HEDGE FUND OUTLOOK

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INTRODUCTION

Through 2015, capital markets and risk assets saw increased volatility and negative returns. Corporate high-yield bonds, international equities (in USD terms), emerging market equities, commodities and even Treasury inflation-protected securities (TIPS) were all negative on the year. Emerging market equities were down 14.9% while commodities were down 24.7%. The only bright spots amongst risk assets were real estate investment trusts (REITs), which were up 2.3%; and U.S. equities, which were up 69 bps.

Unlike traditional long-only managers, hedge funds have flexible mandates that allow them to navigate and manage risk in volatile market environments. The ability to add value in rising and falling markets creates an attractive profile for client portfolios. 50 South Capital's annual hedge fund outlook overlays the analysis of our hedge fund sector specialists with the macro views of our Northern Trust Investment Policy Committee, alongside chief economists and strategists across the financial industry. Our comprehensive understanding of the investment environment and risk implications across geographies, asset classes and instruments allows us to dynamically allocate capital to the best opportunities while reducing those styles that face headwinds or deteriorating risk profiles. Our research team meets with hundreds of hedge fund managers over the course of the year to identify skilled managers that provide attractive risk and return profiles for portfolios. An ability to identify talent early is a hallmark of our process, which often leads us to small and mid-sized manager opportunities. Throughout the year, we continue to reassess our top-down views and rebalance portfolios in response to market opportunities and risks.

2015 STRATEGY REVIEW

From a strategy perspective, we saw positive returns generated in a number of our core strategies led by our long/short equity managers. At the start of 2015, we started to shift our long/short equity exposures away from longer biased managers toward opportunistic and more neutral strategies. This decision was accretive to returns. Outside of equities, we saw positive contributions from global macro and relative value multi-strategy managers, strategies that are diversifying for portfolios and often dampen volatility. Our biggest detractors were event equity managers, in which we have been overweight to take advantage of a robust environment for mergers, acquisitions and activist campaigns. In event credit, we were underweight. Our overall performance in credit was mixed with some outperformers and some underperformers. In 2015, we saw a wide dispersion of credit manager returns, with long energy exposure being the key differentiator. Those managers that jumped into energy early had a tough time, while those who avoided it held up reasonably well.

As we look back on the year, there are some things that we did very well from an allocation and manager selection perspective, and areas where we strive to improve. Our view that asset prices were fair to richly valued and there would be higher volatility across markets, is a view that we believe will continue to play out in 2016. This underpins much of our view on risks and opportunities looking forward.

2016 MARKET OUTLOOK

Looking ahead to 2016, we expect global growth to remain uneven but largely supported by easy central bank policies in Europe, Japan and China. These developments should cause the U.S. dollar to continue to strengthen. In the U.S., we expect growth to remain low, pressured by a stronger dollar, slower manufacturing and challenged export activity; but this low growth should be propped up by a strengthening job market and growing consumer demand on the back of lower energy prices. European growth has shown signs of growing momentum, and we see early signs of green shoots in the form of companies beating earnings and positive earnings revisions.

The Chinese growth slowdown continues to be met by policy responses aimed at supporting a 6.5% growth target. Stimulating the Chinese economy without further magnifying risks in the banking and construction sectors will be challenging and could increase overall tail risk. Japan remains a wild card, but our recent visit to the country led us to believe in the positive implications of the Abe administration's continued commitment to stimulating the economy and reforming corporate governance. We anticipate that emerging markets will continue to disappoint as rising U.S. interest rates and a strengthening dollar prove to be a significant headwind for many of these export-driven economies.

From a central bank perspective, we expect the Fed to follow its recent lift-off with additional rate increases, though likely smaller than Fed and market projections. While the Fed appears sensitive to financial market disruptions, the market's negative reaction to the ECB's December announcement underscores the importance of central bank messaging in a low interest rate environment. We believe the Fed will heed this lesson in future rate decisions, and we expect the U.S. economy to avoid a significant slowdown.

2016 ALLOCATION OUTLOOK

We believe the market is setting up well for hedge funds in 2016. As last year has shown, the policy driven beta trade has run its course, markets are generally fair to overvalued, and higher volatility is likely here to stay. Higher volatility, higher dispersion, and higher interest rates are typically good for hedge fund strategies. With greater divergence between central bank policies, regional growth rates and corporate winners and losers, we see an excellent backdrop for long/short strategies.

As you will see in our updated market outlook, our strategy level views are similar to those offered last year. We continue to favor long/short equity and event strategies over relative value and traditional global macro. Where you will see a change is in the implementation details. Within long/short equity, we continue to favor opportunistic and loose neutral managers. We continue to favor small and mid-size managers that are better equipped to shift exposures nimbly in a market characterized by shallow liquidity. On the margin, we are looking to opportunistically increase our non-U.S. exposure.

While event strategies continue to benefit from a robust M&A market and corporate boardrooms are open to activist investors, we believe we are getting into the latter stages of the cycle. Higher interest rates and greater regulatory scrutiny has increased the probability of deal breaks, increasing risk (and sometimes opportunity) in this space. As we get further into the year, there could be the opportunity for a strategy shift away from event equity strategies and into event credit strategies as the number and diversity of stressed bonds continues to grow. Default rates have been climbing, but early movers are rarely rewarded.

Macro strategies continue to be challenging and we have seen a number of high profile fund closures in the industry. Sometimes events like these portend the end to a difficult environment; however, we will be patient before deploying more capital into traditional G3 type strategies and instead will continue to focus on Asia- and emerging markets- biased managers that invest where there is greater divergence in monetary and fiscal policies. We believe this is an area where managers can form an information edge. Despite recent challenges, global macro remains an important diversifier.

We have been underweight relative value strategies over the past year. These strategies have faced material headwinds for a number of years from ultra-low interest rates and suppressed market volatility. Given our outlook for interest rates and volatility for 2016, we anticipate some of the headwinds to abate.

LONG/SHORT EQUITY STRATEGIES

We maintained our overweight to long/short equity throughout 2015 and were rewarded for this decision. We had positive contribution from our global generalist managers as well as our sector specialists, namely in healthcare and energy. One of the more challenging and unexpected aspects of the U.S. equity markets in 2015 was the narrow market breadth where a few large cap stocks – primarily high growth, consumer-facing tech companies – drove most of the market's total return. In spite of this, our managers were able to uncover unique opportunities to generate performance away from the crowd. Our strong returns were driven by the U.S., followed by Europe and Asia. While still challenging, the environment for shorting companies has improved and we have seen increasing alpha generated from that side of our managers' portfolios.

We continue to maintain an interest in long/short equities in 2016. Although stock valuations are fair to richly valued, we continue to favor equities over other risk assets. With stock dispersion improving to more normalized levels and stock correlations declining meaningfully in 2015, the backdrop for fundamentally-based long/short equity managers remains favorable. We will continue to prefer opportunistic managers which run with low net exposure over higher beta funds. These are not necessarily lower volatility managers. Rather, we continue to prefer concentrated funds with active long and short alpha generating portfolios, as we believe this approach increases the probability for attractive upside capture with less dependence on the market to produce returns.

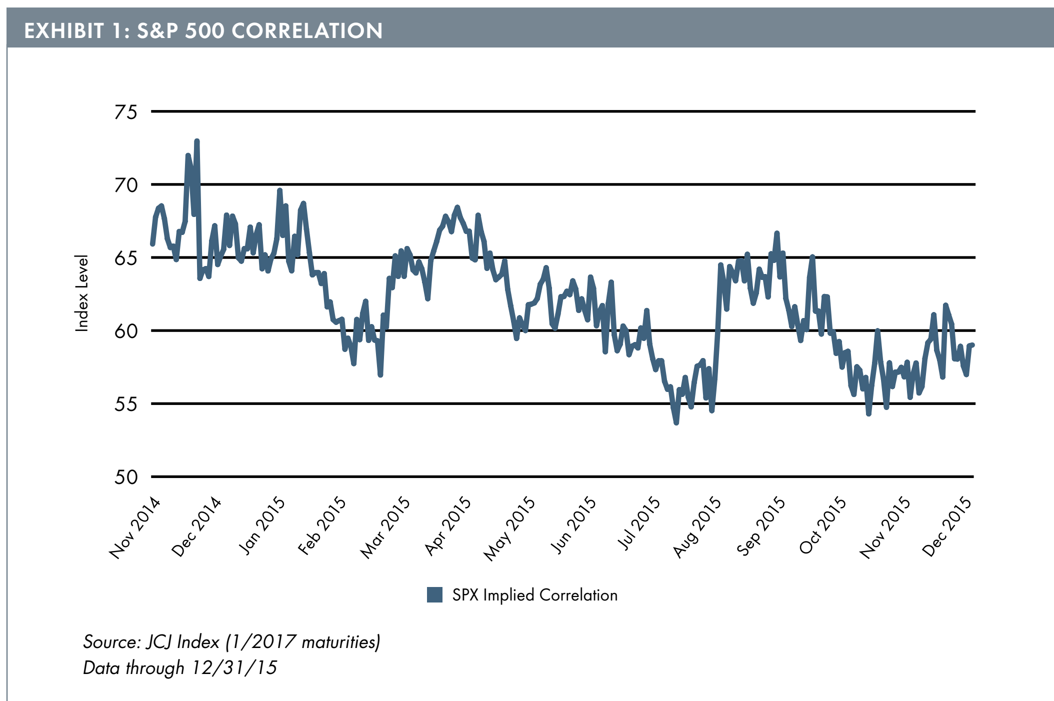


EXHIBIT 1: S&P 500 CORRELATION

Source: JCJ Index (1/2017 maturities)
Data through 12/31/15

Areas of opportunity

- **Global long/short strategies:** While economic growth and positive sentiment in the U.S. is a favorable backdrop for domestic equities, price to earnings ratios are at the highest level since 2007 with multiple expansion accounting for a disproportionate amount of returns. Corporate earnings will likely be the key determinant of stock returns going forward, which is a favorable environment for a fundamental long/short approach. While there is likely to be increased volatility around the Fed raising interest rates, our constructive view is supported by the fact that U.S. equities have historically performed well at the start of a monetary tightening cycle. Although growth remains sluggish across Europe, stock valuations have been supported by the ECB's quantitative easing efforts, making Europe slightly more attractive than the U.S. from a beta perspective. While conditions are also favorable for alpha due to lower stock correlations and increased dispersion, volatility from loose monetary policies and decelerating growth in China are risk factors to monitor. In Asia, we are particularly focused on Japan as the Abe administration's stimulus and corporate reform agenda has been positive for equity markets. This has opened the door for improved rates of return and more investor-friendly corporate initiatives. Asia, outside of Japan, remains an area of continued interest..
- **Specialist strategies:** We continue to believe that healthcare, energy, and the technology media and telecom sectors are fertile ground for sector specialists to add value. Each of these sectors exhibit higher levels of dispersion and are broad and deep as measured by the diversity of industries and companies within each. Healthcare represents a sizeable exposure. Corporate activity continues to be robust, but political and other risk factors related to drug pricing have created increased volatility in the sector. Although we remain constructive, we will continue to monitor opportunities and risks in the healthcare sector closely. In the energy sector, declining energy prices have unsettled the old equilibrium, creating significant opportunities for long/short equity managers that can navigate the implications for individual companies and sub-sectors. Given the wide opportunity set, energy remains an area of continued interest. Technology media and telecom is a sector that has been a reliable source of alpha opportunities for long/short investing due to persistent innovation in the sector that produces outsized winners and many more losers. We believe specialist managers can develop an edge from expertise in capitalizing on the disruptive industry trends impacting this dynamic sector.

EVENT DRIVEN STRATEGIES

Entering 2015, we remained overweight to event driven strategies but with a more moderate view than 2014 as we saw the cycle maturing. Our tilt toward equity-oriented event strategies relative to credit was a good decision, but our manager execution could have been better. As we move into 2016, we continue to see a favorable environment for deal activity, but we are getting later in the cycle. Mega deals are receiving greater regulatory scrutiny and the potential for deal breaks is increasing. As interest rates rise and spreads widen, financing may become more difficult. This is likely to shift our focus towards credit event managers. While our credit exposure has been low, 2015 was a challenging environment and the performance of our managers was mixed. Credit managers that jumped into energy early have been punished, while those that have remained on the sidelines have held up reasonably well.

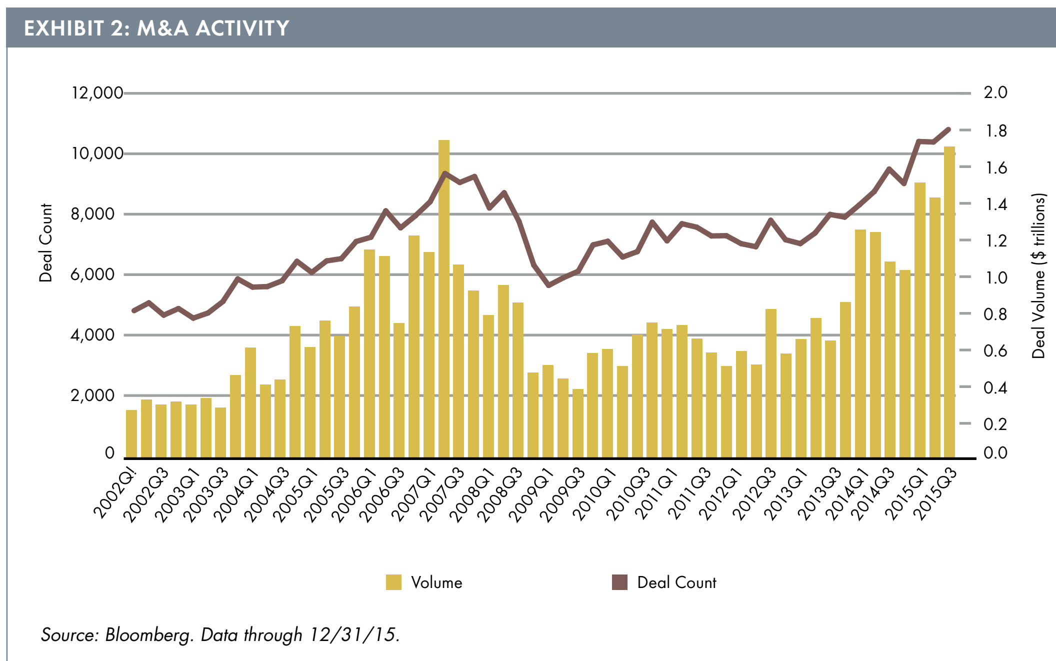
Event Driven Equity Strategies

Event driven equity strategies often perform better in more "bull market" and accommodative environments when the economy is accelerating, debt capital markets are open, and risk-taking behavior is rewarded. In that scenario, management teams will see their stock price rewarded for more offensive corporate actions. However, we see many of those factors moderating as risk aversion and skepticism in the market grows. While there remain plenty of individual event opportunities, the range of outcomes have widened, pushing risk-premiums higher. In general, we see longer biased event strategies as a source of capital to reduce beta while leaning towards more nimble trading oriented managers with real shorting capabilities.

Areas of opportunity:

- **Merger arbitrage spreads:** With the record amount of announced M&A in 2015, deal spreads have materially widened as many of the larger mergers face greater regulatory scrutiny and wider credit spreads have elevated financing risks. The size of these deals has also overwhelmed the amount of dedicated arbitrage capital available to close these spreads. However, many of these deals remain strategic in nature with acquirers committed to deal completion, but the path will remain volatile.
- **Activism:** Shareholder activism has continued to build momentum in the mainstream with larger companies and management teams listening and reacting more quickly to investor demands to unlock value. The longer-biased nature of many managers in the space warrants caution.

EXHIBIT 2: M&A ACTIVITY



Source: Bloomberg. Data through 12/31/15.

Event Driven Credit Strategies

Event driven credit strategies will see many different cross-currents in 2016. Although credit markets have grown during the past easy money cycle, liquidity has worsened as dealers are penalized for holding inventory for market making activities. Managers looking to sell large blocks of securities quickly, may find bids significantly below their previous marks. As a result, mark-to-market losses for sellers can be rapid and painful. In Q4 2015, we saw forced selling from credit funds in liquidation. This has caused large gaps down in price which can trigger additional selling in the market. Further, as credit spreads have widened and the number of bonds trading at distressed levels has increased, the opportunity has improved. However, we will be patient in deploying capital. Because of decreased market liquidity, we favor moderately sized credit managers that can be nimble in trading their portfolios.

Areas of opportunity:

- **Relative value credit and capital structure arbitrage:** With greater dispersion and sometimes indiscriminate spread widening, greater opportunities for hedged trades (long a senior secured/short a junior unsecured, for example) are presenting themselves. Idiosyncratic market structure dynamics in the convertible bond and municipals spaces also provide areas of opportunity.
- **Structured credit:** While we have more moderate views on residential and commercial mortgage-backed securities, we continue to find attractive yield spreads from unsecured consumer credit, which has tailwinds from strong employment figures, lower gas prices, and relatively strong consumer balance sheets. Opportunities exist to lock in cheap financing through securitization markets, which can further enhance yield potential.

- **Distressed credit:** Elevated risk aversion and higher liquidity premiums have resulted in poor performance from distressed credits in 2015. As price levels have fallen, better opportunities for entry are developing. We expect to take slow, methodical step ups in exposure to managers within this space.

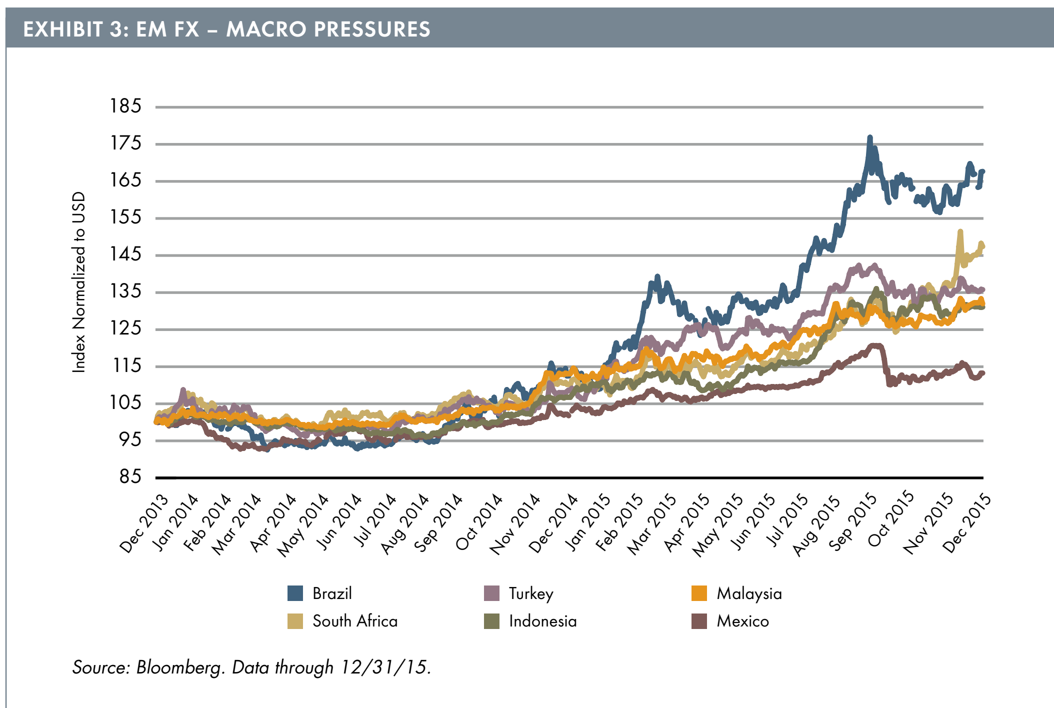
GLOBAL MACRO STRATEGIES

2015 proved to be another challenging year for global macro strategies. While we have started to see differentiated interest rate policies around the world, we haven't seen this translate into consistently improved returns in the macro space. We believe interest rate policies and growth rates across geographies have not been differentiated enough to provide significant opportunities. Rate hikes in the U.S., the continuation/expansion of easing policies in Europe and Japan, and the slowdown in China all have the potential to create opportunities best captured by macro strategies. As a result, we are cautiously optimistic on the global macro opportunity set, but are aware of the continued challenges that traditional directional G3 macro strategies face. With these issues in mind, we diversified our roster of global macro managers in 2015 to include funds with expertise in emerging markets. Given the environment today, we will continue to pursue this strategy in the macro space.

Areas of opportunity:

- **Emerging markets:** Emerging market central banks tend to have a much more heterogeneous mix of policies than developed market central banks, making this a fertile ground for investing. Emerging market experts have an advantage in trading markets that are less-followed with greater structural inefficiencies, allowing skilled managers to extract alpha through high quality research and thoughtful portfolio construction.
- **Trade structuring skill:** Macro managers with skill in trade structuring to express their view can be more robust across a wider variety of environments. This is because their trade implementation can help limit losses when they are wrong and allow them to hold onto trades that would be stopped out by choppy market conditions if they were expressed in a traditional directional fashion.

EXHIBIT 3: EM FX – MACRO PRESSURES



Source: Bloomberg. Data through 12/31/15.

RELATIVE VALUE STRATEGIES

We entered 2015 with a positive view on the opportunity set for relative value strategies as a result of higher levels of volatility across most asset classes. We had been underweight at the start of the year with the intention to raise our allocation as volatility picked up. Our existing relative value managers performed in line with our expectations while maintaining near zero market exposure. However, the broader opportunity set didn't improve enough to warrant a large allocation increase as headwinds caused by low interest rates and low absolute levels of volatility continued to be challenging. In 2016, we believe some of these headwinds will abate. Our view that interest rates will rise through the year coupled with higher bouts of volatility should make the opportunity set for relative value strategies more attractive going forward.

Areas of opportunity:

- **Market structure:** We believe that changes in market structure may create attractive dislocations for skilled relative value managers to exploit. For example, the decline in the market-making and risk warehousing functions of banks has continued to impact the markets in ways that are still being understood as a result of capital adequacy rules and the Volcker rule.
- **Quantitative equity market neutral:** Quantitative equity market neutral is an area we will explore in 2016. Quantitative strategies have benefited from less capital being deployed in the space and by higher stock dispersion driven by fundamentals.

HEDGE FUND OUTLOOK

Strategy	Sub-strategy	Opportunities	Risks
Long/Short Equity Strategies Invest their capital in equities both long and short. Can be sector or geography focused	Global Long/Short Strategies	QE tailwind, growth recovery combined with fundamentals driving returns	Higher correlations, lower dispersion, short selling headwinds
	Specialist Strategies	High dispersion and sector specific dislocations make healthcare, energy, and TMT attractive	Higher correlations, lower dispersion, short selling headwinds
Event Driven Strategies Capitalize on specific events (bankruptcy, mergers and liquidations). Returns can be generated across the capital structure	Equity Strategies	Wide deal spreads, consolidation activities, cross border deals, continued acceptance of activism	Elevated stock valuations, crowding, long-biases in activism, regulatory scrutiny of large strategic M&A deals
	Credit Strategies	Increased credit market volatility, energy sector turmoil, legacy corporate and sovereign restructurings	Illiquid trading environment, too much capital chasing few opportunities, new issue markets close, regulatory risks
Global Macro Strategies Trade broad markets rather than individual securities. Aim to capitalize on the flow of assets across both asset classes and countries	Traditional G3 Macro Strategies	Normalization of volatility, end of US QE and zero interest rate policy, monetary policy divergence	Fed falls back on QE, Eurozone and Japan cannot execute QE
	Emerging Markets Focused Strategies	Wider breadth, higher opportunity for alpha extraction, limited capacity	EM sentiment risk, exogenous geopolitical factors
Relative Value Strategies Use trading techniques that seek to capture value dislocation between similar securities. Typically have little exposure to the broader markets	Multi-Strategy Strategies	Stretched valuations in US equity and credit markets, normalization of volatility, changes in market micro-structure	Fed falls back on QE, liquidity event
	Quantitative Market Neutral	Increased equity dispersion	Increased correlations and lower dispersion, poor liquidity

High Conviction   Moderate Conviction   Low Conviction

These are the opinions of 50 South Capital in January 2016 and are subject to change.

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