In a context were both equity and bond markets rallied in Q1, hedge funds delivered returns close to +2.5% according to the Lyxor Global UCITS peer group. High beta strategies such as Special Situations, EM-Global Macro and directional L/S Equity outperformed (+3.5 to +4%). Meanwhile, relative to others, low beta strategies such as L/S Equity Market Neutral and Merger Arbitrage underperformed (+0.5% to +1%). L/S Credit and CTAs delivered returns in a range of +2% to +2.7%. CTAs delivered strong returns both last week and in March (+2.9%), which compensated for the losses in January when their short equity positioning detracted from performance.

CTAs have recently benefitted from the rally in both bond and equity prices. Momentum signals are strong in those asset classes (see charts below) as the Federal Reserve (“the Fed”) continues to surprise market participants with a dovish stance. At the latest FOMC meeting on March 20th, it announced the end of the balance sheet runoff as soon as end-September 2019, earlier than previously expected. Despite CTAs currently experiencing green shots of recovery, we maintain a Neutral stance on the strategy for the medium term. We continue to have limited visibility over a 6 to 12 month timeframe due to issues such as Brexit or trade wars, which have the potential to cause abrupt trend reversals.

In parallel, we also maintain an Overweight stance on Merger Arbitrage despite the recent underperformance. Global M&A volumes are down year-to-date but stay buoyant in the U.S. This has led several Merger Arbitrage strategies to concentrate their exposures in the U.S. The share of mega deals (above USD 5bn) stays elevated and deal spreads widened in March from very tight levels in February. In our view, there is no reason to reconsider the stance on Merger Arbitrage. The strategy is a powerful source of portfolio diversification due to its low correlation to equities and would provide protection if risk appetite fades.

Finally, perspectives on carry strategies such as EM-focused Global Macro and L/S Credit improved in our view. We maintain an Overweight stance on those strategies, assuming a low bond yield environment will prevail over the medium term.
PERFORMANCE

Most strategies stand in positive territory month-to-date

Hedge fund performance was slightly negative last week (from March 19th to March 26th) on the back of underperformance from L/S Equity and Global Macro strategies (c. -0.5%).

Discretionary Global Macro strategies recorded the worst performance (-0.7%) in a context where bond yields fell significantly in the U.S. and in Europe following the March 20th FOMC meeting. The Fed surprised market participants by announcing the end of the balance sheet runoff as soon as September 2019. Equity markets were slightly down during the period under review on the back of concerns regarding manufacturing activity in Germany.

On a positive note, CTAs outperformed last week (+1.2%). The strategy benefitted from the fall in bond yields thanks to their very long fixed income positioning.

Merger Arbitrage: deal spreads have normalized at a higher level

The tightening of deal spreads in February challenged our Overweight stance on Merger Arbitrage. However, we believe fundamentals remain supportive.

Deal spreads are volatile and are of little help to formulate a midterm view. They normalized at a higher level over the course of March. Yet, they still stand slightly below the average of the past three years. The level of deal spreads is rather useful to formulate short term views on the strategy.

Second, M&A activity has sharply decelerated globally but stays robust in the U.S. Cross border activity has fallen dramatically but the share of megadeals stays high in the U.S. (megadeals – deals above USD 5bn – represented 80% of U.S. M&A activity in March). New deals in the financial sector, such as the USD 35bn Fidelity National Information Services vs. Worldpay were invested by Merger Arbitrage strategies and contributed to the spread widening in March.

Event Driven strategies reduced exposure to Health Care but stay long Communications and Technology

Over the last quarter, Event Driven strategies (including Merger Arbitrage and Special Situations strategies) reduced both their gross and net exposures and shifted sector positioning.

Their overall positioning on cyclical vs. defensive sectors stayed unchanged, with some adjustments.

Exposures to the health care sector have been trimmed down due to the completion of some deals such as the Takeda vs. Shire USD 57bn merger in early January 2019. But exposures to other defensive sectors such as Consumer Non-Cyclical, Communications and Utilities increased. Meanwhile, exposure to cyclical sectors such as Technology, Industrials, and Consumer Cyclicals decreased.

Strong M&A activity in the U.S. financial sector was reflected by higher exposures throughout the quarter, but they remain very low in absolute terms.
METHODOLOGICAL APPENDIX

The information contained in this report on the performance of onshore hedge funds is based on publicly available information. The universe of underlying funds is relatively stable but varies depending on the criteria of inclusion presented below. It is based on an unbiased selection from our hedge fund analyst team.

Performance is calculated on a weekly basis, as of end-Tuesday, using an arithmetic average (equally weighted average).

Regarding share classes used in these peer groups, we selected the primary share class as referenced in Bloomberg. Non-USD share classes are hedged in USD based on hedging costs available on Bloomberg.

Lyxor Hedge Fund Peer Groups: number of funds by strategy

- 245 strategies across the main categories in the industry
- USD 250 billion of assets under management

Criteria of inclusion

The criteria of inclusion are fourfold:

i) We only include UCITS strategies;

ii) Strategies are assessed and categorized based on fund prospectuses;

iii) We only include strategies with assets under management of at least USD 50 million; and

iv) We only include strategies with at least a one-year track record.
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