HEDGE FUND MID-YEAR 2016 OUTLOOK AND REVIEW

The first quarter of 2016 was challenging for active management generally and hedge funds specifically. Headlines highlighted that actively managed mutual funds had their worst quarter of relative performance in at least 20 years. Similarly, the first quarter was the worst quarter reported for alpha generation for hedge funds since the data collection started in 2009. Generalizations can lead to false precision due to the idiosyncratic nature of hedge funds, but we believe a few overarching themes contributed to the first quarter's poor performance.

First, market timing caused part of the poor performance. Many hedge funds added risk in January and the early part of February as the market sold off. The strategy of building positions during selloffs and buying the dips worked well during the recent bull market. As the equity selloff intensified in the second week of February, conviction wavered and we saw large-scale de-risking by many hedge funds. This proved to be ill-timed, as markets reversed and began aggressively climbing to new highs for the year. While we don't invest with the longer-biased funds most affected by this phenomenon, we did see a muted effect on some of our lower-net managers.

Second, sector exposure worked against many hedge funds this quarter. Hedge funds were overweight risk in financials and health care for some time, and those were the only sectors in the Standard & Poor's 500 (S&P 500) index that ended up negative at the end of the first quarter.

Third, in the long/short equity space, many hedge funds held a persistent bias toward risk factors such as long small caps versus large caps, long growth, and long earnings variability. These factor tilts worked against hedge funds on both the long and short sides during the quarter, as there was strong rotation away from factors that worked well for the past few years.

Finally, hedge fund crowding remains an issue. Certain hedge funds widely held names that were down substantially in the first quarter.

MID-YEAR OUTLOOK

Since the start of the year, the global macro environment unfolded as we anticipated in our 2016 Hedge Fund Outlook. Global monetary policy remains accommodative, and we foresee modest worldwide economic growth, led by the United States. We believe equity markets will remain range-bound, with higher bouts of volatility. However, within this construct, many industries and idiosyncratic opportunities are stressed and present opportunities to generate returns.

Our view remains that the Federal Reserve will be slow to raise rates. At the start of the year, the market consensus called for four rate hikes; now, it expects one or two hikes at most, in-line with our previous forecast for "lower for longer." From a risk perspective, we downgraded the risk of a hard landing in China and shifted concerns toward Europe. The United Kingdom's EU referendum on June 23, Greece's June 20 debt-relief deadline and Spain's elections all heightened these risks during the second quarter.

Market reaction to central bank actions remains unpredictable and a source of volatility. We believe the European Central Bank's expanded mandate for purchasing corporate credit likely will cause distortions in the European credit market by artificially suppressing yields and spreads. This is something to watch closely.

STRATEGY VIEW

Long/Short Equity Strategies

With the S&P 500 index trading near its all-time high, we believe the U.S. equity markets are fully valued across a number of metrics. As a result, we believe alpha generation will drive performance over beta, which places a premium on fundamentally biased managers that demonstrate alpha generation on both sides of their portfolios. While the beta trade is potentially over for the broader equity markets, pockets of directional opportunities may exist within the energy and health care sectors.

Past performance is not indicative of future results.

From an alpha perspective, we still believe that dispersion driven by disruptive events in the technology media and telecommunications and energy sectors creates opportunity for specialist managers. In addition, certain parts of the health care sector likely will continue facing headwinds and volatility through year-end, when the election cycle concludes. However, the entire space traded down on numerous negative headlines and events, and we believe meaningful upside may exist medium-term from an absolute perspective.

While we would like to increase our footprint in Europe and Asia, that will hinge on finding managers emphasizing value generated on both the long and short sides of their portfolios. Our preference is for more opportunistic or neutrally oriented managers over longer-biased funds. While we believe equities still offer attractive relative opportunity for alpha generation, we recognize that this environment is demanding. Rich valuations combined with acute crowdedness challenge long and short positions alike. We believe this puts a premium on risk management skill to navigate choppy markets. We believe managers with smaller asset bases likely will keep an advantage over large managers that can less-easily sidestep crowded ideas with gap risk.

Event-Driven Strategies

Credit Event – Price levels are not as attractive as they were in mid-February, when most markets bottomed and credit spreads hit their widest levels since 2009. But the opportunity set has improved and remains attractive for select stressed and distressed investments. We believe managers with smaller asset bases or newer launches without legacy portfolios have advantages. They can survey a wider universe of enterprise values and meaningfully size smaller dollar opportunities in their portfolios. They have the ability to remain nimbler in a credit market now susceptible to wider price gaps and less liquidity.

We expect we are early in the next wave of distressed credit and restructuring opportunities but remain cautious and methodical, deploying capital to select managers in a measured fashion.

Equity Event – When leveraged finance markets are open and accommodating, this generally bodes well for equity event situations. Given that the market for risky credit became much more discerning and costly as spreads widened, we expect the tailwinds we enjoyed since Quantitative Easing began are dissipating for event equities. Although the number of active mergers and acquisitions (M&A) pending completion is still robust, we believe we are moving much later into the cycle and thus are less-bullish on the opportunity set. In addition, the regulatory environment has become tougher, placing significant scrutiny on the largest deals in industries that have consolidated meaningfully. According to Dealogic, the number of broken M&A deals in 2016 rivals levels last seen at the start of the financial crisis in 2007. As our 2016 Hedge Fund Outlook highlighted, we are looking to trim our equity event exposure in favor of event credit opportunities.

On the activist front, opportunities are less attractive than 12 months ago. Equity valuations are elevated, and the markets no longer immediately reward activist campaigns, remaining more skeptical until proven results play out. Opportunities for activist managers that focus primarily on financial re-engineering situations are becoming much less attractive today. However, activist managers deploying a larger toolkit of financial, operational and governance-related strategy turnarounds still have legs but will face market valuation headwinds and require more time for alpha to crystallize.

Global Macro Strategies

The unpredictable negative market reactions recently in Europe and Japan made gaining an edge in developed-market central bank policy more difficult. We prefer managers focused on structuring trades through options and those that skew toward emerging markets. More broadly, we believe macro is a diversifying strategy with potential for strong portfolio benefits. To this end, we will continue to emphasize the same themes we pursued during the last 12 months.

Relative Value Strategies

Our view is that higher market volatility is here to stay. As our 2016 Hedge Fund Outlook noted, low interest rates remain a headwind for most relative-value styles, including strict low-volatility market-neutral; convertible-bond arbitrage; fixed-income arbitrage; and pairs-trading strategies. We see the most opportunity in higher volatility, diversified quantitative market-neutral strategies that trade a broad range of asset classes and geographies. For these strategies, transparency and insight into model return drivers will guide our investment decision-making.

While our strategic views are largely unchanged since the start of 2016, we will continue to evaluate the investment landscape from both an opportunity and risk perspective and make tactical adjustments as new information emerges.

FOR MORE INFORMATION

To learn more, please visit www.50SouthCapital.com or email IR@50SouthCapital.ntrs.com

Strategy	Outlook	Conviction
Long/Short Equity	Continue to focus on fundamentally biased managers that can demonstrate alpha generation on both the long and short sides of their portfolios. Preference toward managers with strong risk-management skill who have smaller asset bases with an advantage in being nimble and avoiding crowded trades. Specialist managers in technology media and telecommunications, energy and certain parts of the health care sector are interesting. In Europe and Asia, continue to favor more-opportunistic or neutrally oriented managers.	**HIGH** Global Long/Short and Specialist Strategies
Event-Driven	Opportunity in credit remains attractive for select stressed and distressed opportunities. Managers with smaller asset bases have the advantage of being very selective in their investments, with the ability to meaningfully size smaller dollar opportunities in their portfolios. Within equities, we are much later in the cycle and less bullish on the opportunity. Activist managers deploying a larger toolkit of financial, operational, and governance-related strategy turnarounds remain attractive but will likely require longer time periods for alpha to crystallize.	**MODERATE** Credit Strategies and Equity Strategies
Global Macro	Continue to pursue the same themes as we have for the last 12 months, including an emphasis on managers focused on trade structuring through options and those that skew toward emerging markets. Additionally, evaluating less-directional systematic macro managers that can provide diversification.	**MODERATE** Emerging Markets Focused Strategies **LOW** Traditional G3 Macro Strategies
Relative Value	In line with year-end outlook views, low interest rates continue as a headwind for most relative-value styles, including strict low-volatility market-neutral, convertible bond arbitrage, fixed-income arbitrage, and pairs-trading strategies. Best opportunities remain in higher volatility, diversified quant market-neutral strategies that trade a broad range of asset classes and geographies. Transparency and insight into model return drivers will guide our investment decision-making.	**MODERATE** Multi-Strategy and Quantitative Market Neutral Strategies

Source: 50 South Capital
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Q54091-RP (6/16)