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CIO Flash Bulletin

Hedge funds: a key to post-QE portfolio returns?

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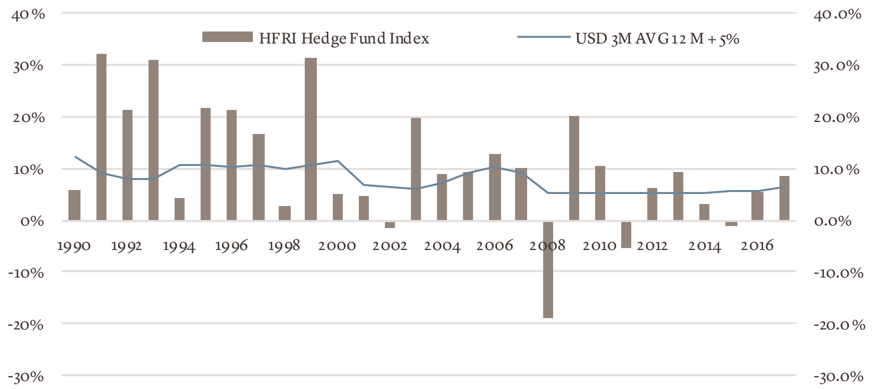
In the aftermath of a positive investment year for hedge funds (HFs), I recently attended the sector's most-fabled annual gathering and came away with insights on a HF industry that is confident that both sentiment and the economic cycle are shifting in its favour.

Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

The 20th Annual Morgan Stanley Breakers Conference, in Palm Beach US, saw the world's leading hedge fund managers and investors gather to address key themes affecting an industry that, we can all agree, has had a difficult decade. However, after 2017's performance[1] – the best in four years, with 12 straight months of positive returns – there was much debate about whether HFs are on the cusp of a turning point.

While the arguments for and against such a sea change were equally compelling, the truth is that it's simply too early to say. However, there are clear trends unfolding in the industry's favour. Along with a marked improvement in performance, last year saw growth in overall AUM, meaningful progress on the restructuring of fees, and a rise in the number of new strategies entering the market. Following five consecutive quarters of net outflows, just under USD 50bn flowed into the industry in 2017. With most forum attendees looking tentatively forward to a new phase in the industry's lifecycle, there are still many lessons to be learned from the dizzying highs and lows of the last 20 years.

1. Annual returns of the HFRX Global HF index vs cash (USD) +5% since 1990



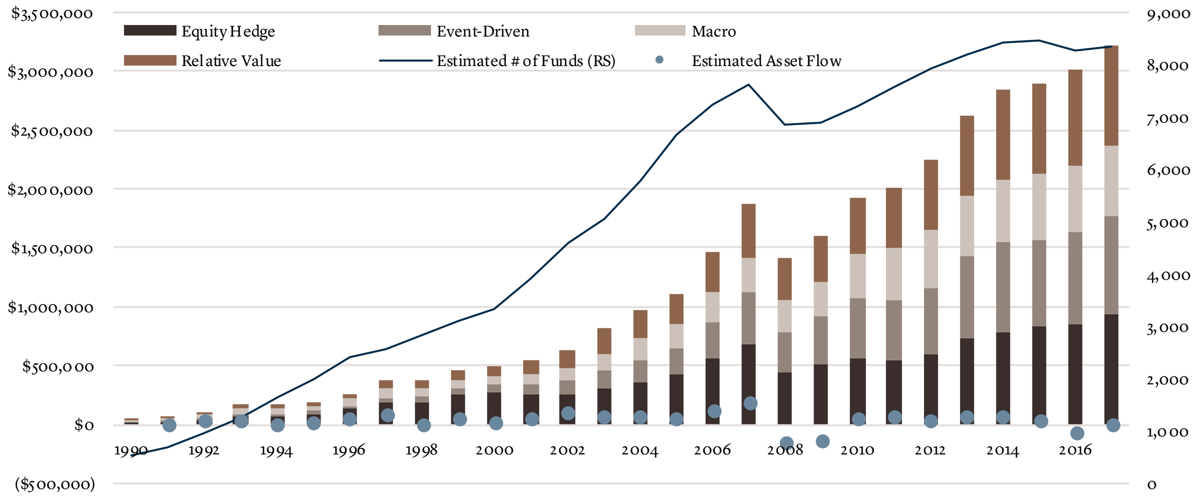
Source: Hedge Fund Research

[1] FY 2017 hedge fund performance was +8.5%, as measured by the HFRI Fund Weighted Composite Index. This is the best calendar year performance since 2013, extending the record Index Value to 14,054, according to data released by Hedge Fund Research on 1 January 2018.

The age of extremes

In 1997, there were just 380 hedge funds in the market with a total of USD 375bn under management and an offering dominated by equity hedged and global macro strategies. Today, approximately 8000 hedge funds manage USD 3.5trn across a plethora of strategies that range from equity long/short and credit to distressed and event driven. Over these two decades, performance has swung between extremes with the HFRX Global HF index returning an average of 14.2% from 1990 to 2007 versus 6.3% between 2009 and 2017.

2. HF Industry Evolution since 1990



Source: Hedge Fund Research

The near-zero interest-rate environment that followed the global financial crisis triggered gravity-defying returns among general risky assets and favoured volatility compressing strategies across the board. 2014-16 represented some of the HF industry's toughest years – a period that coincided with compressed interest rates and the rise of passive investing.

Passive aggressive

Exchange-traded funds (ETFs), which are famed for being low cost, attracted a record USD 490bn of inflows in 2016. During the same period, HF investors withdrew USD 70bn – the largest annual outflow from the sector in seven years.

Pitted in opposite corners of the active/passive debate, HFs and ETFs are often, and wrongly, in my view, pitched against one another. Passive investment enthusiasts will argue that a highly efficient global information network minimises asset pricing errors: the internet and the regulators ensure stock-sensitive information is made simultaneously available to all investors. In such an environment, they argue, there is little value that active investors can add. Proponents of active investing would argue that ETF flows have created markets divorced from underlying fundamentals and that move in lock-step. Large-cap stocks have become overvalued, systemic risk has risen and markets are more vulnerable to sell-offs.

While investors are clearly drawn to the lower cost and perceived transparency of passive instruments, ETFs are not the HF industry's only problem. Structural challenges – including the crowded nature of the sector prompting more funds to chase the same opportunities – were key components of the perfect storm that blew hedge funds off course in the first place. In response, the majority of HF managers have begun to invest in talent, technology and innovation to help them address the next generation of disruption.

Some of the rewards of this work were realised in 2017 as sentiment showed signs of turning around. According to Preqin[2], the proportion of investors *satisfied* versus *disappointed* with HF returns improved markedly over the period, along with the number of investors intending to *increase* versus *decrease* their allocations over the course of the year to come.

It is unsurprising that this trend appears to be unfolding at a time when the market faces a period of monetary policy normalisation, and investment fundamentals are poised to reassert themselves. Passive investing ultimately leads to the misallocation of capital, giving exposure to stocks based on their market capitalisation, rather than to the most deserving. Going forward, it is clear that investors will increasingly value being invested in companies selected on the basis of the quality of their managements, balance sheets, products, services, and valuations.

If we accept that flows from active into passive investments have changed markets, then the cyclical 'normalisation' of such distortions could in future provide a great opportunity for active investors and HF managers, in particular. Meanwhile, given that the world remains a highly uncertain place, any meaningful market correction could see purely passive investors lose out the most.

[2] 2018 Preqin Global Hedge Fund Report

Hedge funds and interest rates

The inability of investors to meet their yield objectives from fixed income markets has caused dividend-paying stocks in many cases to attract an otherwise unwarranted premium, as liability matchers and income investors rotate into equities as a substitute for fixed income. This valuation-insensitive buying has served to push up multiples on many low-growth companies, arguably beyond levels that could be justified under other circumstances.

This scenario becomes self-perpetuating as the inability of active stock pickers to earn alpha prompts investors to switch into low-cost index and enhanced index products. This serves to push up cross-sectional correlations and drive dispersion down, further reducing alpha opportunities.

An increase in interest rates should allow this phenomenon to begin to unwind. Rising capital costs force greater selectiveness in capital allocation and eventually prompt companies with the weakest balance sheets to rationalise and restructure. The worst excesses of capital expenditure are revealed and capital markets will gradually be closed to the least creditworthy issuers. Rising capital costs therefore increase the dispersion of corporate results and, consequently, of stock prices.

A place in portfolios

As well as structural inefficiencies, lacklustre hedge fund performance in recent years can be attributed to a combination of low interest rates, depressed volatility, high inter- and intra-market correlations and the impact of valuation-insensitive investors. Each of these cyclical headwinds is showing clear signs of easing, and HF performance has already improved across the board in step with this changing environment. As the monetary policy environment continues to normalise and volatility picks up, we see a stronger case for HF allocation.

Within portfolios, HFs can act as a diversifier and alternative source of yield in a low and rising interest rate environment. By diversifying sources of returns and limiting risk of loss, we believe HFs can enhance portfolio robustness and improve risk-adjusted returns for investors keen to access this asset class. For these reasons, owning investments that present a convex return profile and that stand a chance of profiting from a bear market is, in our view, sensible portfolio construction.

Investing in hedge funds may not be suitable for all types of investors. It may be necessary to obtain professional advice prior to making an investment.

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SWITZERLAND

GENEVA
Bank Lombard Odier & Co Ltd[1]
Rue de la Corraterie 11 · 1204 Genève · Suisse
geneva@lombardodier.com
Lombard Odier Asset Management (Switzerland) SA
Avenue des Morgines 6 · 1213 Petit-Lancy · Suisse
Support-Client-LOIM@lombardodier.com
Management Company regulated by the FINMA.

FRIBOURG
Banque Lombard Odier & Cie SA · Bureau de Fribourg[1]
Rue de la Banque 3 · 1700 Fribourg · Suisse
fribourg@lombardodier.com

LAUSANNE
Bank Lombard Odier & Co Ltd[1]
Place St-François 11 · 1003 Lausanne · Suisse
lausanne@lombardodier.com

VEVEY
Banque Lombard Odier & Cie SA · Agence de Vevey[1]
Rue Jean-Jacques Rousseau 5 · 1800 Vevey · Suisse
vevey@lombardodier.com

ZURICH
Bank Lombard Odier & Co Ltd[1]
Utoschloss · Utoquai 29-31 · 8008 Zürich · Schweiz
zurich@lombardodier.com

EUROPE

AMSTERDAM
Lombard Odier (Europe) S.A. · Netherlands Branch[2]
Herengracht 466 · 1017 CA Amsterdam · Nederland
amsterdam@lombardodier.com
Credit institution supervised in the Netherlands by De Nederlandsche Bank (DNB) and Autoriteit Financiële Markten (AFM).

BRUSSELS
Lombard Odier (Europe) S.A. Luxembourg · Belgium branch[2]
Avenue Louise 81 · Box 12 · 1050 Brussels · Belgium
brussels@lombardodier.com
Credit institution supervised in Belgium by the Banque nationale de Belgique (BNB) and the Financial Services and Markets Authority (FSMA).

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Suite 921 Europort · P.O. Box 407 · Gibraltar
gibraltar@lombardodier.com
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LONDON
Lombard Odier (Europe) S.A.[2]
Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom
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Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom
london@lombardodier.com
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LUXEMBOURG
Lombard Odier (Europe) S.A.
291, route d'Arlon · 1150 Luxembourg · Luxembourg
luxembourg@lombardodier.com
Credit institution authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF) in Luxembourg.
Lombard Odier Funds (Europe) S.A.
291, route d'Arlon · 1150 Luxembourg · Luxembourg
luxembourg@lombardodier.com

MADRID
Lombard Odier (Europe) S.A. · Sucursal en España[2]
Paseo de la Castellana 66 · 4ª Pl. · 28046 Madrid · España · madrid@lombardodier.com
Credit institution supervised in Spain, by the Banco de España and the Comisión Nacional del Mercado de Valores (CNMV).
Lombard Odier Gestión (España) S.G.I.I.C, S.A.U.
Paseo de la Castellana 66 · 4ª Pl. · 28046 Madrid · España · madrid@lombardodier.com
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MILAN
Lombard Odier (Europe) S.A. · Succursale in Italia[2]
Via Santa Margherita 6 · 20121 Milano · Italia
milano-cp@lombardodier.com
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MOSCOW
Bank Lombard Odier & Co Ltd · Representative Office Moscow
82 Sadovnicheskaya Street · 115 035 Moscow · Russian Federation · moscow@lombardodier.com
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PARIS
Lombard Odier (Europe) S.A. · Succursale en France[2]
8, rue Royale · 75008 Paris · France.
RCS PARIS B 803 905 157 · paris@lombardodier.com
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Bank Lombard Odier & Co Ltd · Representative Office Dubai
Conrad Business Tower · 12th Floor · Sheikh Zayed Road · P.O. Box 212240 · Dubai · UAE
dubai@lombardodier.com
Under the supervisory authority of the Central Bank of the UAE.

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Lombard Odier (Hong Kong) Limited
3901, Two Exchange Square · 8 Connaught Place · Central · Hong Kong · hongkong@lombardodier.com
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Israel Representative Office · Bank Lombard Odier & Co Ltd
Museum Tower, 7th floor · 4 Berkowitz Street · Tel Aviv 6423806 · Israel · telaviv@lombardodier.com
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MONTREAL
Lombard Odier & Cie (Canada), Limited Partnership
1000 Sherbrooke Street West · Suite 2200 · Montreal (Quebec) · Canada H3A 3R7
montreal@lombardodier.com
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NASSAU
Lombard Odier & Cie (Bahamas) Limited
Goodman's Bay Corporate Centre · West Bay Street · P.O. Box N-4938 · Nassau · Bahamas
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Supervised by the Central Bank of the Bahamas and the Securities Commission of the Bahamas.

PANAMA
Lombard Odier & Cie (Bahamas) Limited · Representative Office in Panama
Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá · panama@lombardodier.com
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Lombard Odier (Singapore) Ltd.
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Lombard Odier Trust (Japan) Limited
Izumi Garden Tower 41F · 1-6-1 Roppongi, Minato-ku · Tokyo 106-6041 · Japan
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