

Winning strategies for 2008: Distressed securities, Macro and Emerging markets

Exclusive MondoHedge Survey with 19 Swiss alternative managers. Among the least preferred Long/short equity Europe and US small cap and Statistical arbitrage

by Valerio Magni

Asset management companies analyzed

3A

Altrafin Advisory

Banque Cantonale Vaudoise

Clariden Leu

Credit Suisse Alternative Capital

Fairfield Greenwich

FIM Management (Guernsey)

GAM Anlagefonds

Gerifonds

Gutzwiller Fonds Management

Heritage Bank

HSBC Alternative Investments

Lombard Odier Darier Hentsch & Cie

Man Fund Management Schweiz

Optimal Investment Services

Reichmuth & Co Investmentfonds

SIF Swiss Investment Funds

Swiss Capital Invest Holding (Dublin)

UBP Asset Management

Source: MondoHedge

Event-driven is the only strategy that is present in all portfolios. Three others – Macro, Emerging markets equity, and Multi strategy relative value – are very close to 90%, mainly at the expense of Short seller and Mortgage-backed securities strategies. In fact, the latter is among the least favourite for 2008, together with Long/short equity Europe small cap and Long/short equity US small cap strategies.

Among the top preferences instead are Emerging markets equity, Volatility arbitrage, Distressed securities, and Macro strategies. These are some of the most important results emerging from the latest survey that MondoHedge conducted on Swiss managers' portfolio strategies at the end of 2007 and performance forecasts for the main types of hedge strategies for the first half of the new year. The survey involved 19 Swiss alternative management companies, representing a sample of 176 funds of hedge funds.

What's in the portfolio?

We begin by examining what was in managers' portfolios at the end of December. Though, as mentioned, most contained Event driven and Macro strategies, other strategies also accounted for major percentages. Among these, we point to Emerging markets equity, Distressed securities, Multi strategy relative value, and Long/short equity US large cap strategies, present in 88.2% of portfolios. This is a sign that Swiss money managers have believed in both the upward trend in emerging markets and, in tandem, the creation of opportuni-

ties in extraordinary finance transactions focused on corporate debt restructuring. On the other hand, some managers preferred to take profit on their investments in developing countries. **Robert Seiler**, senior analyst and investment manager at Peak Partners, tells to MondoHedge, "We have reduced our exposure to emerging markets as we are not believers in the so-called "decoupling theory". China's economy is already slowing down and other BRIC countries will probably follow suit. Markets will adjust to this new reality and will therefore create investment opportunities later this year".

At end-December, Swiss money managers also had a predilection for the acquisitions sector (Merger arbitrage was present in 83.3% of portfolios), despite the difficulties plaguing the credit market in the wake of the US subprime mortgage crisis, and opportunities in Europe (Long/short equity Europe large cap at 82.4% and small cap at 76.5%). Another strategy with a big presence in Swiss alternative portfolios was Convertible arbitrage at 72.2%. This strategy came back in vogue after the sharp increase in volatility on the financial markets since it has a positive correlation to it as the embedded option in convertible bonds tends to appreciate. Not only. This strategy also allows managers to profit from the bond component, taking on issuer credit risk according to the credit spread performance.

Returning to other strategies with a significant presence in portfolios, there are seven with percentages ranging from 64.7% to 70.6%: Long/short US small cap, Emerging

The main strategies preferred by Swiss hedge fund managers

	Currently in portfolio		Outlook for the first half of 2008*		
	Yes	No	+	-	=
L/s equity US large cap	88.2%	11.8%	31.3%	18.8%	49.9%
L/s equity Europe large cap	82.4%	17.6%	33.3%	26.7%	40.0%
L/s equity Japan large cap	58.8%	41.2%	18.8%	18.8%	62.4%
L/s equity US small cap	64.7%	35.3%	13.3%	46.7%	40.0%
L/s equity Europe small cap	76.5%	23.5%	13.3%	53.3%	33.4%
L/s equity Japan small cap	58.8%	41.2%	20.0%	20.0%	60.0%
Emerging Markets Equity	88.2%	11.8%	68.8%	0.0%	31.2%
Emerging Markets Debt	64.7%	35.3%	26.7%	6.7%	66.6%
Equity Market Neutral	66.7%	33.3%	35.3%	11.8%	52.9%
Short Seller	33.3%	66.7%	43.8%	18.8%	37.4%
Event Driven	100.0%	0.0%	47.1%	11.8%	41.1%
Distressed Securities	88.2%	11.8%	66.7%	13.3%	20.0%
Merger Arbitrage	83.3%	16.7%	12.5%	37.5%	50.0%
Convertible Arbitrage	72.2%	27.8%	37.5%	0.0%	62.5%
Multi strategy relative value	88.2%	11.8%	43.8%	12.5%	43.7%
Volatility Arbitrage	70.6%	29.4%	60.0%	20.0%	20.0%
Fixed Income Arbitrage	64.7%	35.3%	26.7%	13.3%	60.0%
Mortgage-backed Securities	23.5%	76.5%	7.7%	53.8%	38.5%
Credit Long Short	70.6%	29.4%	53.3%	6.7%	40.0%
Statistical Arbitrage	52.9%	47.1%	7.7%	30.8%	61.5%
Macro	88.9%	11.1%	64.7%	5.9%	29.4%
Managed Futures	47.1%	52.9%	21.4%	14.3%	64.3%
Activist	64.7%	35.3%	13.3%	20.0%	66.7%

* - negative; + positive; = stable

Percentages calculated on answers given by 19 asset management companies.

Source: MondoHedge

table1

markets debt, Equity market neutral, Fixed income arbitrage, Volatility arbitrage, Credit long/short, and Activist. The Activist strategy should actually be considered more of a management approach than a strategy. The so-called Activist manager takes a position in a listed company, puts pressure on management and the board of directors to maximize the entire company's value, and sell the parts that are non-strategic but attractive to the market or impose higher growth targets.

Miguel Tiedra, head of alternative investments at Banque Cantonale Vaudoise, says, "We have a few activists in our portfolios. We believe special situations will continue to develop well. Experienced activist managers should be able to force catalysts that release shareholder value". Other strategies that managers reported present in more than 50% of the survey sample are Long/short equity Japan small cap, Long/short equity Japan large cap, and Statistical arbitrage.

trage. Managed futures round out the list of strategies less frequently present in portfolios at end-December, along with short seller and mortgage-backed securities as already mentioned.

What to bet on

So here we have a snapshot of Swiss alternative funds of funds portfolios at the end of 2007. But what are the strategies that should offer the most attractive opportunities in the first half of 2008?

Reflecting the fact that the new year has begun in a climate of great uncertainty on the financial markets, the answers obtained from the analysis are not particularly concentrated on any strategy. Nevertheless, four of them have attracted the most consensus, starting with emerging markets equity (68.8%), evidently favoured by the continuation of their multi-year growth trend.

Tiedra confirms, "We are positive on Asian emerging markets on the back of local growth, but also very cautious since so far decoupling has not really happened. We have exposure to long/short managers as well as arbitrage managers that should benefit from regional inefficiencies due to a retail driven stock market. Most of our exposure is in Asia".

At 66.7%, distressed securities are also prevalent, confirming the conviction that there are opportunities in extraordinary finance, especially in specific sectors and geographical areas. As Seiler points out, "We believe that some event driven strategies, and especially distressed in the US, will have huge opportunities in the coming 6-18 months. In the meantime, we think that the few credit dislocation funds that have strong analytical power will be able to exploit the opportunities being created in the structured credit markets by the ongoing subprime crisis".

Macro strategies, which allow managers to deal in all asset classes (equities, bonds, currencies, and commodities) to profit from trends observed on the different markets, are present in 64.7% of the sample portfolios.

What are the main opportunities in this area? Again Tiedra, "We like macro

managers more than CTA. We believe that in a period of uncertainty with central banks intervening, these managers should be able to generate attractive returns. Our managers are usually active in most asset classes. Recently performance was more driven by commodities and rates but we like their ability to shift their allocation quickly".

Volatility arbitrage is also a popular strategy for the coming months on the belief that one of the few certainties, at least in the first half of 2008, is that financial markets will remain unstable and so that volatility will be higher than in the past two years.

Finally, Short sell, Multi strategy relative value, and Event driven strategies are present in 40%-50% of the sample portfolios.

Tiedra explains his preferences as follows: "M&A came to a halt over the summer 2007 when credit tumbled. Last year more than half of M&A deals were financial deals.

This underlines the importance of private equity and LBO deals. Now financing is more difficult and we expect strategic deals to become more important again. On the positive side, spreads have increased (so has uncertainty: we have recently seen big deals falling through at a very late stage). On the negative side, the overall deal size will probably shrink this year. We are neutral on distressed securities since default rates are still low and most managers still struggle to find good deals. Once default rates start to increase we will add to that strategy. Among event driven strategies, we favour managers active in special situations. Depending on where you classify ABL, we are very positive on this segment since banks are now very reluctant to lend to small companies and they have to turn to hedge funds for financing, increasing their deal flow".

Strategies to avoid

Meanwhile, Swiss alternative managers are still very sceptical about the chances for Mortgage-backed securities, with as many as 53% expecting a negative trend in the next six months. They also view as hardly attractive the potential for listed small and medium-

sized businesses in all geographical areas throughout the world: in Europe, 53% have a negative view on Long/short equity Europe small cap; in Japan, 20% on Long/short equity Japan small cap; in the US, 46.7% on Long/short equity US small cap.

Tiedra affirms, "We agree with the consensus and we believe that indeed small caps have outperformed large caps in recent years. But this last quarter we already saw large caps and growth stocks outperforming. In this period of uncertainty, it is most likely

that investors will turn again to large caps, seeking safety".

In any case, no European equity market is convincing since even the Long/short equity Europe large cap strategy is not among the most preferred, with 26.7% negative views for the first half 2008.

Merger arbitrage strategies have 37.5% negative views, Statistical arbitrage 30.8%. Even the Activist approach seems to have lost its appeal, with 20% negative views against only 13% positive views. ■

The view of 3A Alternative Investments: be conservative

A mostly conservative approach, especially on asset-based lending (ABL) strategies. In short, this is the message from the December 2007 Alternative Outlook produced by the specialists at 3A Alternative Investments.

The sharp turbulence on the credit markets came back to the fore in the final two months of 2007, causing investors to lose confidence and, later, the financial market correction at the start of 2008. It has been difficult for the different alternative strategies to limit portfolio damage, though there is a small minority of managers that has taken advantage of the fall in markets like those, for example, who have positioned their portfolios with long volatility exposure. But what to do in the coming months? The strategists at 3A are particularly confident about arbitrage strategies and Macro-CTA strategies, while they recommend going underweight in Event driven strategies.

In detail, the experts at 3A say that Arbitrage strategies have proven their worth by their steadiness in this period featuring high volatility and, in the coming months, they should be able to generate attractive returns for investors. The high market volatility is also behind their positive outlook for Macro and CTA strategies that provide specialised managers with a wide range of investment opportunities and potential for gain.

The outlook for Event driven strategies is the exact opposite with capital markets seized up and access to credit increasingly difficult. Finally, while 3A experts are cautious on Long/short equity strategies (though they admit that some sectors already now offer good buy opportunities), as for credit strategies a distinction needs to be made between the short and medium term.

In short, their forecasts call for a deterioration in the so-called Distressed situations but, at the same time, the conditions are coming into place for their becoming excellent sources of gain in the medium term for specialised Credit managers.