



# O'Connor CIO letter

2022 outlook



Anxiety about inflation and central bank policy has dominated the first several weeks of 2022. The good news is that alternatives offer an outstanding value proposition relative to simple beta investment strategies this year.

Alternatives always have a place in diversified portfolios due to their absolute return profile, low correlation, and volatility characteristics. This year, we expect absolute return strategies to serve an especially important role in diversified portfolios, as we believe beta strategies will offer more muted returns compared to their recent history. In fact, we expect one of the big stories for investors in 2022 will be likely lower returns from beta investments in equities, credit and fixed income.

### **Equity markets have reached full valuation**

The simple fact is that as we begin 2022, equity markets globally are at the upper end of their historical valuation range. The combination of persistent inflation pressures and tightening monetary policy is likely to weigh on returns in both credit-spread products and longer duration fixed income. And as often as we implore investors to consider alternative investments on an absolute basis and to assess their performance based on the diversification, lower correlation, and volatility reduction they bring to diversified portfolios, our sense is that investors often view their alternative investment returns through the lens of long-only beta investments.



**Kevin Russell**  
Chief Investment  
Officer, UBS O'Connor

The ability of alternatives to deliver absolute returns with attractive correlation and volatility properties coupled with the more muted return outlook for beta strategies more broadly is driving strong interest in alternative investment strategies amongst a host of client segments, setting the stage for sustained flows into alternatives. Fortunately, O'Connor has always operated on an absolute return basis. We think our strategies are particularly well suited for a year like 2022, when relative value disciplines should offer one of the most compelling risk-adjusted return profiles.

**Interest rates and equity market performance: What is discounted?**

Recognizing that investors have likely been inundated with outlook pieces and detailed work by strategists analyzing the interplay between inflation, higher interest rates, and equity market performance, we will take the space here to simply

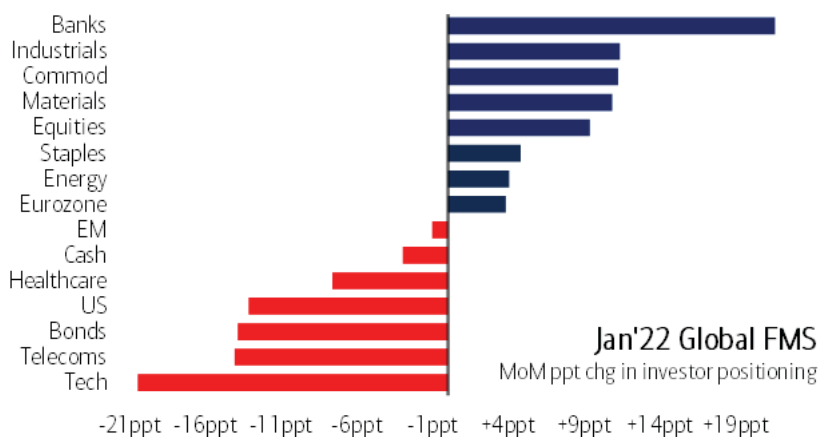
observe that a lot of these changes are already discounted by the market three weeks into 2022. Understanding the markets is always a two-step process, with the first step determining the changing fundamental corporate finance or economic realities and the second step assessing how well discounted these changes are by market participants.

With ten-year Treasury yields having moved almost 50 bps higher from early December to mid-January, it has become increasingly clear that investors have already adjusted to the reality of a higher interest rate environment, even though the velocity of that move is unsettling. Even more importantly, the internals of the equity market from a sector and factor positioning perspective indicate that substantial portfolio changes, notably a reduction in technology positioning, has already occurred.

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**Figure 1: Global reopening hopes trump Fed tightening fears in post-pandemic Jan FMS**

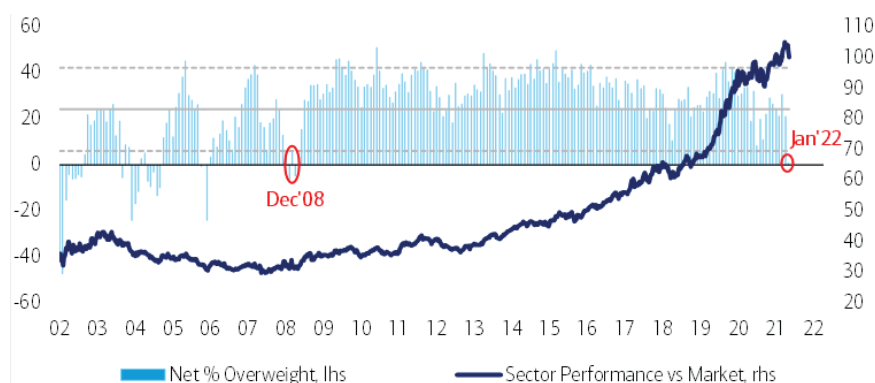
Month on Month change in FMS investor positioning



Source: "BofA Global Fund Manager Survey," BofA Global Research. Data as of January 2022.

**Figure 2: Tech net allocation fell to the lowest level since Dec'08**

Net % OW Technology

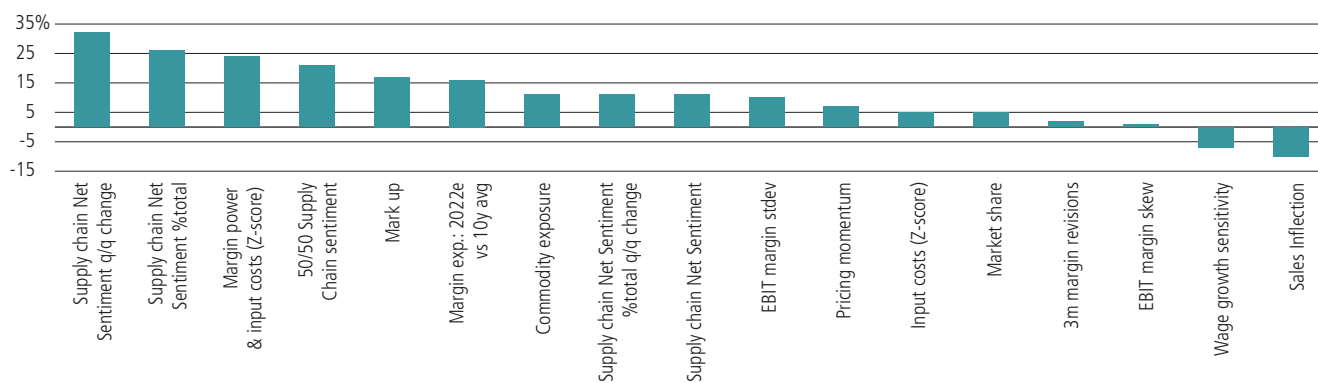


Source: "BofA Global Fund Manager Survey," BofA Global Research. Data as of January 2022.

Another indication inflation risks have become top of mind for equity investors is the fact that the best performing companies in the S&P500 that have reported earnings early are those

which have demonstrated the best supply chain management, pricing power, and margin durability.

**Figure 3: Supply chain and pricing power cost exposure measures have been indicators for who is getting rewarded (ex Financials)**

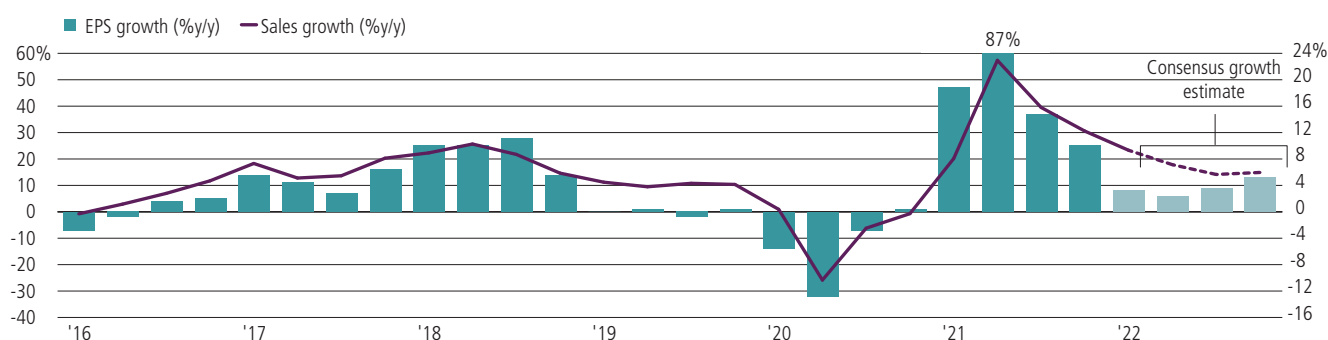


Source: FactSet, UBS. Data as of January 2022.

A quick review of consensus earnings and sales growth expectations for 2022 shows that the extreme year over year changes that characterized the COVID years of 2020 and 2021 will likely dissipate in 2022. Simply put, as earnings and sales

growth expectations normalize to levels below 10% and 5% respectively, it is reasonable to expect a more muted return environment for equities.

**Figure 4: S&P 500 quarterly EPS and sales Growth**



Source: FactSet, UBS. Data as of January 2022.

The more we look at equity market internals and positioning, the more convinced we are that market participants have substantially adjusted to the reality of higher inflation and a higher yield environment. And a long-held principle of O'Connor is that once equity markets have become aware of and begin to discount risks such as inflation and changing policy, the frenetic trading that has characterized the beginning of 2022 begins to transition to more deliberate and rational portfolio adjustments, steeped in traditional corporate finance maxims and economic principles. It is just such an environment, one characterized by elevated but not extreme levels of volatility, where our relative value strategies may deliver a compelling risk/return profile.

**Alpha not Beta**

Having convinced ourselves that 2022 will be much more about alpha than beta, we are excited to be able to lean on our core investment capabilities to derive absolute returns for investors. We have spent so much time in recent years reflecting on the six mega trends that have become such contributors to our performance that we understand why investors think all of our capital is allocated against these structural alpha segments of the market. We are also pleased that 2022 sets up as another year where these mega trends should provide a tailwind to performance as each of these trends remain in place: China transitioning from beta to alpha, the energy transition, SPACs and the convergence of public and private

equity markets, the dearth of dynamic risk capital in corporate credit, working capital finance emerging as an investable asset class, and private credit disintermediating banks in special situation lending.

Of particular interest is the ongoing opportunity set that we see in both private credit and working capital finance more broadly. With our O'Connor Capital Solutions team having recently closed its second fund and deploying capital at a steady pace, we are starting to feel that this structural alpha opportunity to disintermediate banks in special situation direct lending is increasingly well understood by our investors.

We believe that the risk/reward profile of private credit exposures, given the high carry and strong collateral coverage, is amongst the most compelling investment profiles available in today's market, but the allocation will always be somewhat limited from a multi-strategy perspective given the liquidity profile of those loans relative to the liquidity terms offered to investors. However, the working capital space aligns better with liquidity terms of the multi-strategy perspective given the 30- to 90-day duration of many of those positions.

As the working capital strategies offer excess spreads ranging from 150 to 600 bps relative to comparable spreads available to

investors in the investment grade and high yield markets, and with our bank partners beginning to deliver efficient financing solutions for the asset class, we plan to continue to manage overall credit beta tightly and concentrate net credit exposures in this highly inefficient segment of the market.

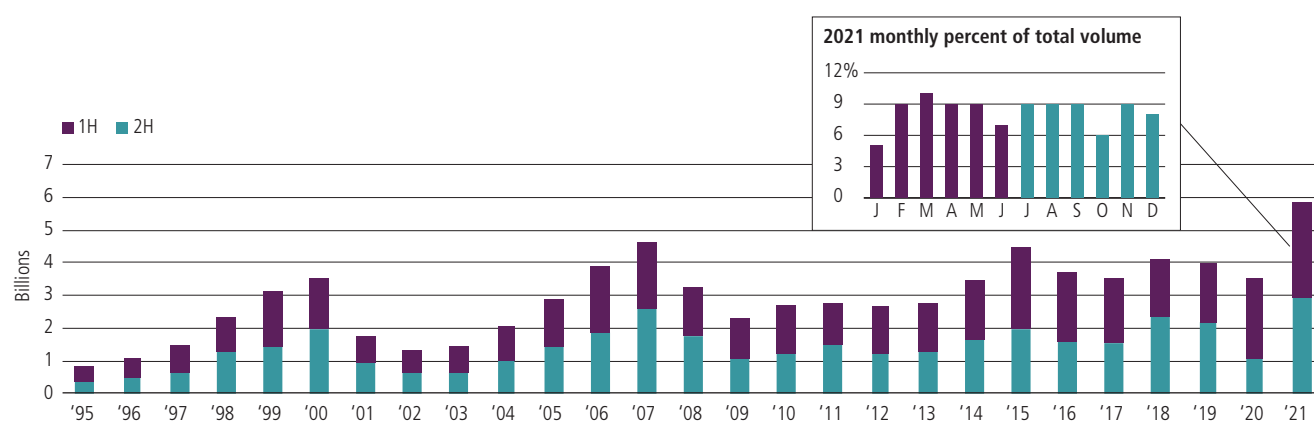
While we are starting to have very good dialogue with some larger institutional investors who seem intent on allocating dedicated capital to the strategy, the short-term opportunity remains wide open and compelling for current multi-strategy investors.

### Back to merger arbitrage

Since the launch of O'Connor as a hedge fund manager back in 2000, merger arbitrage investing has been a core investment competency. We do not highlight the strategy enough as the core driver of returns it has been over many market cycles, but the current opportunity set merits increased investor attention as we increase the capital allocated to, and focus on, the strategy. After a steady flow of deal announcements over the course of 2021 amounted to an all-time record activity level of USD 5.8 trillion for the year, the market seems set up for robust returns for 2022.<sup>1</sup>

**Figure 5: Global M&A volume by half year**

For the first time in the history of the M&A market, activity was evenly split across the first half and second half of the year.



Source: Dealogic, Citi Banking, Capital Markets & Advisory/Mergers & Acquisitions, data as of January 2022.

Beyond just the broad and diversified deal landscape that we have to invest in right now, our key banking relationships believe that these record volumes of 2021 will sustain well into 2022, serving to broaden the investable universe and likely keeping spreads wide on deal announcements which should enable us to scale into investments efficiently. We hear that corporate and sponsor confidence and activity levels are high.

When we account for the high cash component of deal considerations announced in the fourth quarter of 2021 and already in the first several weeks of 2022 (despite the record multiples being paid for companies at 14.7x LTM EBITDA and healthy, average take-over premiums of 28%) it is impossible to conclude anything other than another very active year for M&A activity is in store.<sup>2</sup>

<sup>1,2</sup> "Global Executive M&A Summary – 2021 Year In Review," Citi Banking, Capital Markets & Advisory | Mergers & Acquisitions. January 2022.

Yes, the regulatory approval environment is tougher, especially here in the US, and that will bear close monitoring in position risk-grading and sizing. However, we and most other investors have already accounted for this higher approval risk in assessing deal breaks and are requiring higher baseline returns, but more importantly, companies announcing the deals and their advisors also know this regulatory landscape has shifted, so we can expect them to be more measured in the forms of consolidation and market power being pursued.

### **More mega trends?**

When we laid out the six mega trends we were following to find structural alpha opportunities within market segments, asset classes, or strategies, we knew this would require consistent monitoring, not just to assess when crowding or changes had begun to occur in the associated strategies, but also to prepare to capitalize on emerging trends. And the nuance between trends and our classification of mega trends centers on the size of the market opportunity, and the expected duration of that opportunity. Trends can lead to trades; mega trends can lead to resource and capital allocation. We like both, but mega trends are foundational at O'Connor.

In one-on-one discussions with investors, we have laid out several trends we are following closely, and the incomplete list includes healthcare therapeutics, China credit, carbon markets, and digital assets. While we do not have the time and space here to delve into each of these opportunities, we are seeing many of the core characteristics that we look for in mega trends and structural alpha opportunities in each of these segments.

But while we will continue to allocate more time and energy to evaluating all these opportunities, we are getting increasingly convinced that the trend that bears following most closely is the breadth of healthcare companies in the public equity markets and the lack of commensurate capital and expertise necessary to efficiently invest in those companies. COVID has continued to pressure the healthcare industry broadly and government regulatory bodies, creating unprecedented levels of uncertainty for both companies and investors looking for normalization of hospital procedure volumes and regulatory processes. Additionally, approximately 14% of overall US equity issuance in 2021 (as listed in Bloomberg LEAG tables for 2021) occurred in the healthcare industry, with a staggering 325 biotech IPOs and secondary offerings saturating the market.

This confluence of events has created one of the most challenging periods in history for small and midcap biotech and medtech investors, as a vicious cycle of performance challenges and redemptions plagued healthcare specialist funds, creating a fundamental mismatch between the size and breadth of public healthcare therapeutic companies and the amount of capital and investment diligence capabilities that exist to effectively support this changing market landscape.

With valuations of these companies at decade lows, and large biopharmaceutical companies flush with over USD500bn of cash and an additional USD500bn of leverage capacity, this segment of the market, which has always been prone to high dispersion of returns and high barriers to investment participation due to the scientific and data complexity of the industry, is looking increasingly like a strategy worthy of including on the O'Connor platform. As always with O'Connor though, this is not a beta call on healthcare therapeutics companies, but rather an assessment of a capital imbalance and structurally higher dispersion going forward.

O'Connor's strength in both performance and asset flows has enabled us to bring in additional resources to support this growth including: added investment professionals in Asia and Credit, planned hires of investment teams for new strategies, incremental business development professionals outside the US, and additional control function resources in finance, operations and legal. We also continue to be flexible in our return to office plans as our communities around the world experience varying COVID challenges and policies. Having experienced a flare up in COVID infection rates here in New York City in early January, recent data seems to show an improved virus outlook, so much so that we are planning to travel and participate in some industry events in late January. 2021 marks the third full year of the ongoing transformation of O'Connor, and the entire team is energized and excited to deliver for investors in 2022.

We hope you are all well and healthy.

Thank you for your support and trust in us,



**Kevin Russell**

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