

# Strategy Outlook

UBS Hedge Fund Solutions  
Fourth Quarter 2023

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# Macro thoughts and portfolio themes

Risk sentiment turned negative in Q3 as hawkish Federal Reserve (Fed) rhetoric, concerns over fiscal sustainability, and a surge in oil prices culminated in a notable sell off in equities and rates.



While conventional 60/40 portfolios were challenged as correlations across asset classes turned positive, UBS Hedge Fund Solutions' ("HFS") broad based diversified and broad based neutral hedge fund strategies generally produced positive returns for the quarter. Within Trading, curve steepening positions benefited from the move higher in long-term rates, while natural gas trading in commodities was also additive to returns. In Equity Hedged, the risk-off tone bode well for managers' short positions. These gains were supplemented by income derived from ABS and agency mortgage strategies, as well as cash/futures basis trading within fixed income relative value

(FIRV). Overall, we are pleased with our outperformance (versus traditional risk assets) as it showcased the key role hedge funds can play in a well-diversified strategic asset allocation. That said, we recognize that a 5% risk-free rate is a formidable benchmark which we strive to beat without altering the consistency of our returns.

We believe the repricing in Q3 reflects market participants coming to terms with a higher-for-longer rate environment, aligning with our views. While COVID-induced supply shocks have mostly faded, the inflationary forces stemming from secular dynamics such as an aging population, the energy transition, and tectonic shifts in

geopolitics, warrant higher rates for the foreseeable future. Further corroborating the case for higher real rates is economic resilience. Despite a general slowdown in some of the forward-looking growth indicators, the private sector is in much better shape than it has been in previous cycles. US consumers, particularly homeowners, continue to enjoy historically low mortgage debt payments, rising real income (albeit decelerating), and 15 years of accumulated wealth (via financial [and housing] asset inflation). Trends like these have helped sustain GDP growth, which in turn, may require restrictive monetary policy to prevent a rapid pick-up in inflation.



# Portfolio positioning

We expect a prolonged period of higher cost of capital will inevitably result in some form of recession. The recent rise in treasury yields and the escalating conflict in the Middle East may also increase the risk of recession and/or a left tail event (relative to last quarter).



As such, we maintain a defensive positioning across our allocations. FIRV and macro strategies remain core allocations as they are expected to benefit from a continuation of elevated rate volatility. Tactical Macro Trading managers may also offer positive convexity should there be a more pronounced deterioration in economic conditions and asset prices

(as they have done so historically). In Equity Hedged, our allocations are primarily driven by bottom-up factors; in addition to market neutral/multi-PM strategies, we position ourselves with sector specialists trafficking in more inefficient, alpha-rich pockets of the market, as well as with managers who have demonstrated expertise on the short side. Within Credit/Income, and

with cash yielding 5%, we place increasing emphasis on sourcing short duration, carry-oriented strategies that offer less correlation to broader markets. This is mostly complemented by allocations to more trading-oriented corporate long / short managers that can be nimble in turbulent markets.

# CIO model portfolio

Strategy	Sub-strategy	Q4 2023 Forward looking target weight %
<b>Equity Hedged</b>	Fundamental	14
	Opportunistic Trading	11
	Equity Event	1
	<b>Equity Hedged total</b>	<b>26</b>
<b>Relative Value</b>	Quantitative Equity	3
	Merger Arbitrage	1
	Capital Structure/Volatility Arb	7
	Fixed Income Relative Value	13
	Agency MBS	6
	<b>Relative Value total</b>	<b>30</b>
<b>Credit / Income</b>	Distressed	1
	Corporate Long / Short	10
	Reinsurance / ILS	⊕ 2
	Asset-Backed	5
	Other Income	⊕ 5
	<b>Credit / Income total</b>	<b>⊕ 23</b>
<b>Trading</b>	Systematic	3
	Discretionary	12
	Commodities	⊖ 5
	<b>Trading total</b>	<b>21</b>
<b>Niche &amp; Other</b>	<b>Niche &amp; Other total</b>	<b>1</b>

⊕ Increasing target weight

⊖ Decreasing target weight

## Credit/Income

– We plan to increase exposure to short duration income-focused strategies while maintaining our core allocations to trading-oriented corporate long/short managers. We are maintaining agency MBS exposures, having added to these allocations in the past few quarters.

## Commodities

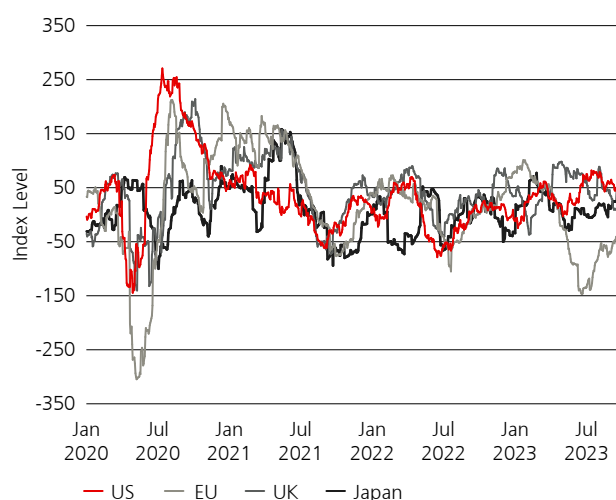
– We continue to reduce our allocation to commodities as inflation has been moderating, with our remaining exposure focused on gas/power strategies, complemented by strategic long investments in less correlated green materials.

# Strategy outlook

## Trading

We believe that the outlook for developed market (DM) macro strategies could improve with a more persistent trend of curve steepening in the US and other G3 markets. Managers could also benefit from short rates in Japan if inflationary pressures continue. Additionally, we expect DM-focused managers to perform well in a recessionary environment, be it via front-end longs or bull steepeners, as well as short positions in equities and credit. We maintain our allocations within emerging markets (EM), after having added to this segment in previous quarters. While EM managers were challenged amid the risk-off tape in Q3, the opportunity set still appears to be attractive, with potentially better entry points into some of the receiver trades and FX carry trades in countries that still hold a material real rates buffer. In commodities, we continue to reduce our target allocation, with our remaining exposure focused on gas/power strategies, complemented by strategic long investments in less correlated green materials.

Citi Economic Surprise G10 Index



Source: Bloomberg; Daily data; Jan 2, 2020-Oct 4, 2023. Discretionary trading strategies generally tend to underperform when the index is closer to zero, which indicates that economic data releases are generally in line with market expectations. Macro managers tend to perform better on macro data surprise, be to the upside or downside. US numbers continue to surprise to the upside, while negative news in Europe seems to have been more priced in and the backdrop is generally improving. There is less variation in the UK and Japan. Indices are for illustrative purposes only. Please see end notes for index descriptions.

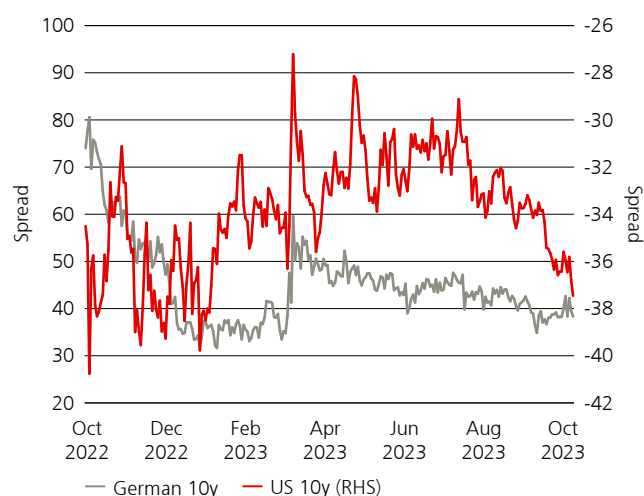
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## Relative Value

We continue to favor fixed income relative value (FIRV) strategies and plan to maintain our allocations. Q4 and Q1 tend to be beneficial for FIRV managers, with opportunities arising from potential year-end funding dislocations and the release of issuance schedules; thus, our 6-month forward-looking return expectations for the strategy remain strong.

Meanwhile, our outlook for capital structure/volatility arbitrage remains positive as the 2025-2026 maturity wall could lead to a surge in new issuance and corporate actions which should benefit the opportunity set.

German vs US Invoice Spreads



Source: Bloomberg; Daily data; Oct 6, 2022-Oct 17, 2023. Data illustrates German and US 10y "invoice spreads" over the last year. Short swap spreads have been additive to manager performance this year across both macro and FIRV strategies. The underperformance of cash bonds (sometimes expressed via futures, as shown here) against swaps is expected to continue as central banks continue the QT process while governments need to issue more debt to fund higher fiscal needs. Indices are for illustrative purposes only. Please see end notes for index descriptions.

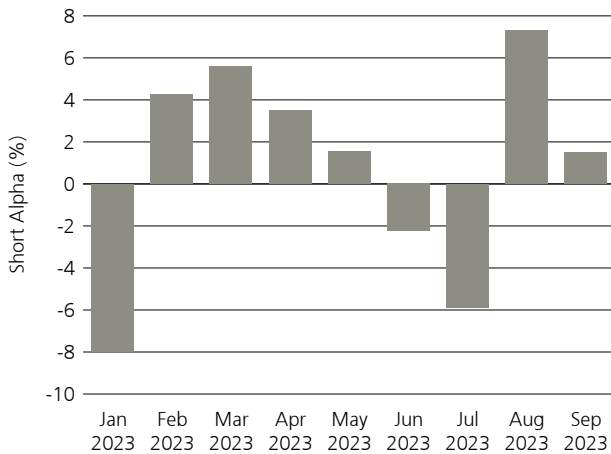
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## Equity Hedged

We strive to maintain a low-beta construct. Our allocations mostly consist of sector specialists trafficking in more inefficient, alpha-rich pockets of the market (e.g., technology/AI), as well as managers with more diversified exposure that have demonstrated strength on the short side. This is also complemented by allocations to market neutral/multi-PM strategies.

We maintain minimal exposure to China given the weak economic rebound thus far and underwhelming government stimulus. While we have seen signs of stabilization in markets, liquidity constraints may present additional challenges for managers with a focus on short selling. After 30 years of depressed inflation, Japan may be transitioning to the next phase of the economic cycle, where rising inflation and higher interest rates could create a healthy amount of dispersion in equity markets that is conducive for fundamental investing.

### Short Alpha



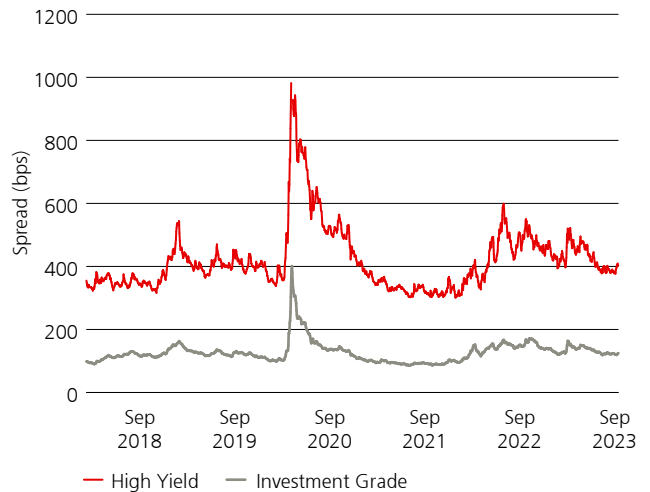
Source: Bloomberg; Monthly data; Jan 1, 2023-Sep 29, 2023. Data illustrates the short alpha (calculated as SPX index minus the average of GSCBMSAL index, MSSHRTUS index, MSXXSHRT index, GSTHVISP index). Please see end notes for index descriptions.

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## Credit / Income

As rates reach peak levels, we continue to seek short duration income opportunities with lower correlation to corporate credit spreads, expressed through a mix of thematic funds and co-investments with attractive carry. One example of this is an opportunity in US residential real estate debt that, despite strong fundamentals, was attractively priced due to funding pressures faced by regional banks. Elsewhere in credit, our exposure to agency MBS remains full as it provides a source of carry without credit risk given the government guarantee. The strategy also benefits from multi-decade low prepayment speeds. We plan to maintain current allocations to corporate long/short approaches. The opportunity is expected to remain as corporate distress, default activity and overall dispersion picks up, providing opportunities across fundamental long/short, event-driven, stressed and special situations. Our allocations to corporate long-biased and distressed remain underweight. Distress in the corporate sector has increased, spreads remain tight and better entry points will likely emerge later in the credit cycle.

### Investment grade and high yield cash spreads



Source: Bank of America Merrill Lynch; Daily Data; Jun 30, 2018-Sep 30, 2023. Indices are for illustrative purposes only. Please see end notes for index descriptions.

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# Endnotes

## Index descriptions

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### **Citi Economic Surprise**

The Citi Economic Surprise Indices measure data surprises relative to market expectations. It represents the sum of the difference between official economic results and forecasts. A positive reading means that data releases have been stronger than expected and a negative reading means that data releases have been worse than expected.

### **BofA Merrill Lynch US High Yield Master II (H0A0) index**

The BofA Merrill Lynch US High Yield Master II (H0A0) index tracks the performance of below investment grade US dollar-denominated corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on a composite of Moodys, S&P and Fitch) and an investment grade rated country of risk. In addition, qualifying securities must have at least one year remaining term to maturity, a fixed coupon schedule and a minimum amount outstanding of USD 100 million. Original issue zero coupon bonds, 'global' securities (debt issued simultaneously in the Eurobond and U. S. domestic bond markets), 144a securities and pay-in-kind securities, including toggle notes, qualify for inclusion in the index. Callable perpetual securities qualify provided they are at least one year from the first call date. Fixed-to-floating rate securities also qualify provided they are callable within the fixed rate period and are at least one year from the last call prior to the date the bond transitions from a fixed to a floating rate security. DRD-eligible and defaulted securities are excluded from the index.

### **ICE BofA U.S. Corporate Index**

The ICE BofA U.S. Corporate Index consists of investment-grade corporate bonds that have a remaining maturity of greater than or equal to one year and have \$250 million or more of outstanding face value. In addition, the securities in the Index must be denominated in U.S. dollars and must be fixed-rate. Fixed-to-floating rate securities also qualify provided they are callable within the fixed rate period and are at least one year from the last call prior to the date the bond transitions from a fixed to a floating rate security.

### **German 10y invoice spread (RXAISPE Comdty)**

Invoice spread based on RXA Comdty. Invoice spread is calculated as the difference between the yield of a forward starting interest rate swap with a maturity date equal to the maturity of the Cheapest to Deliver issue minus the forward yield of said futures contracts.

### **US 10y invoice spread (TYAISPS Comdty)**

Invoice spread based on TYA Comdty. Invoice spread is calculated as the difference between the yield of a forward starting interest rate swap with a maturity date equal to the maturity of the Cheapest to Deliver issue minus the forward yield of said futures contracts.

### **S&P 500 (SPX Index)**

The Standard and Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

### **GSTHVISP Index**

The GS Very Important Short Position (VISP) list tracks short exposure of hedge funds. The equal-weighted basket consists of 50 S&P 500 constituents with the highest total dollar value of short interest outstanding. The VISP basket is designed as a short hedge for the Hedge Fund VIP List (GSTHHVIP) to replicate the performance and long / short nature of hedge fund holdings.

### **GSCBMSAL Index**

An equally weighted basket of the 50 highest short interest names in the Russell 3000. Names in the basket have a market cap greater than \$1billion. This basket is updated on a monthly basis.

### **MSSHRTUS Index**

MSSHRTUS is an informational index that represents an equally weighted basket of 50 conviction shorts in the US, as defined by Morgan Stanley's proprietary Crowding Factor. It provides a gauge of short alpha performance within this focus universe, rather than through traditional short interest lenses.

### **MSXXSHRT Index**

The Morgan Stanley High Short Interest basket consists of 150 names within the Russell 3000 that have a float-adjusted market cap greater than \$1bn and rank high on several metrics including short interest % of float, days-to-cover, and short interest variability. The basket systematically rebalances each month when new data becomes publicly available and is liquidity weighted with a 2.0% cap.





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