2021 HEDGE FUND **OUTLOOK**

A NEW DAWN FOR UNCONSTRAINED ACTIVE MANAGEMENT

50 SOUTH
CAPITAL

2021 HEDGE FUND OUTLOOK

A NEW DAWN FOR UNCONSTRAINED ACTIVE MANAGEMENT

TABLE OF CONTENTS

2020 Global Markets Review

We entered 2020 fairly constructive on the global economy. The U.S. consumer was strong and household debt service was low, bolstered by record low unemployment. Global equity market valuations were elevated, but justifiable given accommodative monetary policy and easing trade tensions between the U.S and China. Unexpectedly, Covid-19 brought the global economy to a screeching halt. Countries around the world scrambled to contain the virus and went into lockdown. It took the S&P 500 only 22 trading days to fall 30% from its record high, marking the fastest 30% sell-off in the index's history. In response, governments and central banks around the world acted with unprecedented force and speed. In addition to restarting facilities from the Global Financial Crisis, Congress passed a $2.2T stimulus bill and the Federal Reserve added facilities intended to support lending to municipalities, corporations, and small and medium-sized businesses.

As economies began to stabilize, market pundits were quick to attach letters of the alphabet to describe the shape of the recovery. As debates surged between "V" and "W", what emerged was a recovery looking something like a "K" - a bifurcation of winners and losers. These winners and losers have been evident across all areas of the economy:

- Rising permanent job losses vs. declining temporary unemployment
- Accessibility of remote work for high-income earners vs. no remote work option for lower-income workers
- Strong trends in goods production and consumption vs. weaker services
- Growing demand in residential real estate vs. vacant commercial real estate
- Disruption of online retail vs. dwindling brick & mortar retail
- Strong money supply growth vs. weak money velocity
- Big 5 stocks' outperformance relative to the rest of the S&P 500
- Speculative, unsophisticated day traders vs. traditional mutual fund/ETF flows
- Stay-at-home stocks vs. re-opening stocks
- Non-contact food delivery vs. salad bars

When we wrote our 2020 Hedge Fund Outlook, we failed to predict any of these changes. Like many, if not all, we overlooked a global pandemic as a key risk to economic growth. For all of the time we spend preparing for the known unknowns, this year reminded us that "unknown unknowns" often pose the greatest risk to markets. It reinforced the importance of investing in managers with strong risk management frameworks that employ deep fundamental research.

2021 Global Markets Outlook

Looking ahead, we find reason to be optimistic about the prospects for global growth. The pandemic continues to disrupt areas of economic activity, but with wide dissemination of a vaccine in sight, it is reasonable to believe further stimulus can help bridge the gap to the vaccine. The clearer timeline on the vaccine gives companies ample time to prepare for an increase in demand after the economy reopens.

We expect monetary policy to remain exceptionally accommodative. The Fed clearly stated it intends to keep rates near 0% until the U.S. once again reaches maximum employment and inflation exceeds 2% for some time. While we expect interest rates to remain low, the tapering of central bank liquidity remains a key risk. Central bank liquidity has been a tailwind to equity valuations and any signal that global central banks intend to taper asset purchases could put downward pressure on equity multiples.

2021 Hedge Fund Strategy Outlook

2020 was a stand-out year for many fundamentally focused hedge funds. Market volatility throughout the year provided a tumultuous ride for long-only investors and rewarded those that could nimbly navigate the opportunity set through unconstrained active management. In the depths of the first quarter, there was no tailwind for markets. Our bias towards smaller and more nimble managers helped protect capital as markets were drawing down. These managers were quick to manage exposures, take gains on their short portfolios and rotate into new long opportunities created by the disruption. Managers delivered strong performance from both long and short security selection, and had limited beta to equity markets. Overall, hedge funds did a good job protecting capital when markets were down. Just as markets reprice and recalibrate risk, so do active investment managers. As the COVID-19 related sell-off intensified and correlations between assets rose to one, it gave our managers the ability to play offense and reposition themselves to take advantage of a potential market rally. Our managers leaned into the sell-off and invested in businesses at extremely attractive valuations, unafraid of any potential near term mark-to-market pain. As markets rallied in the back half of the year, our managers benefited from their re-positioning, generating both alpha and strong absolute returns. When we look at hedge fund performance for 2020, we have been pleased to see our managers adapt and recalibrate risk in a measured way.

We expect 2021 to be another strong year for unconstrained active management. Last year was characterized by lockdown and vaccine headlines which drove asset prices in “stay-at-home” versus “reopen” groupings. Going forward, the opportunity set is more nuanced and dependent on predicting when economies reopen and what the “new normal” will look like. Without the benefit of positive headlines, fundamentals will be brought to the forefront. This will expose companies that have seen an unsustainable pull forward in demand as consumers altered their behavior out of necessity. On the other hand, it will prove that some are long term disruptors and will benefit from permanent behavioral changes. Additionally, markets will keep a watchful eye on companies that issued debt to survive shutdowns rather than invest in growth. It remains to be seen how these companies will manage their over-levered balance sheets or secular challenges in their industries. Whether market dynamics create further bifurcation or a convergence to normalcy, we believe active management has the ability to discern the long term impacts of COVID-19. The resulting dispersion will provide substantial opportunities for hedge funds to generate alpha on both the long and short sides. As always, manager selection will be paramount, but we continue to utilize portfolio construction to lean into pockets of opportunity across our portfolio.

PORTFOLIO
OPPORTUNITIES

STRATEGIES

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

LONG/SHORT EQUITY
U.S.

CONVICTIONS:

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

LOW
US Large Cap Long/Short and Systematic Strategies.

Our conviction in long/short equity remains constructive due in large part to our view that 2021 can provide as vigorous of a stock picker's environment as 2020 did. As market leadership potentially rotates from stay-at-home and work-from-home beneficiaries to pro-cyclical stocks that can thrive in a large scale re-opening of global economies, we anticipate wide dispersion across and within sectors. Irrespective of the market's direction in 2021, this would be a highly favorable backdrop for long/short hedge funds as they are uniquely structured to capitalize on opportunities on the short side that may be as compelling as those on the long side. Many of our managers, for example, are focusing their short selling activity in stocks trading at excessively rich valuations that may underperform as a result of unsustainable spikes in demand, which they believe have been temporarily pulled forward.

We continue to maintain high conviction that U.S. equity markets will provide a supportive environment for unconstrained active management. In U.S. equity markets, the 2020 presidential election garnered an initial benign reaction at the macro level. This response reflects the constraints that will likely be in place on policy, and also a view that the impact of the reopening of the global economy over the next year with widespread vaccine availability will be more impactful to growth and markets than the upcoming political change. Investors have also generally taken relatively sanguine views of corporate earnings, while many industries may likely benefit from easy year over year comparisons in the first and second quarters of 2021 versus trough earnings reported in the midst of the pandemic last year.

With respect to sectors, we don't spend much time on the highly fraught endeavor of trying to prognosticate the winners and losers among sectors. Rather we focus our research on rigorously assessing investment themes that are likely to play out over the near-, medium-, and long-term. Our goal is to be on the right side of tailwinds and headwinds emanating from secular trends, which can lead to compelling opportunities in both longs and shorts. Over the last several years, many of the farthest-reaching investment themes resided in TMT and healthcare due to disproportionately massive innovation and disruption occurring in these industries. We believe that many of the most compelling themes will continue to emerge here, and, as a result, our sector specialist allocations are primarily dedicated to these areas. Across our long/short equity book we have exposure to investment themes including the rollout of 5G cellular wireless technology, pent-up demand for productivity-enhancing technologies, antitrust regulatory momentum for Big Tech, warp speed drug therapeutics and medical science innovation, positive long-term demographics globally for healthcare usage, increased focus on ESG considerations, the alternative energy and electric vehicle boom, and increasing acceptance by US states for regulated markets in cannabis and online sports wagering.

What remains a key risk factor is how quickly a safe and effective vaccine can be widely disseminated in the U.S. Momentum and growth stocks, deemed "new economy businesses" have been among the largest beneficiaries of the pandemic, leading to a wider chasm versus traditionally value-oriented or "old economy enterprises". Our expectation is that we will continue to see violent factor rotations emanating from COVID infection numbers and vaccine news.

LONG/SHORT EQUITY
NON-U.S.

Outside of the U.S., we also remain constructive. European equities recovered in 2020, but were not as vigorously resurgent as the US, Asia, and Emerging Markets, with some indices not making it back to positive territory. As activity across Europe has been negatively impacted by lockdowns, this region could see the biggest change in growth in 2021 if successful vaccines and better treatments allow more reopening of their economies. With a normalization of the economic environment, earnings should rebound from depressed levels, especially within cyclicals that now have very attractive upsides. As Brexit is finalized, we also anticipate a reduction of uncertainty and expect further tailwinds.

In Asia and Emerging Markets, an improved trade sentiment under the new Biden administration may not necessarily ease tensions, but it should certainly be less erratic. This would be a positive change for emerging market exporters, and therefore equities, especially in China. News flow surrounding trade tensions should reduce and bring fundamentals of growth and yield to the forefront. Equities in this region, especially value stocks, are offering record discounts to their benchmarks and appear to be mispriced. There could be significant opportunities to find cheap stocks with quality characteristics like good business fundamentals and good financial strength. Growth stocks are still relatively more attractive than the US as well, so we should expect to see further inflows into Asian and Emerging Market countries. It is also worth mentioning that many countries in this region have managed to contain the virus and are further ahead in the economic restart compared to their developed market peers.

While we are optimistic about the global opportunity set in equities, we believe manager selection will remain the dominant factor in performance. Given the uncertainty of the vaccine's trajectory, we continue to prefer a long/short approach where managers have sizeable short portfolios that are expected to generate alpha. We continue to favor managers with varying investment styles and have allocations in the U.S., Europe and Asia with managers who have demonstrated the ability to generate absolute returns from both long and short positions.

CONVICTIONS:

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

LOW
US Large Cap Long/Short and Systematic Strategies.

EVENT DRIVEN

2020 was a very strong year for event-driven and credit-oriented managers, particularly for nimble funds who captured opportunities presented by market volatility, wider credit spreads, distressed restructurings, central bank interventions, tremendous new issuance, M&A, and even SPAC-mania. With the rollout of vaccines and additional fiscal stimulus measures, credit spreads have significantly recovered back toward pre-pandemic levels as the market has begun to look through near term shortfalls and price in an eventual cyclical recovery. We expect existing portfolios of recently restructured companies as well as lower quality credits of smaller issuers that have lagged behind in the early parts of the recovery, to begin to catch up and close the gap in performance. Monetary policy continues to remain highly accommodative, and capital markets have remained extremely receptive and open. As such, many companies have raised fresh capital to bridge themselves through this period of economic weakness. Defaults peaked in 2020 at ~8-9% and have slowly leveled back to a normalized ~3-4% coming into 2021. While we anticipate the pipeline of distressed opportunities to be relatively constrained and idiosyncratic going forward, we do believe opportunities will remain in disrupted industries such as travel, retail and real estate. As such, we continue to favor managers with a tactical trading approach in addition to strong fundamental underwriting capabilities.

In event equity, our outlook continues to improve as M&A deal activity begins to pick up again after a pause in 2020. The disruption of COVID-19 created clear winners and losers in various sectors, and the winners are making strategic acquisitions and the losers are consolidating in order to cut costs. The market will likely tread cautiously at first as they look to see how the new Biden administration approaches regulatory and antitrust scrutiny as well as trade relationships. Strategics and sponsors are aware that the window of opportunity of depressed fundamentals and low interest rates may diminish as the economic recovery unfolds. Our exposure to merger arbitrage will be primarily through event equity funds rather than dedicated merger arbitrage focused managers.

CONVICTIONS:

HIGH
Equity Strategies

MODERATE / HIGH
Credit Strategies

RELATIVE VALUE

The goal of the relative value portfolio is to provide diversified exposure and take advantage of mispriced idiosyncratic opportunities in inefficient markets. Market dynamics in 2020 have created pockets of dispersion that we believe will bring value to our relative value portfolio in the year ahead. Most recently, we have found interesting opportunities in structured credit and fixed income arbitrage.

With the strong rally across traditional credit and equity markets coming into 2021, we have remained positive on structured credit where spreads and yields remain wider on a relative basis. We remain positive on U.S. residential real estate backed securities, given continued strong fundamentals on underlying collateral - tight housing supply, strong home price appreciation, and significant demand driven by work-from-home trends and the millennial generation entering prime child rearing years. Throughout 2020 we saw spreads in certain subsectors remain much wider than where they started the year. As the economy looks through to a potential vaccine roll out, we expect further price upside as spreads compress. In addition, niche areas of specialty finance continue to provide attractive risk-reward opportunities particularly given less competition in the space as lenders retrenched over the past year. In corporate structured credit, we expect continued recovery in more junior tranches as the economic recovery accelerates, but balance that with liquidity risks and potentially lower loan recovery values than historical given the dominance of covenant-lite structures in the market today. We also anticipate continued headwinds in commercial real estate, as fundamental questions remain outstanding and likely will for some time.

We have also maintained allocations to convertible arbitrage and commodity relative value. 2020 was a strong year for convertible arbitrage, as exceptional levels of issuance drove strong performance for the asset class. Given the change in the U.S. administration and the recent news on vaccine dissemination, it remains to be seen how much of a tailwind the convert asset class will continue to enjoy. We have a dedicated manager on our roster that we believe is positioned to nimbly take advantage of any pockets of opportunity within the strategy, should they arise. Additionally, global commodity markets are in constant flux, creating potential opportunities for commodity specialists with deep fundamental knowledge in the space. At times, macro considerations can cause difficulty and overwhelm trades. For this reason, we believe the opportunity set is fairly limited and our allocations will be primarily driven by quality of bottom-up selection.

CONVICTIONS:

MODERATE
Structured Credit Strategies – RMBS focused, Convertible Bond Arbitrage and Commodity-based Relative Value

LOW
Quantitative & Market Neutral Strategies

GLOBAL MACRO

Going into 2021, we are positive on the opportunity set for macro, as the process of recovering from COVID is going to unfold differently across countries and will have varied macroeconomic implications. For instance, Asian countries have generally been the most effective in the world at containing COVID and many countries in the region are well on their way back to pre-pandemic levels of economic activity. On the other hand, with the new US administration there is scope for a shift to a multi-lateral challenge to China, which could materially impact market outcomes. Another crucial development will be the path of inflation and interest rates in the US, as there are compelling arguments both for and against the emergence of meaningful inflation in the wake of unprecedented coordinated fiscal and monetary policy stimulus.

Although we are constructive on the outlook for macro, the main determinant of our level of exposure, as always, will be our conviction in potential managers. Although quite a few global macro funds had strong performance in 2020, it is important to understand that in many cases P&L was driven by once-in-a-decade trades. For instance, several headline making macro funds generated very large gains on convex options on US rates going to zero – that is an opportunity that simply does not exist at this point. Successful macro trading requires an intersection of both market opportunities and the ability to execute, and the opportunities that present themselves in 2021 are likely to be vastly different from those that arose in 2020. We are focused on sourcing managers who we believe are best positioned to execute across the widest set of market scenarios. We also maintain our view that systematic strategies are not well calibrated to the current environment, as their investment processes have no visibility into issues like fiscal support, COVID recovery plans, changing trade relationships, etc.

CONVICTIONS:

MODERATE
Traditional Directional Macro Strategies

LOW
Systematic Macro Strategies

2021 OUTLOOK SUMMARY

Strategy	Outlook	Conviction
Long / Short Equity	Our strong conviction in long/short equity is due in large part to our view that 2021 can provide as many opportunities for stock pickers as 2020 did. As market leadership potentially rotates from stay-at-home and work-from-home beneficiaries to pro-cyclical stocks that can thrive in a large-scale re-opening of global economies, we anticipate wide dispersion across and within sectors. Irrespective of the market's direction in 2021, this would be a highly favorable backdrop for hedge funds as they are uniquely structured to capitalize on opportunities on the short side that may be as compelling as those on the long side.	**HIGH** Non-US Long/Short and US Small/Mid Cap **LOW** US Large Cap Long/Short and Systematic Strategies.
Event Driven	In event equity, our outlook continues to improve as M&A deal activity begins to pick up again after a pause in 2020. The disruption of COVID-19 created clear winners and losers in various sectors, and the winners are making strategic acquisitions and the losers are consolidating in order to cut costs. Coming off of a strong 2020 in credit markets, we remain moderately constructive as we expect portfolios of recently restructured companies, as well as lower quality credits of smaller issuers that have lagged in the early parts of the recovery, to begin to catch up and close the gap in performance. Opportunities will remain in disrupted industries such as travel, retail and real estate. As such, we continue to favor managers with a tactical trading approach in addition to strong fundamental underwriting capabilities.	**HIGH** Equity Strategies **MODERATE/ HIGH** Credit Strategies
Relative Value	We are moderately constructive on relative value strategies. Market dynamics in 2020 have created pockets of dispersion that we believe will bring value to our relative value portfolio in the year ahead. Most recently, we have found interesting opportunities in structured credit and fixed income arbitrage. We are positive on structured credit where spreads and yields remain wider on a relative basis. Specifically, we are positive on U.S. residential real estate backed securities, given continued strong fundamentals on underlying collateral and positive industry tail winds such as tight housing supply, strong home price appreciation, and significant demand driven by work-from-home trends. In corporate structured credit, we expect continued recovery in more junior tranches as the economic recovery accelerates, but balance that with liquidity risks and potentially lower loan recovery values than historical given the dominance of covenant-lite structures in the market today. We also anticipate continued headwinds in commercial real estate, as fundamental questions on future demand remain outstanding. Last we remain cautiously optimistic for opportunities in convertible bond arbitrage and commodity-based relative value strategies.	**MODERATE** Structured Credit Strategies – RMBS focused, Convertible Bond Arbitrage and Commodity-based Relative Value **LOW** Quantitative & Market Neutral Strategies
Global Macro	We are becoming increasingly positive on the opportunity set for macro, as the process of recovering from COVID is going to unfold differently across countries and will have varied macroeconomic implications for both developed and emerging economies. Although we are constructive on the outlook for macro, the main determinant of our level of exposure, as always, will be our conviction in potential managers. We are focused on sourcing managers who we believe are best positioned to execute across the widest set of market scenarios.	**LOW** Traditional Directional Macro Strategies **MODERATE** Systematic Macro Strategies

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