

A grayscale photograph of a city skyline, likely Chicago, featuring several tall skyscrapers and a bridge over a body of water. The image is partially obscured by a large blue geometric shape on the right side.

# 2019 HEDGE FUND *OUTLOOK*

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# 2019 OUTLOOK

## MARKET REVIEW

The Dow Jones Industrial Average crossed the 25,000 mark for the first time in early January 2018 to much fanfare by the financial media. On the heels of corporate tax cuts and a seemingly synchronized global economy, the hype was real, and the talking heads were seen sporting “Dow 25,000” hats all over television. Those hats turned out to be a great value investment as, by our count, the Dow crossed that 25,000 mark on nine separate occasions during the year. The year end market malaise left the Dow a little over 23,000 as 2018 closed, so they’ll hopefully get to break those hats out again at some point in the future.

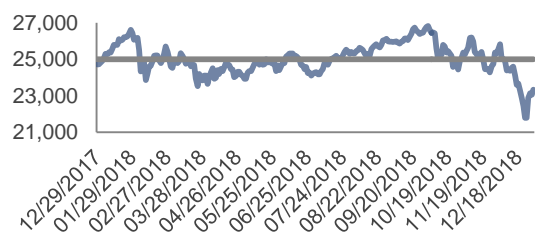
While 2017 was a year that saw the VIX, a measure of implied volatility of the S&P 500 Index, steadily decline to record lows below ten, 2018 proved to be a different story where we saw the VIX spike above 30 in February reaching its highest level since August of 2015.

We have often said that higher volatility, higher interest rates, and lower correlations across geographies and asset classes are typically good for hedge funds, which strive to provide investors with alpha, diversification against traditional asset classes, and downside protection. It is important to note that these characteristics will manifest themselves over quarters and years rather than day-to-day or even month-to-month when technicals can overwhelm in the short term. Just as markets reprice and recalibrate risk, so do active investment managers. When we look at broad hedge fund performance for the fourth quarter we have been pleased to see many managers adapt and recalibrate risk in a measured way when it appears the old rules of buying the dip may no longer apply.

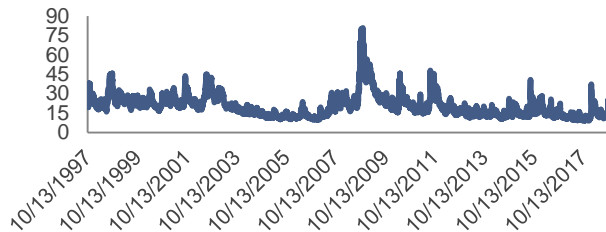
The process of dismantling more than a decade of easy monetary policy has begun in earnest and markets are entering a discovery phase where risk is repriced, and perhaps more appropriately priced, by market participants. The policy induced era of peace and tranquility appears to be coming to a close and the fourth quarter was unkind to managers accustomed to buying the dip in anticipation of a quick recovery.

2018 was a challenging investment environment where the world settled into a higher, more normalized volatility regime. It’s been infrequent that cash out performs a 60/40 portfolio of 60% MSCI ACWI and 40% Barclays US Aggregate. It has happened six times since the year 2000. Three of those times were 2000 – 2002, the fourth was 2008 and the fifth and sixth were close calls in 2011 and 2015 where cash outperformed by ~1.25%. 2018 was the seventh time with cash outperforming by nearly 750 bps. While corporate fundamentals remain solid in the U.S., economic data from Europe and China has been showing signs of weakness across industrial production, manufacturing activity, and retail sales, moving us from a backdrop of synchronized accelerating growth to uncertainties around deceleration.

**EXHIBIT 1:**  
DOW JONES INDUSTRIAL AVERAGE INDEX



**EXHIBIT 2:**  
CBOE VIX Index



Past performance is no guarantee of future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

As we look forward, we expect these trends to continue. With global growth clearly slowing, financial markets have become more sensitive to Fed policy pronouncements and geopolitical risks that will have real ramifications on the economy. Given these uncertainties, investor sentiment has become more cautious than we have seen in years as they discount them in the market today and require additional return premia for the risk. The U.S. China trade war will not only affect those countries but will also have a continued negative drag on many other emerging markets. In Europe, the possibility of a hard Brexit is bringing uncertainty over the U.K. economy and the financial sector specifically. In addition, populist party political gains across Europe are impacting ruling coalition agendas across France, Germany, Italy and Spain. With much to be concerned about, coupled with an inability to predict outcomes, we expect all of these events to continue weighing on market sentiment in 2019.

While we don't expect a recession this year in our base case scenario, and as prices have adjusted lower given the uncertainties, in the near term we continue to maintain many of our current allocation themes, while emphasizing a more balanced approach to risk taking. As we have seen more pockets of dislocation in both global equity and credit markets, we hope to prudently take advantage by marginally rotating capital into these areas where we can find talented and nimble managers who can navigate these opportunities, while also looking for less correlated, idiosyncratic investments.

## THE YEAR AHEAD

From a research perspective, we have two primary responsibilities: 1) find opportunities within markets that can provide differentiated sources of return; and 2) find managers to execute on those opportunities. These opportunities can be as niche as municipal bond trading in the U.S. or as broad as equity selection in Europe. The opportunity set is ever evolving and managers within our portfolios evolve along with these changing opportunities. Equity markets will always be there for investors to take risk in, and with a high degree of confidence we can say that the Dow will either be above 25,000 at the end of 2019, or it will be below 25,000. If opportunities play themselves out in Relative Value, Global Macro, Long/Short Equity and Event Driven as we see them, where the Dow ends the year won't matter much to us.

# ALLOCATION *THEMES*

## STRATEGIES

- EVENT DRIVEN
- LONG SHORT EQUITY
- RELATIVE VALUE
- GLOBAL MACRO

# EVENT DRIVEN

Our broad event driven bucket can be subdivided into either equities or credit. Event equity continues to be our highest conviction strategy as we continue to favor managers with meaningful allocations to corporate M&A. Globally, we expect debt capital markets to remain open and relatively cheap, while organic growth remains more difficult than growth through acquisitions. However, we are mindful that we are entering the later stages of the cycle and global quantitative tightening could become the impetus for capital markets to close quickly. In addition, we are closely watching the deal pipeline, the regulatory environment, funding costs, and boardroom confidence to guide our allocation. 2018 saw heightened volatility in the space with uncertainty around deals like Time Warner / AT&T and deals that failed to close like Qualcomm / NXP Semiconductors, providing additional risk premia for tactical managers to take potentially advantage of. This leads to our preference for managers with both the experience, expertise and resources needed to navigate this volatility. For instance, legal and regulatory expertise can often be of more importance than expertise in fundamental equity valuation, while trade structuring and options expertise can positively alter the risk and reward dynamics. Given many banks no longer have proprietary trading desks adequately closing these spreads, this is a strategy where hedge funds are uniquely qualified to deliver returns.

On the event credit side, we currently have a mixed view. Despite corporate credit leverage metrics rising significantly over recent years, our base case view of slowing, but moderate economic growth will continue to keep default rates low in 2019. As such, opportunities in distressed credit strategies will remain sporadic and well picked over at this point in the cycle. We will wait for clearer signals that the credit cycle is turning before adding more capital to distressed managers in the portfolio. With this in mind, the energy sector will remain a risk-area of focus. Should supply not properly adjust to lower global demand levels in this slowing environment, weakness in this sector could put pressure on credit spreads. Despite fewer distressed opportunities, we are finding better setups for long/short credit managers who can focus on performing stressed credit on the long side while also shorting rich credit trading near par. Credit markets are not especially deep at the moment and it is common to see bonds gap up or down depending on supply-demand imbalances. To counter that risk we prefer managers that can be quick to turn those risks into opportunities through tactical trading skills. The key for us is working with managers with smaller asset bases that allow them to be nimble and dynamic in the way they trade their credit portfolios. Structurally, much has been written about the illiquidity mismatch between either daily valued mutual funds or exchange traded ETFs, and the liquidity of the underlying bonds that they hold which may only trade on appointment. From an active management perspective, we want to be in a position to provide this liquidity. If a mutual fund or ETF has to sell to meet redemptions, our managers can provide that liquidity while buying at discounted prices (particularly if they're already short that bond). By focusing on managers with strong fundamental underwriting capabilities in addition to trading acumen, it ensures we can play offense when needed, and allows us to weather the marks-to-market.

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## CONVICTIONS:

### HIGH

Equity Strategies

### MODERATE

Credit Strategies

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# LONG SHORT EQUITY

We also have a mixed view of long short equity. US growth is slowing but still positive, unemployment is at record lows and inflation remains contained; but that doesn't necessarily translate to interesting long/short equity opportunities. The continuous move to passive investing and low breadth of market leadership has diminished the alpha opportunities in large cap US equities. However, it is not the case in US small caps and non-US markets which continue to show good levels of dispersion, higher volatility, and better opportunities for long short managers that look to generate alpha from deep fundamental research on both sides of their book. We have rotated our long short equity exposure away from US large caps in favor of less efficient markets, and we expect to maintain that positioning in 2019.

Outside of the US, uncertainty abounds given the China growth slowdown and their trade tensions with the US. Additional uncertainty in Europe given Brexit concerns and fiscal discipline woes in countries like Italy continues to cast a pall. A long only approach to these markets is a willingness to accept this uncertainty, or a call that all will be fine and those markets will move up. However, we only want to take risk where we think the reward fairly compensates us for this risk. We don't know where these markets will end in 2019 or how the markets will react to this heightened uncertainty. It's likely the reward of long only investments won't justify the clear risks we see in 2019. We therefore would eschew a longer biased approach here and prefer a long/short approach where managers have real short portfolios that can generate alpha. We have allocations in both China and Europe not because we can predict the outcome, but because our managers have shown the ability to generate performance from both long and short positions, and we believe the uncertainty will provide them with more opportunities on both sides of their portfolio.

We believe manager selection will be the dominant factor in performance in 2019. Last year was a year where equity hedge funds couldn't mask beta as skill as momentum and "buying the dip" strategies finally cracked. The dispersion we have seen in 2018 amongst managers within the long short equity space has been dramatic and we believe this will continue into 2019. Year to date through November, the interquartile range for managers within the HFR Equity Hedge Universe has been 11.5% with the third quartile manager down 9.8% and the second quartile manager up 1.7%.

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## CONVICTIONS:

### HIGH

Global and Non-US  
Long/Short and  
US Small/Mid Cap

### LOW

US Large Cap  
Long/Short

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# RELATIVE VALUE

Relative value is a more opportunistic allocation that is dependent on the underlying bottom-up manager set and specific portfolio risk needs. There is a wide variety of managers and strategies that fall into this bucket. Most recently we have found interesting opportunities in convertible bond arbitrage, municipal bond trading, and select areas of structured credit. The common theme for the strategies we like in relative value is that they are diversifying and focused on inefficient markets where market participant dynamics are evolving.

We find the convertible bond arbitrage space more interesting for a few reasons; nearly 50% of US convertible issuers are non-rated which creates opportunities for proprietary credit analysis, the market is inefficient where most issuers are small and mid-cap companies that have a new business or are in transition, and the risk profile is constantly changing as stock prices move up and down. In addition, issuance levels are up providing for more opportunities. This structural set up along with the changing dynamics of the participants within the convertible markets, presents us with an opportunity. Today, roughly two-thirds of the participants within the convertible bond market are long only managers. This is up from one-third pre 2008 financial crisis. This shift creates a greater opportunity to add value through fundamental research and trade structuring. We feel experienced hedge fund managers with smaller AUMs can provide positive and diversifying returns to portfolios.

Another area of relative value opportunities lies in the municipal bond market, which remains highly fragmented with approximately \$3.7 trillion in bonds, 44,000 issuers, and over one million individual CUSIPs. It also remains largely traded over-the-counter which creates additional market liquidity inefficiencies. Further, there has been significant pullback from the sell-side in holding inventory due to post-crisis regulatory reforms. The ratio of Broker-Dealer to Mutual Fund municipal assets went from 0.15 in 2005 to 0.02 by 2015. This has created pricing volatility which creates more short-term trading opportunities. We find this highly fragmented market, with an evolving participant base, interesting. While tax reform from 2017 left issuance levels lower in 2018, we expect an increase in 2019 to aid the opportunity set. Dynamic trading-oriented managers can potentially take advantage of these trends with little market exposure. Sitting in a position to provide liquidity to participants when needed can lead to positive performance in volatile markets.

The theme continues in structured credit where post-2008 the banking industry has continued to consolidate along with an increased regulatory cost of capital. Banks have gotten larger and small loans needed for small and medium sized companies don't fit the model of larger banks looking to scale up processes and products. This is creating opportunities for new participants in an inefficient market. Specialty finance assets can provide attractive returns with shorter duration compared to other risk assets. Similar to the municipal bond market structure, the ability to offer liquidity when others can't, often leads to attractive outcomes. Like the convertible bond market, proprietary credit analysis is of high importance and forces many out of the market.

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## CONVICTIONS:

### **MODERATE**

Arbitrage and Trading-oriented Strategies

### **LOW**

Quantitative & Market Neutral Strategies

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# GLOBAL MACRO

In the macro space, we continue to favor emerging market focused strategies. We were rewarded for this tilt in 2018 as our thesis that specialized managers, with expertise in on-the-ground research, can find pockets of opportunity within a broad asset class. The MSCI EM-ND Index was down -14.6% in 2018 while the JPM EMBI Global Diversified Index was down -4.3%. In spite of the negative performance of the long-only benchmarks, we saw a number of EM macro managers produce double digit returns for the year. The structural inefficiencies and higher barrier to entry for analyzing EM assets should continue to allow skilled managers to identify and monetize unique opportunities.

We also continue to favor macro managers who have expertise in trade structuring. Our thesis that even the most liquid markets (rates, FX, equity index futures) are more subject to gap risk, illiquidity, crowding, and irrational price action than in the past was proven out in 2018. Examples of erratic market moves in 2018 include the implosion of the short volatility trade in February, the largest move in Italian bonds yields since 1992 in May, and the worst Christmas Eve for stocks on record. In our opinion, trade structuring is now a necessary skillset. Managers who have the expertise to use options and relative value trades to express their views can limit losses when they are wrong and hold onto trades that would otherwise be stopped out by market gaps.

While we continue to have strong conviction in our current manager line-up, we will be selective in our investments and any change in allocation will be based on bottoms up manager selection, rather than an increased conviction in the macro space.

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## CONVICTIONS:

### LOW

Traditional G7 Macro Strategies

### MODERATE

EM Macro Strategies  
Trade Structured  
Macro Strategies

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## 2019 OUTLOOK SUMMARY

Strategy	Outlook	Conviction
Long / Short Equity	We have a mixed view of long short equity. The continuous move to passive investing and low breadth of market leadership has diminished the alpha opportunities in large cap US equities. However, it is not the case in US small caps and non-US markets which continue to show good levels of dispersion, higher volatility and better opportunities for long short managers that look to generate alpha from deep fundamental research on both sides of their book. We have rotated our long short equity exposure away from US large caps in favor of less efficient markets and we expect to maintain that positioning in 2019.	<b>HIGH</b> Global and Non-US Long/Short and US Small/Mid Cap <b>LOW</b> US Large Cap Long/Short
Event Driven	Event equity continues to be our highest conviction strategy as we continue to favor managers with meaningful allocations to corporate M&A. Globally we expect debt capital markets to remain open and relatively cheap. Companies continue to find growth through acquisition is easier than growing organically. However we are mindful that we are entering the later stages of the cycle and global tightening could become the impetus for capital markets closing quickly. We are also closely watching the deal pipeline, the regulatory environment and board room confidence to guide our allocation. On the credit side we have a mixed view. We will wait for clearer signs that the credit cycle is turning before adding to distressed credit strategies. More interesting are managers focusing on performing stressed credit on the long side with skills to short rich credit trading near par. Because market liquidity has been poor, we prefer managers with smaller asset bases that can be nimble and dynamic in the way they trade their portfolios.	<b>HIGH</b> Equity Strategies <b>MODERATE</b> Credit Strategies
Relative Value	Changes to market structure and the demographic of market participants have created new opportunities for the next generation of relative value managers. We see opportunities for managers who aim to profit from changes in global market flows, sector rotations, and the regulatory limitations on the balance sheet and proprietary risk taking of investment banks. The unwinding of QE should create interesting opportunities for arbitrage strategies. Most recently we have found interesting opportunities in convertible bond arbitrage, municipal bond trading, and select areas of structured credit. The common theme for the strategies we like in relative value is that they are diversifying and focused on inefficient markets where market participant dynamics are evolving.	<b>MODERATE</b> Arbitrage and Trading-oriented Strategies <b>LOW</b> Quantitative & Market Neutral Strategies
Global Macro	In the macro space, we continue to favor emerging market focused strategies over traditional G7 macro strategies because of greater diversity in the opportunity set. We recognize that we are in a higher risk regime driven by the strong dollar, slowing growth in China, and are wary of crowding and liquidity risks. In 2019 any changes in allocation will be driven bottom up by manager quality rather than increased conviction in the overall macro space. We continue to prefer managers with a focus on trade structuring that can better weather gap risk and lower market liquidity.	<b>LOW</b> Traditional G7 Macro Strategies <b>MODERATE</b> EM Macro Strategies Trade Structured Macro Strategies

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