

Building return-oriented portfolios

Strategies in Focus: Hedge Funds

Despite compressed risk premia we believe it is still possible to “manufacture“ a robust return stream using hedge funds. Bottom-up manager and investment selection will be paramount – i.e. betting on the right horse rather than just being in the game.

Our approach going into 2016 focuses on seeking to build portfolios that are able to protect capital in an environment of elevated market volatility. This is not a market where clear strategy or beta bets should be expected to drive performance. We expect to achieve alpha-oriented results via a core-satellite approach. Manager and strategy diversification is critical in an attempt to mitigate the gap risk associated with less liquid markets and the unwinding of crowded trades. Targeted asymmetrical exposures via bespoke and coinvestments can offer positively convex outcomes to eke out excess returns without taking broad market exposure.

Tailoring exposure to highly diversified and risk-aware managers

We have evidence that our approach has worked well recently. The results are most apparent in our neutral portfolios (see table below). For example, in 2015, the majority of returns in our neutral products have come at a high level from diversifying strategies: Multi-Strategy and Relative Value. Even the Equity Hedged allocation has been a positive contributor, illustrating the advantage of tailoring the exposure to highly diversified and risk-aware managers.

The benefits of this approach are clear in a market selloff, as we had in August 2015. For example, while risk assets such as global equities and high yield were down notably that month, our neutral diversified products performed positively. Even our broad-based diversified flagship products, which take more market beta, were down by far less than one would have expected relative to the wider hedge fund universe.

Broad-based neutral product average strategy gross contributions 2015 (as of November)

Contributor	in %	Contributor	in %
Multi-Strategy	1.98	Equity Hedged	0.44
Relative Value	1.75	Trading	0.19
Credit/Income	0.93	Other	0.06

Past performance is not indicative of future results. The data shown represents an average contribution by strategy detail for 5 products currently managed by UBS Hedge Fund Solutions. Products were selected that have broad-based neutral mandates, are discretionarily managed, and were being actively managed (i.e. not put into liquidation) for the entire 2015 period as of November. Monthly contribution by strategy is determined by aggregating sub-fund contribution values for each sub-fund mapped to a specific strategy. Net returns of the fund reflect the deduction of any applicable management and performance fees, as well as applicable fund expenses.

Source: UBS Asset Management

In hedge fund investing, it is very difficult to disentangle the top-down from the bottom-up. While UBS Hedge Fund Solutions spends a great deal of time trying to understand the market backdrop in order to assess the fertility of different strategies, sub-strategies, and micro-strategies, at the end of the day our portfolios are largely constructed to reflect conviction in individual managers and their ability to extract potential opportunities across all asset classes.

In an uncertain environment, we have taken this approach to another level by seeking to complement core, diversified multi-manager platforms that are very factor aware and risk-controlled with a diversified collection of idiosyncratic co-investments / bespoke structures where we identify potentially positive return asymmetries.

Portfolios reflect our conviction in individual managers' ability to extract potential opportunities across asset classes

Looking into 2016, we expect to continue this approach. Now, we believe, is not the time to reach for return by concentrating allocations or taking more beta in portfolios.

For those investors looking to generate higher returns, we would recommend adding leverage to this risk-averse approach rather than taking more market risk (beta) in their hedge fund portfolios. However, please note that investing in a leveraged version entails more risk as well.



Bruce Amlicke is the Chief Investment Officer (CIO) for UBS Hedge Fund Solutions. He started his career at O'Connor & Associates in 1986. From 2003 to 2004, he was CIO of the O'Connor Multi-Manager Program. Bruce re-joined UBS Asset Management in 2010 and has 30 years of industry experience.

Ongoing divergence – the call for relative value managers

Moving into 2016, at O'Connor we anticipate continued divergence in global monetary policy. In this macro environment, allocations to liquid relative value investment managers may lead to superior investment outcomes compared to other hedge fund strategies. Also in 2016, we plan to emphasize broad geographical diversification.

After six years of relatively strong returns and high correlations of risky assets, 2015 delivered mixed results and markets that seemed to be more prone to liquidity gaps and volatility spikes. We witnessed an example of this on 24 August when the VIX volatility index reached levels not seen since the Lehman default. Moving into 2016, we anticipate continued divergence in global monetary policy as the US Federal Reserve begins a slow tightening process while the European Central Bank, the Bank of Japan, and the People's Bank of China among others ease monetary policy further still. We believe the performance of risk assets will differ more by region and asset class than we have seen in over a decade, while in our view market liquidity is likely to remain challenged. We believe this should lead to moments of outsized dislocation relative to fundamental valuations as news is digested by market participants.

Relative value managers nimbly move capital to the best opportunities and actively reassess pressure points and risk correlations

Against this backdrop, we believe that there are divergent opportunities and that an allocation to a liquid relative value investment manager will be

rewarded. Such allocations should lead to better investment opportunities given that these types of managers may be able to nimbly move capital to the best risk-to-reward opportunities and can actively reassess pressure points in markets and changing correlations of risks.

In 2015, we were aggressive in shifting capital among our seven core strategies – Long/Short Conservative Equity, Long/Short Market Neutral Equity, Merger Arbitrage, Long/Short Credit, Long/Short Quantitative Fundamental, Convertible Arbitrage, and Opportunistic. We materially reduced our allocations to non-investment grade credit and quantitative equities in favor of allocations to our fundamentally-driven low-net market exposure equity long/short strategies (see chart below).

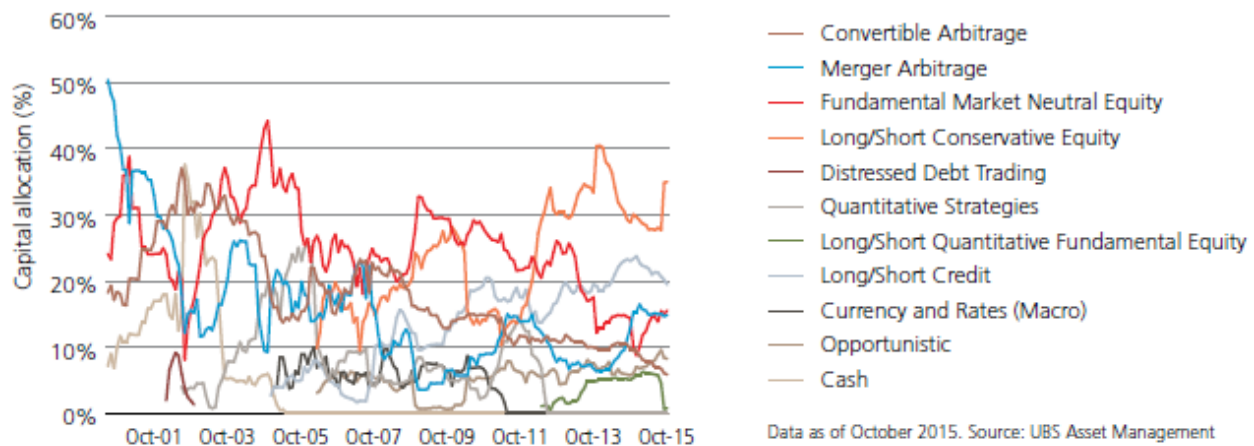
Remaining well diversified across major markets

There were three key drivers to our decisions:

- We believe the liquidity re-rating in credit is only partially completed and near term, corporate credit markets will be driven more by the technicals of fund flows than by company fundamentals. In our view this makes them difficult to trade in a long/short context.

- We believe we are near – or in – a market regime change. As a result, we would rather have experienced stock pickers looking at buying and selling opportunities as equities have outsized moves relative to a given headline rather than purely computer-driven models.
 - We favor the flexibility the relative liquidity of equities affords us compared to credit.
- From a geographical perspective, we plan to remain well diversified across all major markets.

Capital aggressively shifted among strategies in favor of equity long/short



Dawn Fitzpatrick is Head of Equities, Multi Asset and O'Connor. She is a member of the UBS Asset Management Executive Committee and the Americas Risk Committee. Prior to taking on her current role in January 2016, Dawn was Head and CIO of O'Connor, responsible for all aspects of O'Connor's portfolio management, capital allocation and risk management. She has 24 years of industry experience.

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