 is a year for stock pickers, a year for equity hedge strategies.

• Alpha: We think the current environment is conducive to stock picking and is likely to remain in place for the foreseeable future. Higher interest rates, for example, should support increased intra-stock dispersion, which is positive for this style, enabling managers to generate excess returns. Some industries have elevated debt levels, and higher costs of carry will negatively affect their earnings per share. Among the examples are REITs and telecoms. Conversely, other industries will benefit. Banks, for example, should be able to charge more on loans.

• Beta: There are also good reasons to own equities. Most economies are recovering, earnings are either growing or about to grow, and merger and acquisition activity is high. However, considering current geopolitical risks, bouts of equity volatility could be ahead. Investors can consider gaining some degree of market exposure through equity hedge strategies that can capitalize on rising equities but also offer a good degree of downside protection.

• Shorting: So far, managers have struggled to generate attractive returns on the short side. Companies that mistakenly extrapolate years of robust future demand will spend on higher investment growth or provide overly optimistic forward earnings guidance that could lead to earnings disappointments and consequently negative performance. This could contribute to a more favorable short-selling environment for most equity hedge managers.

Recent developments
Equity hedge strategies posted a loss of –0.77% in July led by fundamental growth focused funds (–1.57%). We continue to see a vast opportunity set for equity hedge strategies. However, the different states of the global economies require different regional equity hedge approaches. While the European and Japanese equity markets are still better suited to top-down driven trades, the US offers more opportunities for fundamental stock pickers. Having said this, we continue to prefer managers running lower gross and net exposures with a strong focus on alpha generation through deep fundamental stock selection.

At a glance
• Equity hedge strategies should perform well in the current low-correlation and low-volatility environment, where stock performance is driven by company-specific fundamentals.
• These strategies tend to be net-long US equities markets, for which we have a positive outlook.
• Going forward, we expect potentially excess returns to be offered by short positions.

Hedge funds year-to-date performance
Despite some weakness in recent weeks, equity hedge strategies are still in strong positive territory for the year. We maintain our constructive outlook.

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Non-Traditional Assets

Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- **Hedge Fund Risk:** There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, “junk bonds,” derivatives, distressed securities, non-U.S. securities and illiquid investments.

- **Managed Futures:** There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.

- **Real Estate:** There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.

- **Private Equity:** There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.

- **Foreign Exchange/Currency Risk:** Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer’s “home” currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.