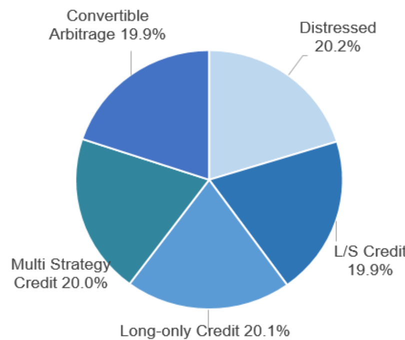
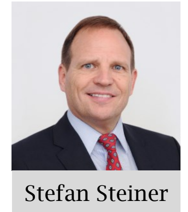
Credit versus Equity

In the last newsletter we wrote about the difficult environment for equities. Since then, a consolidation has occurred and will continue because high interest rates offer an alternative, equity valuations are still high, a more significant economic slowdown is coming and the geopolitical risks have increased again with the conflict in the Middle East.

Credit strategies offer however interesting opportunities, be it in the area of convertible bond arbitrage, long/short credit or stressed/distressed investments. The higher interest rate level offers a good starting point and experienced managers earn a few percentage points on top, which could lead to an annualized return of +10% for the next few years.

We recommend a well-diversified credit portfolio that occupies different niches as shown in the chart. See below for more information ("In the limelight").




Stefan Steiner

Equities will face headwinds for some time and we do not expect any price advances for passive long-only strategies in 2024. Here we continue to focus on long/short strategies that can generate positive returns also in sideways markets. Furthermore, we are evaluating market-neutral and trading-oriented strategies that generate stable alpha. These managers were positive in 2022 and are positive year-to-date in 2023 again.

They also benefit from higher interest rates because they can invest cash that is not needed for margin requirements in US T-Bills at a rate of +5% per annum. On page 2 of this newsletter we present such a strategy for Asian equities, which, based on fundamental models and through systematic implementation, generates an alpha of +10% per annum. These trading-oriented strategies also have a high Sharpe ratio, which means they generate a very attractive risk-adjusted return (return over volatility).

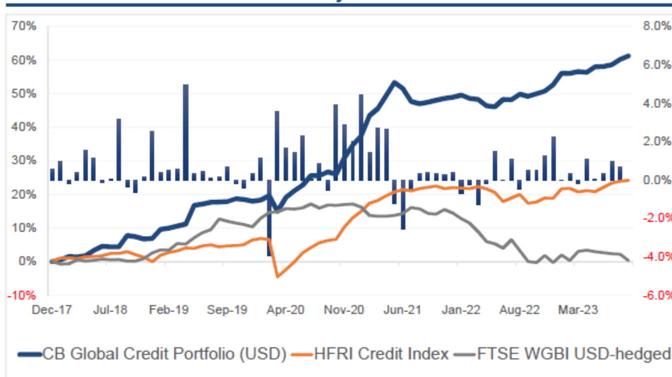
For more information please contact Stefan Steiner at ss@cb-partners.com.

In the limelight

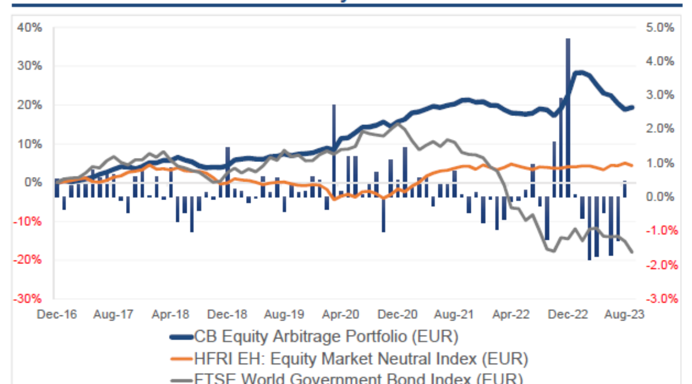
Credit strategies are becoming increasingly interesting because the credit market has priced in a weaker economic environment much more than the equity market. There are various credit niches that promise good, sometimes double-digit returns, and where we can count on long-standing, experienced hedge fund managers. They will be able to capture the upside potential and protect the portfolio against corrections. The CB Global Credit Portfolio (USD) is a proposal for a new certificate that has not yet been launched, but is being discussed with various investors. The liquidity of the certificate would be monthly, as the majority of the underlying funds also offer monthly redemptions.

Trading-oriented and market-neutral equity strategies have delivered very consistent returns over the past two years. They were able to show that they can generate consistent, positive returns in a weak 2022 and a positive 2023, regardless of the market direction. We have evaluated a few managers in this strategy that we recommend to our clients. The CB Equity Arbitrage Portfolio (EUR) will also benefit from these managers and should perform well over the next 12 months. The liquidity of the certificate is bi-weekly with 15 days' notice, which means one can buy or sell in the middle of the month or at the end of the month. Many of the underlying funds offer weekly redemptions.

Cumulative returns since January 2018



Cumulative returns since January 2017



Investment Case - Asia Equity Market Neutral

Summary

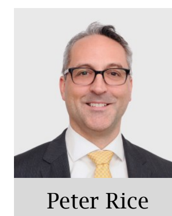
The global equity environment is becoming increasingly difficult to navigate. Inflation, debt levels and consumption are predicting different economic outcomes. While the credit market is becoming more cautious, the equity market is still priced relatively expensively. In this environment, a directional strategy struggles with a lot of headwinds, which can lead to sudden painful losses. We therefore focus on trading-oriented and market-neutral strategies that rely on relative stock movements and do not assume a specific market trend.

Diversification

Asia is diverse and multi-layered. On the one hand, different factors determine long-term stock prices in each country. For example, in China the export sector or in Taiwan the technology sector. On the other hand, the behavior of equities varies according to capitalization. Large-capitalization companies are strongly influenced by ETF capital flows and the behavior of global investors, while mid- and small-capitalization companies tend to be dominated by local investors and domestic issues

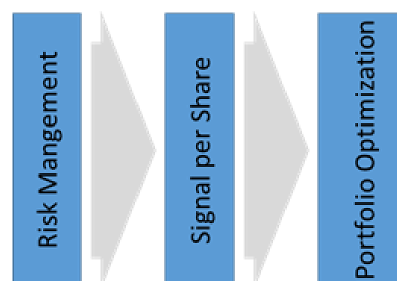
The different behaviors are an important prerequisite for rule-based strategies to be successful. These trading-based strategies hold over 2,000 individual stocks and use quantitative models to model effects that statistically predict positive or negative price changes. Taking different, independent factors together leads to a stable and efficient portfolio that can generate very attractive returns with low volatility

The important thing is to keep the complexity under control. Purely statistical models can be very complex, making it difficult to understand how the models react. Therefore, in crises, complexity can become a risk factor, which is why you need to react quickly to limit losses. This is the model of Millennium, one of the most successful hedge funds, which bundles a variety of trading-oriented strategies together and can intervene at any time via sophisticated risk management.


Peter Rice

The featured manager used to manage money for Millennium, generating excellent returns. He has further developed his models to incorporate complementary strategies. The manager focuses on understandable effects and captures them using robust models. An example are models that take fundamental company data such as balance sheet and income statement, calculate key ratios, and process these ratios in an optimization step into a trading signal per share.

Risk management also plays an important role in achieving attractive risk-adjusted returns. In systematic managers, risk management is usually an integral part of their models. This has the advantage that it is applied consistently.



Implementation

Trading-oriented and market-neutral strategies focus on alpha generation. They have little or no dependence on market direction. These approaches usually have limited capacity and require identifying attractive portfolio managers early on. A successful market-neutral manager improves returns and reduces portfolio risk. The risk-adjusted returns are very attractive and the best strategies achieve a Sharpe Ratio of 2, which means that they achieve twice the return per unit of risk. However, there are also market phases that challenge model-based managers, such as large liquidation moments where stocks must be sold regardless of quality.

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Unobserved Performance of Hedge Funds

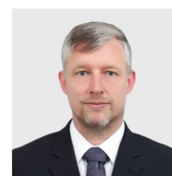
Vikas Agarwal, Stefan Ruenzi, and Florian Weigert investigate hedge fund firms' unobserved performance (UP), measured as the risk-adjusted return difference between a firm's reported gross return and its portfolio return inferred from its disclosed long-equity holdings. Firms with high UP outperform those with low UP by 6.36% p.a. on a risk-adjusted basis. UP is negatively associated with a firm's trading costs and positively associated with intraquarter trading in equity positions, derivatives usage, short selling, and confidential holdings. They show that limited investor attention can delay investors' response to UP and lead to longer-lived predictability of fund firm performance. A trading strategy based on UP continues to deliver positive abnormal returns even after considering real-world trading restrictions and transaction costs. UP predicts fund performance for up to three years in the future. This relatively long-term predictive power can emerge because investors only react to UP with a significant delay, after observing realized performance.

Decresing Returns to Scale and Skill in Hedge Funds

Yun Ling in his PhD thesis submitted to University of Sidney, together with Stephen Satchell and Juan Yao investigated the value creation by hedge funds using Berk and van Binsbergen's (2015) value-added. They find that, on average, a hedge fund manager extracts USD 0.76 million per month from the market. They provide strong evidence of persistence in value creation by hedge fund managers. Compared to previous results from another study, hedge funds managers are more skilled than active mutual fund managers who typically add USD 0.2 million per month.

Of three skill indicators—skill ratio, fee ratio, and total compensation—they find that total compensation best identifies the skilled manager out-of-sample. Investors in value-creating funds benefit from a better risk–return payoff. Using skill ratio as a skill metric, investors could achieve at least a 13% increase in the Sharpe ratio by investing in top-skilled funds instead of bottom-skilled funds at three- to six-year horizons.

While hedge funds operate in a less competitive market than mutual funds, incentive fees do not indicate greater skill. The value that hedge funds can extract from the market depends on both the profitability and scalability of the investment strategy.


Armin Vogel

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Their results on fee structure suggest that hedge funds with higher incentive fees do not necessarily add more value. The impact of fee structure on value-added is related to fund strategy. Hedge funds with balanced scalability and profitability add the most value. They document evidence that hedge funds with more scalable investment strategies tend to set a higher management fee relative to incentive fee, and thus are more management-fee-driven, whereas funds with more profitable investment strategies tend to set a higher incentive fee relative to management fee, that is, they are more incentive-driven. For funds whose strategy is of high scalability and low profitability, incentive-driven funds add less value because they tend to be oversized. For funds whose strategy is of low scalability and high profitability, incentive-driven funds add less value because they tend to be undersized.

A Closer Look at 'Cut Your Losses Early; Let Your Profits Run'

White, Ragulin and Haghani from Elm Wealth look at the well known quote "cut your losses early; let your profits run" ("CLE-LPR") with following conclusion: Most people are naturally inclined to patiently, and painfully, stick with losing decisions for too long while cashing out of winning decisions too quickly. Indeed, this was an early finding in the field of behavioral economics, and was important enough to be given a name: the "Disposition Effect". It is often the case that controlling our natural instincts can be rewarding. We suspect that much of the power of cutting losses quickly and letting profits run, at least when it comes to investing, lies in the difficulty of overcoming our propensity to do the exact opposite.

If you wished to receive the above mentioned papers, please contact Armin Vogel at av@cb-partners.com.