Crossbow Partners
Experience & Discipline

London Manager Trip

March 12 - 13, 2018

Executive Summary

The trip to London focussed on multi-manager funds, macro / trading funds and alternative risk premia funds

Multi-manager funds have proven themselves to be alternatives to fund of hedge funds because of their diverse nature and centralized risk management while size, culture and risk framework are differentiating factors

Macro / trading hedge funds view the sharp sell-off in February mostly as technical or behavioural in nature as macro-economic fundamentals did not warrant the speed and magnitude of the market's reaction

Hedge funds reduced directionality across all strategies, as gross and net exposures have come off recent highs, while the outlook is more muddled, mostly due to policy and geo-political uncertainty on the rise

Alternative beta is gaining traction as a less costly way to access alternative risk premia, which have academically been an element of certain hedge fund strategies

Reactions to February Market Events

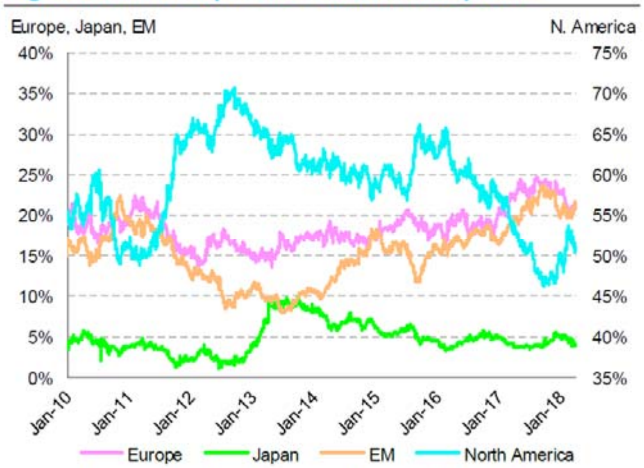
The environment of rising equity markets and low volatility, which investors had become accustomed to, ended abruptly at the beginning of February 2018. Market participants generally agree that the primary catalyst was the January US labour market report, showing the annual pace of wage growth rising 0.2 percentage points to 2.9%. This fed investor's concerns of a swifter pick-up in inflation and played an important role in the sell-off.

There is, however, also consensus that fundamentals did not justify the sharp and pronounced sell-off markets experienced. Fundamental managers highlighted that there still is not compelling evidence that inflation is picking up meaningfully and that the overall economic backdrop is still strong. For these managers, the reaction was more technical due to common risk management strategies, the reaction of systematic strategies to trend reversals or the increased use of ETFs which resulted in broad-based sale of markets.

Many systematic managers, notably CTAs, do not make fundamental predictions and did not take a view on the macro-economic outlook. For them, the sell-off was a behavioural effect as investors switch between greed and fear.

While fundamental data remains reasonably supportive, the managers on this trip highlighted the increased uncertainty from issues such as trade policies, central bank policies and politics notably in China and EU, creating a more muddled picture. These policy and geo-political uncertainties have led to some reduction in directionality in portfolios. At the end of February, Value-at-Risk levels seemed broadly based similar or slightly lower than at the start of the year. Some funds were required to reduce position sizes were to maintain comparable risk levels.

Figure 9: HF Net Exp as % of Global Net Exposure



Source: Morgan Stanley Prime Brokerage, data as of Mar 30, 2018

Figure 10: HF Leverage Levels (4)

Gross Leverage By Region

Region	Current Level	1-Year %-tile Rank	%-Tile Rank Since '10	MTD %-tage Change	YTD %-tage Change
US	162%	25%	90%	1%	0%
Europe	193%	41%	79%	-3%	1%
Asia	148%	24%	90%	1%	-3%

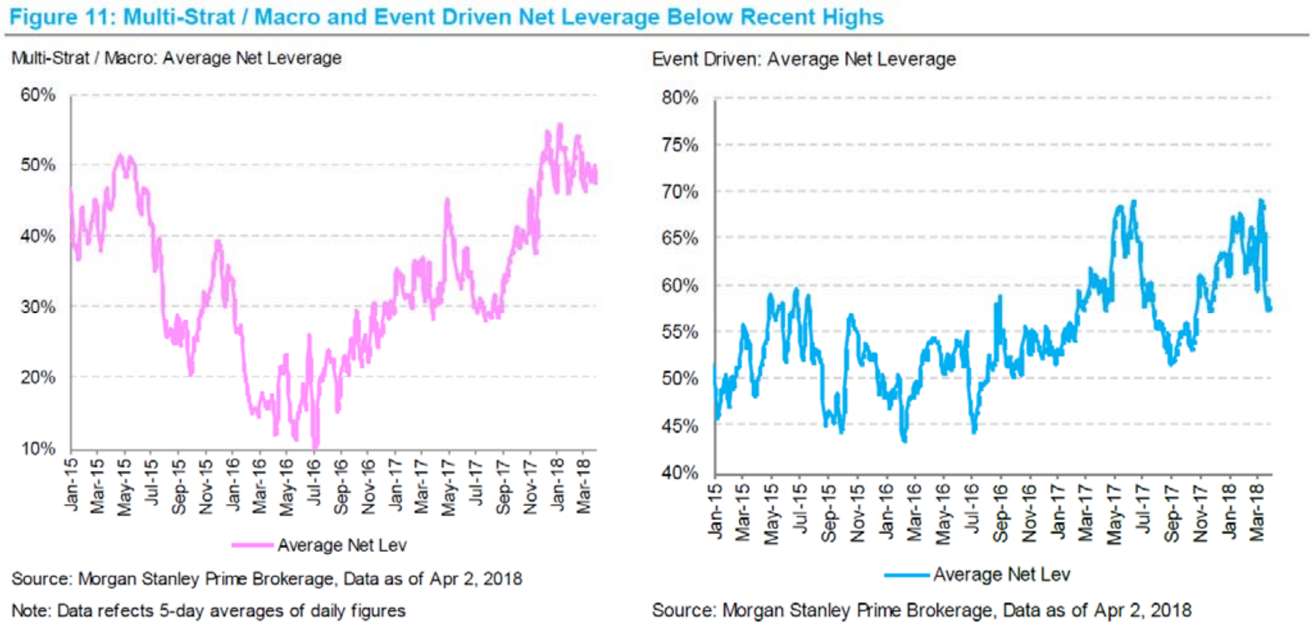
Net Leverage By Region

Region	Current Level	1-Year %-tile Rank	%-Tile Rank Since '10	MTD %-tage Change	YTD %-tage Change
US	52%	72%	46%	-4%	-2%
Europe	33%	1%	22%	-2%	-3%
Asia	55%	43%	67%	-6%	-7%

Source: Morgan Stanley Prime Brokerage, data as of Mar 30, 2018
Note: Figures across all regions are 5-day averages based on daily figures. US & Asia leverage are based on daily medians; Europe leverage figures are based on daily averages.

Long/Short Equity Net Hedge Fund Exposure by Region

Among long/short equity hedge funds net and gross exposures have come off recent highs. The reduction was fairly global but North America was the most net sold region. The decline in directional positions has been broad-based across non-equity long/short funds as well.



Source Morgan Stanley Prime Brokerage

Alternative Beta Funds

One of the developments of recent years has been the interest in alternative beta funds. The concept of alternative beta originated in academia, as studies were made into what factors (risk premia) drive hedge fund returns. While earlier hedge fund replication focussed on regression-based factor analysis of hedge fund returns, newer alternative beta concepts focus on alternative risk premia as sources of hedge fund returns.

Hedged Academic Factors	**Macro Alternative Risk Premia**
Market Neutral Value	Carry
Market Neutral Size	Value
Market Neutral Momentum	Volatility
Market Neutral Quality	Illiquidity
Market Neutral Low Beta	Dynamic Allocation
Event/Arbitrage Strategies	**Market Anomalies**
Merger Arbitrage	Momentum / Trend
Convertible Arbitrage	Mean Reversion

The definition and scope of an alternative risk premium still depends to some extent on the provider, but a common is the fact that an alternative risk premium is a persistent driver of return, that is well understood by the market and is expected to remain resilient because it is the reward for bearing risk, or arises through market inefficiencies and behavioral factors.

Crossbow: Schematic Placement of Alternative Beta between Long-only and Hedge Fund Investing

The universe of alternative beta products is growing as the number of providers increases and investors allocate increasing amounts to these products. We estimate up to 40 providers with alternative beta programs exist today, managing between USD 200 to 400 billion in alternative beta products. Long-only smart beta products still manage more assets.

From a provider perspective we categorise the providers into three basic groups:

- Investment Banks: Single risk premia or multi-premia indices available as swap or individual security. Clearly defined calculation methods executed through investment bank's execution platform.
- Broad Asset: Top-down, multi-asset expertise used to construct portfolios of single premia (typically provided by investment banks). Focus on selection, asset allocation and portfolio construction.
- Quantitative Investment Managers and Hedge Funds: focus on modelling and execution, this group typically leverage off excess capacity in their models and efficiency of their execution platform.

One of the objectives of alternative beta offerings is to provide investors with a less expensive access to key underlying returns drivers, typically found in certain hedge fund strategies. These are systematic strategies with greater capacity than hedge fund strategies.

We follow academic publications because academia continues to have an important influence on the alternative beta sector. A recent study by K. Vatanen and A. Suhonen highlights the robustness of alternative risk premia as a function of their underlying rationale:

Robustness decreases →

	Fundamental Premia	Behavioral Premia	Structural Premia
Defensive / Non-levered premia	Balance Sheet Quality Premia: Quality	Crowd Behavior Premia: Momentum & Value (Mean-reversion)	Seasonal Flow Premia: Rolling Period Premia etc.
Offensive / Levered premia	Tail Risk Insurance Premia: Carry & Volatility Carry	Leverage Avoiding Behavior Premia: Low Beta & Curve Carry	Market Structure Premia: Size & other Inefficiencies in the market structure

A Framework of Risk Premia Investing, K. Vatanen u. A. Suhonen

Fundamental premia, driven by economic rationale and risk-aversion, are considered the most robust. Others, dependent on persistent behavior of investors or persistent structural effects such as flows, are considered less robust in comparison. In addition, selecting and investing in alternative risk premia have a unique set of risks which are different to long-only investing, such as data-mining, publication bias, leverage and model overfitting. This additional complexity and variable robustness ultimately means that buy-and-hold investing does not work for alternative risk premia. Exposures and investments need to be managed on an ongoing basis by a portfolio manager.

Also, it is important to understand that, even though these risk premia are associated with hedge fund returns, they are not absolute return products. The underlying investments will change over time, and even might change directionality (eg. Trend premia), but the premia are not managed to an absolute return objective but to gain exposure to a specific risk premia.