UBS

For professional / qualified / Institutional clients and wholesale fund selectors investors only

Hedge funds

UBS Asset Management | Viewpoints Market Outlook 2022

On November 30, **Jerome Raffaldini,** Head of Products Specialists, UBS O'Connor, spoke with **Kevin Russell,** CIO, UBS O'Connor. They discussed how hedge funds are coping with inflation, volatility and China.

The keys to O'Connor's longevity

- O'Connor has been in existence for 21 years, much longer than the typical three- to five-year lifespan of a hedge fund.
- We have been able to navigate a wide variety of markets and interest rate environments due in part to our constant focus on managing liquidity and downside risk.
- From an investment perspective, we believe a manager must always be willing to evolve and change.
- In our own history, there were times when we weren't finding as much success. We were too parochial in how we managed our strategies. We took a critical look at our approach, and determined to focus more on global markets. We moved our capital away from more crowded and consensus strategies. And we made a strong effort to align our capital with areas of the market that we thought would be structurally conducive to alpha.
- Adhering to best practices such as risk management and operational excellence is key. But managers must also be sure they're adapting their approach for the realities of the market.
- Things have changed in the last six or seven years. Markets are more driven by passive and quantitative systematic flows than they used to be. Managers who don't evolve can find their return profiles eroding.

What we look for in our strategies and sub-strategies

- While many hedge fund managers take a "black box" approach with little transparency, we believe that the strategies we pursue are intuitive for investors. Our three core strategies are:

  1. Long-short equity relative value
  2. Credit relative value
  3. Event-driven

- Within those three global strategy competencies, we have 16 sub-strategies. We allocate capital to the specific sub-strategies of our broader strategy competencies.
- When we add an investment strategy, we look for the intersection of three qualities: (1) strong investment talent across the analysts and portfolio managers; (2) the ability to capitalize on cyclical alpha, which we define as inconsistencies in discounting and the evolution of the markets, economic developments, policy changes or corporate strategies; and (3) visible structural alpha opportunities in the sub-strategies.
- Our passionate belief is that the interplay between those three alpha sources – high-quality investment talent, cyclical alpha capitalization, and structural or secular alpha opportunities – you can achieve compelling risk-adjusted returns for investors.

How we manage correlation

- We spend a significant amount of time on the correlation of our strategies to each other, the correlation of our strategies to the overall master portfolio level, and the correlation of the overall master portfolio to equity indexes, beta indexes and other macro risk factors.
- For us, the exercise is primarily mathematical correlation analysis. We have a team that evaluates our strategies every month, looking for more subtle risk exposures that are inherent in the portfolio.
- We particularly like an environment in which our three strategy competencies are modestly or even inversely correlated, and even one in which the sub-strategies are inversely correlated to each other.
- The periods when O'Connor struggled in the past occurred when we were too focused on managing that correlation. Simply put, we had our capital too diversified.
- We reoriented our approach to focus first on alpha and second on the marginal contribution to risk and the correlation properties.
- While it is great to have diversifying strategies, if those strategies don't have alpha, they're not going to contribute much to the bottom line.
- We are looking for the core alpha profile of new strategies before we onboard them, and then we ensure that they fit our correlation profile and risk model.

Our emphasis on structural alpha

- Structural alpha is a fancy way of saying that something is changing. It could be regulatory policy, overall public policy, or global thematic or geopolitical changes, both positive and negative. It could be investor capital allocation inefficiencies. It could be market structure composition or evolution. It could be bank behavior.
- When we say structural alpha, we're saying that something is changing in a specified segment of the market that we think is going to lead to one of two things:

  1. Either structurally higher dispersion of performance within securities involved in that strategy, or
  2. Inefficiencies within that segment of the market.

- We are following six megatrends that we have identified as likely to deliver compelling structural alpha opportunities.
- They are sizable both in terms of the liquidity opportunity, as well as in terms of the duration of the opportunity. These megatrends are:

  1. **The growth and size of the corporate credit markets.** We saw a massive rush of issuance in 2020 as companies looked to shore up their capital bases and liquidity ahead of the COVID-19 crisis, but there wasn't a commensurate increase in the amount of dynamic risk capital provided by banks and hedge funds in the market. There is a capital gap, with a glut of bonds trading inefficiently, and a shortfall of capital from banks, broker-dealers and hedge funds. We're seeing a high Sharpe ratio and an exceptional risk-adjusted return profile from our credit relative value strategies.
  2. **Chinese equity markets transitioning from beta to alpha.** Investors in the US and Western Europe are concerned about the Chinese policy regime, approach to markets and changing regulatory policies. As a result, many investors have been under-allocated to China, and we believe that they are likely to remain so. The recent interventionist regulatory change has also spooked investors. But we don't see that as a negative or something we can't manage. We see it as something that is likely to drive a high dispersion of performance. Some stocks, sectors and sub-sectors will go up, while others will go down. But if we're on the right side of those relative value positions, we believe we can derive exceptional returns without investing in beta. For example, while the focus has been on how difficult regulatory policy has been for some large internet companies, almost no one is talking about the positive impact on Chinese electric vehicle (EV) companies, battery manufacturers, semiconductor companies and telecom equipment companies. China has been investing in these new infrastructure areas to help the economy grow. For us, that dispersion represents an alpha opportunity.
  3. **The energy transition.** We see opportunity in the ways that companies, consumers and regulators are reacting to the realities of climate change. When we first started looking at this several years ago, we were concerned about the common approach to environmentally oriented investing. Most people were simply avoiding any sector or industry that had a significant carbon exposure. We think that is taking the easy way out. In order to help the economy transition from oil and gas to battery storage electrification and renewables, investors should focus on those companies that are going to make the capital expenditures (capex) to drive this transition. Therefore, we believe that there are going to be profound winners and there are going to be profound losers. We have been able to derive positive returns from fundamentally investing in these stocks.
  4. **The convergence of public and private equity markets.** This was manifested through the special purpose acquisition company (SPAC) market. Companies are coming to market earlier in their lifecycle. Private companies are trading more actively. And there is a tremendous amount of inefficiency associated with those trends. Investors are having difficulty managing and accessing the liquidity, and as such, we're seeing what we think are tremendous relative value opportunities in this space.
  5. **Private credit.** This theme capitalizes on bank behavior. Banks in this day and age are not efficient lenders, particularly when it comes to more complex areas. We have been able to step into that void, making direct loans ourselves and capitalizing on what we see as some of the most compelling risk-reward profiles in the market.
  6. **Working capital finance.** This includes financing of supply chain and working capital, primarily for US and European corporates. This is another example of how bank behavior has changed. Banks are less willing to have those types of exposures on their balance sheets. Thus, funding working capital has to migrate from bank balance sheets to investor balance sheets. Across the board in this space, we see higher yields and shorter durations. The asset class has had historically lower default rates and higher recovery than corporates. But investors are not equipped yet to take advantage of it, and that's why we have been so focused on working capital.

Interest rate outlook

- Volatility in interest rates is inherently destabilizing for most markets and investors. Rates are the best barometer of what policy and economic conditions are likely to be. When we see rates moving rapidly, it's an indication that there is a lot of uncertainty about economic conditions and policy.
- Interest rates are at the core of everything we do, from valuing cash flows, to investment returns to coupons. Our valuations are all based off discount rates. So when interest rates move, there's a thread that gets pulled throughout every risk asset.

- Higher inflation has definitely caused some other hedge funds to stumble, particularly discretionary macro strategies that take interest rate risk, and fixed income relative value strategies that are based on historical relationships in the rate markets and mortgage and asset-backed markets.
- We actually welcome interest rates going higher. We welcome the volatility. Higher inflation and stronger economic growth appear to be a near certainty, as does tighter monetary policy.
- The likely implications for beta are pretty straightforward: marginally positive for equities, flat to marginally negative for bonds, and flat to marginally negative for corporate credit.
- That creates an attractive backdrop for alternatives. If investors are not getting their returns from beta in equities, fixed income or credit, they still can earn absolute returns in the alternatives space. This is an environment where relative value opportunities should be successful.
- We think returns are going to be much more driven by alpha than by beta over the next 12 months. They'll come from picking stocks, picking credits, and focusing on different themes or factors.
- In fact, some investors are reducing their fixed income allocations and starting to look at alternatives as a partial replacement. The volatility and return profile of a multi-strategy hedge fund looks a lot like a credit-type return, and alts can be value-added in portfolios.

The risks of remaining too accommodative

- The markets are incredible discounting mechanisms. The risk isn't the things that people are talking about. It's the things people aren't talking about that could have an impact.
- The markets had an aggressive reaction to the Omicron variant because people weren't expecting it.
- We think the risk is that the Federal Reserve and central banks globally could remain too accommodative because of concerns about the virus or political pressures.
- The global economy is accelerating and there are clear inflationary pressures. Right now, policy is lined up to address that. But if something goes wrong, and central banks stay accommodative too long, we could get an inflation scare that could be difficult for the market to address.

For information purposes by UBS. For professional / qualified / institutional clients and investors only. Published December 2021.

This document does not replace portfolio and fund-specific materials. Commentary is at a macro or strategy level and is not with reference to any registered or other mutual fund. PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

Americas
The views expressed are a general guide to the views of UBS Asset Management as of December 2021. The information contained herein should not be considered a recommendation to purchase or sell securities or any particular strategy or fund. Commentary is at a macro level and is not with reference to any investment strategy, product or fund offered by UBS Asset Management. The information contained herein does not constitute investment research, has not been prepared in line with the requirements of any jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith. All such information and opinions are subject to change without notice. Care has been taken to ensure its accuracy but no responsibility is accepted for any errors or omissions herein. A number of the comments in this document are based on current expectations and are considered "forward-looking statements". Actual future results, however, may prove to be different from expectations. The opinions expressed are a reflection of UBS Asset Management's best judgment at the time this document was compiled, and any obligation to update or alter forward-looking statements as a result of new information, future events or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual security, asset class or market generally, nor are they intended to predict the future performance of any UBS Asset Management account, portfolio or fund.

EMEA
The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith, but is not guaranteed as being accurate, nor is it a complete statement or summary of the securities, markets or developments referred to in the document. UBS AG and / or other members of the UBS Group may have a position in and may make a purchase and / or sale of any of the securities or other financial instruments mentioned in this document.

Before investing in a product please read the latest prospectus carefully and thoroughly. Units of UBS funds mentioned herein may not be eligible for sale in all jurisdictions or to certain categories of investors and may not be offered, sold or delivered in the United States. The information mentioned herein is not intended to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. Past performance is not a reliable indicator of future results. The performance shown does not take account of any commissions and costs charged when subscribing to and redeeming units. Commissions and costs have a negative impact on performance. If the currency of a financial product or financial service is different from your reference currency, the return can increase or decrease as a result of currency fluctuations. This information pays no regard to the specific or future investment objectives, financial or tax situation or particular needs of any specific recipient.

The details and opinions contained in this document are provided by UBS without any guarantee or warranty and are for the recipient's personal use and information purposes only. This document may not be reproduced, redistributed or republished for any purpose without the written permission of UBS AG.

This document contains statements that constitute "forward-looking statements", including, but not limited to, statements relating to our future business development. While these forward-looking statements represent our judgments and future expectations concerning the development of our business, a number of risks, uncertainties and other important factors could cause actual developments and results to differ materially from our expectations.

UK
Issued in the UK by UBS Asset Management (UK) Ltd. Authorised and regulated by the Financial Conduct Authority.

APAC
This document and its contents have not been reviewed by, delivered to or registered with any regulatory or other relevant authority in APAC. This document is for informational purposes and should not be construed as an offer or invitation to the public, direct or indirect, to buy or sell securities. This document is intended for limited distribution and only to the extent permitted under applicable laws in your jurisdiction. No representations are made with respect to the eligibility of any recipients of this document to acquire interests in securities under the laws of your jurisdiction.

Using, copying, redistributing or republishing any part of this document without prior written permission from UBS Asset Management is prohibited. Any statements made regarding investment performance objectives, risk and/or return targets shall not constitute a representation or warranty that such objectives or expectations will be achieved or risks are fully disclosed. The information and opinions contained in this document is based upon information obtained from sources believed to be reliable and in good faith but no responsibility is accepted for any misrepresentation, errors or omissions. All such information and opinions are subject to change without notice. A number of comments in this document are based on current expectations and are considered "forward-looking statements". Actual future results may prove to be different from expectations and any unforeseen risk or event may arise in the future. The opinions expressed are a reflection of UBS Asset Management's judgment at the time this document is compiled and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed.

You are advised to exercise caution in relation to this document. The information in this document does not constitute advice and does not take into consideration your investment objectives, legal, financial or tax situation or particular needs in any other respect. Investors should be aware that past performance of investment is not necessarily indicative of future performance. Potential for profit is accompanied by possibility of loss. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice.

Australia
This document is provided by UBS Asset Management (Australia) Ltd, ABN 31 003 146 290 and AFS License No. 222605.

Source for all data and charts (if not indicated otherwise): UBS Asset Management

The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.

© UBS 2022. All rights reserved.
AMT-1264 1/22
www.ubs.com/am

For professional / qualified / institutional clients and investors only.

UBS