

A normalizing trading environment would support hedge fund returns in 2012, latest Lyxor Research shows

2012 starts on a robust footing for the hedge fund industry. January monthly returns have been one of the strongest in over a decade. After a lackluster 2011 – in fact, the second worst year out of the last twenty – hedge fund performance is now set to benefit from a normalizing trading environment.

For markets, 2011 again was one of the most volatile years in history. But for hedge funds, volatility *per se* has not been the real issue. The main driver of sub-par performance was to be found in the abnormally high level of correlation. Correlations across assets surged and stayed high once the European debt problems began to dominate at mid-year. In any given month, there was little differentiation among performances of securities in an asset class, and managers found it difficult to benefit from security selection. In other words, fundamental research and stock selection were drowned by pure risk on / risk off. Policy and political uncertainty trumped everything else, triggering extreme market reversals. Accurate market timing was the only skill rewarded last year.

The correlation levels reached in 2011 were, by all measures, extreme and abnormal. They have already started to correct. We see strong reasons for this normalization process to gather speed.

Even though our central scenario remains that of a structural debt deflationary backdrop, reflationary forces have recently gained ground. The improvement is striking in the US, where credit is again expanding and where housing could offer a welcome positive surprise. With elections looming in November, we expect fiscal tightening to be delayed until 2013. Economic momentum

should thus remain supportive in 2012. In Europe, we do not expect any straightforward solution to the sovereign debt crisis. Many hurdles remain, and downbeat activity is one of them. Markets are thus likely to remain caught between the structural debt-deflationary backdrop in developed countries, central banks' massive reflationary efforts and the recessionary impact of fiscal consolidation.

Yet, we view the ECB's backdoor quantitative easing as a game changer. The introduction of the three year long term refinancing operations significantly reduced systemic risk, triggering a turnaround in market sentiment. Major central banks are probably not done with their unprecedented reflationary measures. At the same time, lots of negatives about world growth and equity market returns are already priced in. All this paves the way for a less risk averse, and more normal trading environment.

We expect the highly correlated market structure, which was so detrimental to last year's hedge fund performance, to correct further. The 2011 wall of fear has opened opportunities that many hedge fund managers stand ready to monetize as market conditions normalize.

In an environment where yields on safe have bonds stand at historical lows and where equities have lost their appeal as a long term investment, alternative investments retain all their appeal.

Reference:

Lyxor AM, Cross Asset Research: Towards Normalization, Quarterly Strategy, *First Quarter 2012*, www.lyxor.com



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