2023 HEDGE FUND INVESTMENT OUTLOOK

EXECUTIVE SUMMARY

- Our moderate conviction in long/short equity is due in large part to our view that other strategies are more attractive on a relative basis. That said, the environment for active equity investing has improved materially. Many questionable business models have been able to thrive on cheap debt. The higher cost of capital will pressure those weaker business models creating a larger gap when compared to well run peers. Long/Short equity managers that generally buy high-quality, well-run businesses on the long side, while shorting lower quality businesses on the short side should benefit from the widening of this spread in fundamentals.

- Event Credit is our highest conviction strategy. The combination of higher interest rates and wider credit spreads benefits Long / Short Credit strategies due to the higher cost of capital that is forcing greater differentiation between high- and low-quality businesses. We believe that opportunity is here today in Europe and will follow in the U.S. in the first half of 2023.

- We expect markets to continue to be dominated by concerns over rates and inflation. This should bode well for fixed income arbitrage strategies as we would expect volatility in government bond markets to stay elevated as central banks reduce their holdings.

- We remain positive on the opportunity set for global macro, but success will come down to manager selection. Higher rates, higher inflation, and geopolitical conflicts will increase the opportunities and risks for traditional directional macro. It will require a skilled and experienced macro manager to profit and protect capital over the coming year.

INTRODUCTION

The past year was one of transition as both the global economy and markets came to grips with the end of over a decade of easy money policies. Coming into 2022, there were still many that believed – or hoped – that higher inflation was transitory. However, as rates of inflation hit double digits in many countries in the first half of 2022, it became clear that central banks would have to act quickly and aggressively to dampen rising prices. Central banks proceeded to hike interest rates at an unprecedented pace, and stocks and bonds fell sharply. The public markets no longer favored growth at any price, and steady, profitable companies became safe havens for capital. High growth, unprofitable companies that had been market darlings in 2021 all but disappeared in 2022. Volatility and dispersion increased across asset classes and has remained elevated.

For a traditional long-only portfolio, including the historically popular 60/40 model portfolio, 2022 can be simply summarized as "no place to hide". Last year turned out to be one of those rare times when both bonds and equities sold off significantly. The MSCI ACWI closed the year down -18.4%, the Bloomberg U.S. Aggregate Bond Index closed down -13.0%, and the ICE BofAML U.S. High Yield Constrained Index closed down -11.2%. Traditional diversified portfolios failed to hold up and protect capital – the standard 60/40 portfolio model would have been down -17.2% in 2022[1], the worst performance since 2008 and the second worst result in real terms in a calendar year since 1937, during the Great Depression[2].

The challenges of 2022 shone a spotlight on the importance of a consistent exposure to unconstrained active management in a portfolio

A bright spot in public markets was hedge funds, and investors with an allocation to hedge funds were likely pleased with their investment. The HFRI Fund Weighted Composite Index was down -4.3% in 2022, outperforming stocks and bonds by a wide margin and demonstrating the downside mitigation that is expected from a hedged allocation. The challenges of 2022 shone a spotlight on the importance of a consistent exposure to unconstrained active management in a portfolio. Heightened volatility and dispersion are challenging for passive strategies, but they create a good environment for hedge funds as managers have more opportunities to prove their skill (alpha). Short positions, which are designed to profit from declines in stocks and bonds, are vitally important to a portfolio. Higher absolute levels of interest rates, which negatively impacted stocks and bonds, are a positive tailwind for hedge funds, as higher interest rates provide the opportunity for higher returns from short positions. We have just started to see this impact on hedge fund returns.

[1] Based on a static 60% allocation to the MSCI ACWI and a 40% allocation to the Bloomberg U.S. Aggregate Bond Index from the beginning of 2022.
[2] Source: Deutsche Bank, as of 12/31/22, calculated based on allocations to the S&P 500, 10-year U.S. Treasury and predecessors. Wall Street Journal, as of 1/15/23.

We expect that this favorable environment for hedge funds will continue into 2023. The market characteristics that set the stage for outperformance by hedge funds last year are likely to persist: higher volatility, higher dispersion, and higher interest rates. We expect that rates of inflation will come down from the highs of 2022, but inflation may remain stubbornly elevated above 2%. Central banks will realize that dampening inflation from the high single digits to ~4%-5% will be much easier than the move from 4% to sub-2%. Taming inflation to long-term targets will require restrictive monetary policy for longer than many market participants are currently forecasting.

Global growth rates have already begun to slow. We believe decelerating growth will continue, at least in the first half of 2023, as higher absolute levels of interest rates work their way through the economy. Europe is likely already in a recession, and if Europe is not technically in a recession already, the markets are behaving as if growth is negative. We expect the U.K. and/or the European Central Bank to be the first of the major central banks to pivot and pause interest rate hikes as concerns about economic growth take priority over managing inflation. In the U.S., we believe the probability of recession is 50/50. Unemployment remains low and data suggests the consumer remains strong. The relative strength of the labor market gives the Federal Reserve the ability to keep interest rates higher for longer than other developed markets and keep its focus on inflation over GDP. However, slower economic growth and higher interest rates will begin to show a negative impact on corporate profits. Many corporations have shown the ability to pass through higher costs to consumers, but that is likely to stall for most companies in 2023.

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There are several economic and geopolitical developments we are watching closely in addition to interest rates and inflation. The ongoing war in Ukraine and the severity of winter in Europe could have a large influence on global inflation – in both directions. Our base case is that global energy prices climb higher through the first quarter, but a mild winter and/or a resolution to the war could mean a big downside surprise to energy markets. Meanwhile, we expect the start-and-stop re-opening of China to move more squarely into re-opening in 2023, but the impact that will have on the world is less certain. Constraints around supply chains are expected to lessen and be deflationary, but the impact that re-opening will have on the Chinese consumer is likely to be inflationary.

If 2022 was a year of transition, we expect 2023 will be a year of adjustment as a regime of higher interest rates becomes the new normal and markets adjust to the impact this will have on the economy. Throughout this Outlook, we discuss where we see the best opportunities for hedge funds in this new environment. We see compelling opportunities that are expected to drive strong returns in the coming year. However, we caution that, while we have a baseline view of how the year may unfold, the error bands around that forecast seem to be wider than in previous years. It is more important than ever to be invested with highly skilled active managers that can adapt along with markets.

EQUITY LONG/SHORT

U.S./GLOBAL EQUITY LONG/SHORT

We don't know whether equity markets will close up or down for 2023, but we do know that the environment for equity long/short has improved steadily over the last 12 months – particularly on the short side. This is largely due to higher absolute levels of interest rates. Higher interest rates have two key positive impacts. First, managers' short portfolios are now earning real income on the cash they have deposited from short sales.

MODERATE
Non-U.S. Long/Short
U.S. Small and Mid Cap

LOW
U.S. Large Cap Long/Short

At the time of writing, managers have indicated those deposits are earning approximately 3%, whereas they were earning close to zero 12 months ago. Think of this as a sprinter starting ahead of the starting line. As rates continue to rise, this carry increases and is meaningful for portfolios. The second effect is the increased financing costs for businesses. Many questionable business models were able to not only survive, but to thrive in an era of cheap debt. Higher financing costs will start to put pressure on weak business models and create a larger gap compared to well-run businesses. The managers we typically invest in tend to buy higher quality companies on the long side of their portfolios and short lower quality businesses that they believe are overvalued. When financing costs were at historic lows, the valuation spread between these kinds of businesses was narrow. As interest rates have risen, along with higher input costs across the board, we expect to see the quality gap widen – creating a much more compelling backdrop for equity long/short investing.

Meanwhile, the Federal Reserve does not appear to be done hiking interest rates and the economy will be feeling the lagged effects of prior interest rate increases. The likelihood of a global recession has risen. Lower corporate earnings in a recession may lead to more near term pressure in the stock market as companies cut earnings forecasts, benefitting those managers that have the ability to short. In general, long portfolios include companies that are in strong secular growing industries where earnings power tends to be more resilient in an economic downturn. Short books are comprised of businesses that have benefitted from low interest rates and inflated revenues over the past few years where an economic downturn would negatively impact earnings.

EUROPEAN EQUITY LONG/SHORT

European equities will remain challenged in the near term as the economy deals with the energy crisis, the ongoing war in Ukraine, post-COVID-19 supply-side pressures, and double-digit inflation. A higher cost of living will curb consumer spending, higher costs of goods sold will impact corporate margins, and persistent inflation will put pressure on central banks to remain hawkish. Investors should expect heightened market volatility across the region and an increased risk of a recession this winter, followed by a slow recovery. Europe's outlook will be heavily influenced by energy prices and gas supplies for this winter and the next, while policy mistakes could result in additional exogenous shocks.

As equity prices reset, targeted security selection should provide attractive opportunities for both longs and shorts. Equities with pricing power will offer more of an inflation hedge and present the best near-term long opportunities. Managers are expected to focus on stable, double-digit compounders that will help deliver high-quality, risk-adjusted returns and strong upside capture as markets recover. Longer term, more broad based opportunities are expected to develop with visibility into potential for stabilization of energy prices and rates of inflation.

CHINA EQUITY LONG/SHORT

Our outlook for investing in China remains highly uncertain. In the near term, China may represent one of the highest upside opportunities in global equity markets, but it also presents one of the largest risks. Again, the error bands around forecasts and potential outcomes are wide. As a result, our exposure to China is driven by manager talent and strategy flexibility. We believe there is significant alpha to be earned in equities as China moves away from zero-COVID-19 policies. Managers are looking to their developed market re-opening playbook as a blueprint to investing in China over the next 9-12 months. Inflation has been low in China, giving the Chinese Communist Party ("CCP") the flexibility to stimulate the economy and promote growth. However, we expect there will be fits and starts in reopening as spikes in infection rates are likely to cause some targeted restrictions and closures. Flexibility in portfolios and positioning will remain key to managing through this high risk environment. Over the long term, we are less constructive on the opportunities in China due to the lack of predictability of the CCP and the previous reordering of the CCP's priorities towards common prosperity and combatting inequality at the expense of innovation.

SECTOR EQUITY SPECIALISTS

We continue to believe the best opportunities for alpha generation in dedicated sector funds are in the technology, media and telecom space ("TMT"), energy, and healthcare, and we focus on the opportunity in those areas below.

Our view of TMT is mixed as interest rates and inflation continue to dominate performance. The last year demonstrated that being a TMT specialist fund is not necessarily helpful in navigating and mitigating the severe drawdowns across these sectors. In fact, many of the largest and most well respected TMT-focused firms experienced some of the most severe drawdowns in the industry, and firms that have material access and expertise in the private technology markets have generally not fared much better. Many of these firms now recognize the mistake of positioning their funds with too much beta and momentum. With the steep sell-off in TMT, many technology stocks that were beneficiaries of COVID-19 are now trading below pre-2020 levels. In spite of this price correction, we remain skeptical on taking a long-biased tactical view on TMT. Non-traditional methods of valuing many of these companies have been set aside as investors re-focus on cash flows and profitability. We think the TMT sector still has many of the least attractive business models across the market, and the opportunity to continue generating alpha from shorting in the sector will remain compelling. We believe a lower net approach is the best way to approach this sector that is still in transition.

Healthcare, and biotech in particular, may have the most compelling long opportunity set in years following the volatility in the space from late 2021 through 2022. Despite the severe devaluation of the industry recently, innovation in biotech/therapeutics/healthcare is robust. M&A has picked up considerably despite higher interest rates, because large pharmaceutical companies are still flush with cash and need to fill depleting drug pipelines. At these attractive valuation levels, many small and mid-cap biotech companies are in play, which makes long investing more compelling but makes shorting more treacherous. In healthcare, we prefer a specialist approach due to the high bar of technical expertise required to invest in and navigate the space. Many of the most successful funds aim to create a team with balanced knowledge and experience in both science and business fundamentals.

Energy has become a more interesting area for investment as the industry transitions towards renewable resources and greener technologies. We believe this will create a decades-long reordering of supply chains, delivery infrastructure and fuels that will foster many winners. First, M&A has been accelerating across the energy space. The oil majors are the most informed participants in energy transition, and they have the largest pool of deployable capital. In the near-term, the majors are looking for renewable fuel sources. These businesses are easy for oil majors to understand and they have existing infrastructure to blend and distribute renewable fuels. Also, they already trade many of the underlying fuels credits which they can optimize through integration. High utility bills and gas prices continue to enhance the attractiveness of clean alternatives for companies and consumers. Interestingly, 2022 looks to be the first year ever in which global capital expenditures on renewables will be greater than that on oil & gas development. In addition to continued growth within the sector, the Inflation Reduction Act (“IRA”) is loaded with tax credits and other incentives that will spur trillions of dollars of investment into the decarbonization sector over the next decade. Meaningful new subsidies are now available for many energy transition subsectors, including solar, wind, energy storage, carbon capture and green hydrogen. Despite these positive developments, broader economic concerns have pressured stock prices in this space. At least for now, nervous investors have not been paying attention to the energy transition despite the growth and recent game-changing legislation. We believe this disconnect provides an excellent opportunity for managers that are specialists in the energy space.

CREDIT/EVENT

DISTRESSED

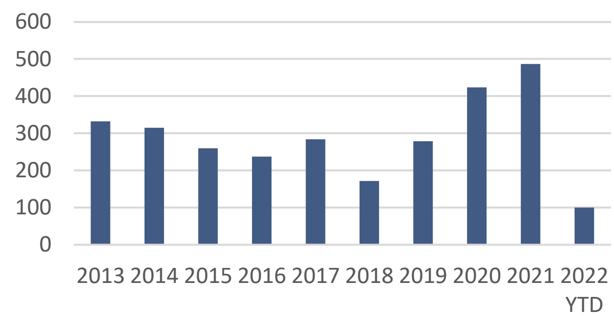
Credit is our highest conviction strategy going into 2023. An opportunity in distressed credit is emerging as the cost of capital has risen significantly for businesses. We believe a robust opportunity set for distressed credit investing has already arrived in Europe and more opportunities will develop in the U.S. as we move through the year. We, like many other hedge fund investors, get excited for a distressed environment considering the strategy has been the best performing hedge fund strategy over the last 30 years. The challenge with distressed is it is episodic and unpredictable.

HIGH
Event Credit Strategies:
Long / Short Credit
Distressed Special Situations

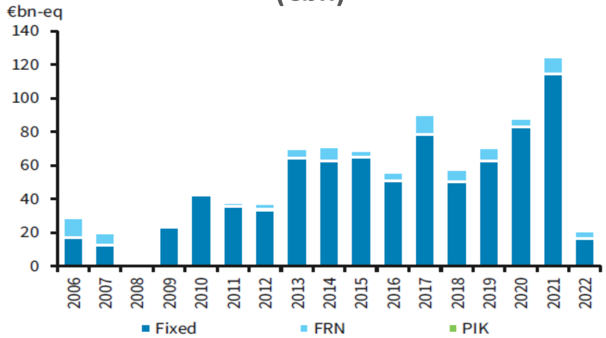
MODERATE
Event Equity Strategies:
Merger Arbitrage
Spin Offs

Over the past decade, easy monetary policies and aggressive central banks have limited the number of global bankruptcies. The actions of central banks in the early days of the pandemic sowed the seeds for the opportunity that we see today. A lot of money was borrowed by companies in both the U.S. and Europe facilitated by monetary policy. Much of this debt was termed out to 2024 in the U.S., while Europe's maturity wall starts in 2023. Most companies look to refinance debt at least 12 months prior to maturity to avoid debt becoming a current liability. This has the potential to be a powerful catalyst at a time when credit new issuance markets in the U.S. and Europe have been virtually closed.

US Corporate High Yield Issuance ($bn)



European HY Annual Issuance (€bn)



New issuance has fallen to levels not seen since 2007 and 2008. While we find the bond maturity wall compelling, we believe the bigger catalyst for refinancing and restructuring will come from the amount of floating rate debt that has been issued in both public and private markets in recent years. This is most obvious in Europe, where it is a heavily banked market and interest rate re-sets are common. The cost of capital for many companies has gone up significantly and margins are being squeezed with high prices for materials, wages, and energy. There are signs that consumer behavior is changing as personal budgets are being impacted by higher rents, more costly car insurance and gas prices, and higher grocery bills. Most home mortgage debt in Europe and the U.K. is floating rate – putting pressure on household discretionary spending. With all of this in mind, a recession in the European region is looking increasingly likely, and default rates will pick up as growth slows.

An unexpected pause in tightening plans or central banks reversing course earlier than expected are risk factors that could limit the opportunity in distressed credit. However, it is our view that, due to persistently high inflation, central bankers cannot change plans for higher interest rates to stave off a recession. Market participants may be hoping and looking for signs that the Federal Reserve and other central bankers will curtail tightening measures, but we believe lessons learned from the Federal Reserve's efforts to control inflation in the 1970s make a quick pivot unlikely. Further, Chairman Powell has made controlling inflation the Fed's top priority at the expense of a recession.

New issue markets being closed and banks pulling back on lending has created an opportunity for hedge funds to step into the market as providers of capital at attractive terms. Today, hedge funds are providing bridge loans and rescue financing to companies that are under stress and in need of near-term capital, but have limited default risk. There are also stressed and distressed situations emerging in good businesses that are viable long term, but have over-levered capital structures that will need to be restructured.

EVENT EQUITY

We are moderately constructive on Event Equity and Merger Arbitrage. Deal volume fell in the back half of last year given the uncertainty in the global economy, and we do not expect deal activity to pick up in the near term. Investment banks have taken a significant hit on hung bridge deals like Twitter and Citrix, putting further pressure on the potential for deal levels increasing. There are a number of legacy transactions still outstanding and trading at attractive spreads, but these generally come with regulatory uncertainty. We don't expect merger and acquisition activity to pick back up in a meaningful way until financing markets stabilize and corporate executives have more confidence in their business outlooks.

On the event equity side, the uncertain economic backdrop can lead to an increase in spinoffs and divestures – a trend we saw pick up towards the end of last year. We expect this trend to persist as corporations refocus on their core businesses. This should create opportunity for event managers – especially those with a broader mandate than strictly merger arbitrage. There should be increased opportunities in the event equity space with corporates that are forced to generate cash through equity issuance. Managers that have the ability to work directly with corporates and can structure and/or lead equity deals should have an advantage in this environment.

RELATIVE VALUE

STRUCTURED CREDIT

The opportunity set in structured credit is beginning to improve, but it varies across the investment universe. Skilled underwriting will be key in finding value in the near term. Structured credit markets faced negative technicals throughout 2022. New supply to the market remained higher as originators like Sofi and Carvana came to market to get existing loans off their balance sheets. Rising interest rates have extended many fixed rate securities as prepayment and refinancing activity slows. Meanwhile, the massive swing in duration in 2022 put pressure on bank's tier 1 capital ratios, removing banks as a marginal buyer of structured paper. Large institutional asset managers and mutual funds, who make up a large portion of the buyer universe for structured credit, are managing for redemptions and raising cash – keeping them out of the market.

HIGH
Fixed Income Arbitrage
Relative Value Strategies

MODERATE
Convertible Bond Arbitrage
Structure Credit
Market Neutral

LOW
SPACs

Net supply in U.S. agency residential mortgage-backed securities (RMBS) is poised to slow from the record pace of the past few years as cash-out re-financings have essentially disappeared and purchase activity slows down. Given the rapid increase in mortgage rates following years of a hot housing market, affordability is the most stretched it has been in over forty years. We expect home prices to come down, but only moderately given the lack of supply in housing markets. Ongoing problems with housing inventory are exaggerated by the fact that home buyers that locked in a 3% or lower mortgage are less likely to move. The commercial mortgage-backed securities market ("CMBS") experienced price declines in 2022 due to uncertainty in financing markets, particularly in the back half of the year. Looking ahead, we expect credit risk to be in focus. Cap rates tend to be stickier than interest rates, but are likely to re-price in 2023 given the dramatic rise in interest rates.

CONVERTIBLE BOND ARBITRAGE

Returns in the convertible bond arbitrage strategy were dispersed in 2022, ranging from down -10% to positive returns in the mid-teens, according to reports from prime brokers. The environment for convertible bonds in 2022 was challenging. The sell-off in growth and in higher risk assets drove many convertible bonds deep into busted territory. The average convertible bond became more credit sensitive and more difficult to hedge. As convertible bonds move lower in delta, hedging becomes more difficult and more fundamental credit work is required. In addition, interest rate hedges have required more nuance, as a simple interest rate hedge now leaves funds exposed to risk-off moves. Additionally, optionalized rate hedges require more expertise, especially in an environment of elevated interest rate volatility. The opportunity set in convertible bond arbitrage is generally less attractive in the near term due to the higher level of credit sensitivity in the universe. However, we would expect managers who have expertise in off-the-run and catalyst-driven opportunities to outperform while adding valuable diversification to portfolios.

FIXED INCOME RELATIVE VALUE

We expect fixed income markets will continue to be dominated by concerns over the direction and absolute levels of interest rates and inflation in the medium-term. This should bode well for fixed income relative value strategies. We would expect volatility in government bond markets to stay elevated as central banks reduce their holdings. Today, the most compelling opportunity is in the U.S. as investors shift to a focus on terminal rates, as opposed to the potential size of the rate hike at each meeting. This shift in investor focus is likely to keep volatility elevated but manageable – creating a good environment for this relative value strategy.

GLOBAL MACRO

GLOBAL MACRO

HIGH
Traditional Directional Macro Strategies

MODERATE / LOW
Systematic Macro Strategies

In 2022, developed markets-focused global macro funds were generally the highest returning hedge fund strategy with many funds up double digits. Exposure to rising interest rates and the stronger U.S. dollar were key drivers of performance. We expect the environment for global macro to continue to be positive due to the market's continued focus on interest rates and inflation, high interest rate differentials that should benefit the opportunity in foreign exchange, and the likelihood of continued volatility and elevated geopolitical risk. However, the "easy money" may have already been made given the substantial increase in interest rates to date and the move seen in the U.S. dollar last year. There are a few potential areas of opportunity for global macro funds in the near term, including the Federal Reserve's continued experiment with quantitative tightening, the potential for a seismic policy mistake in Japan, and the global impact of China's policy decisions. We believe the investment environment is more favorable for global macro generalists than for asset class specialists, considering there are more degrees of freedom for generalists in an inherently a low-breadth strategy. As always, our focus is primarily on finding manager talent rather than making any top-down allocation decisions on the sector.

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