# THE WEEKLY BRIEF

By LYXOR CROSS ASSET RESEARCH

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# MARKET NEUTRAL L/S TO REMAIN UNDER PRESSURE


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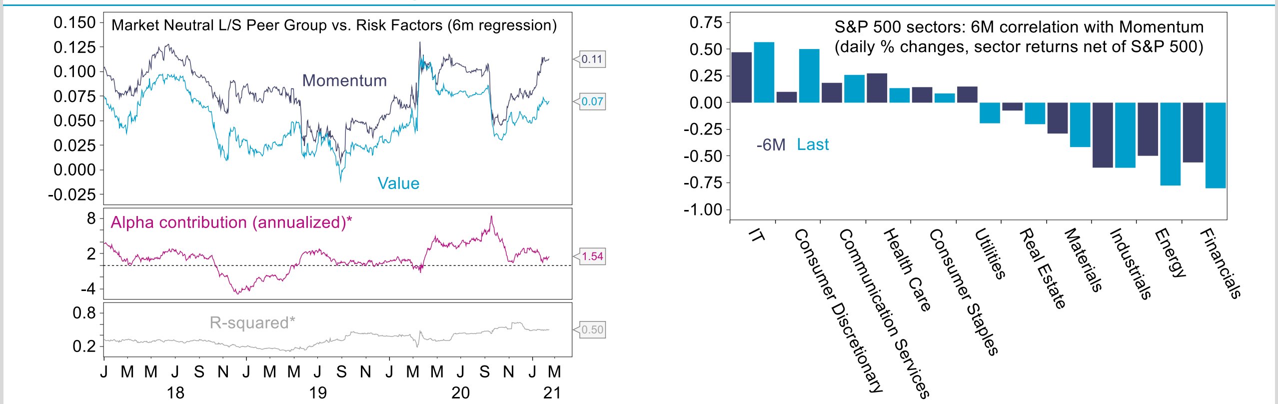
In recent months, Market Neutral L/S strategies underperformed other hedge fund strategies, in a context where risk assets rallied following the Pfizer vaccine announcement in November 2020. While the strategy is not designed to capture the equity market beta, the alpha contribution has declined since Q4-2020. Our stance on the strategy remains Underweight on the back of its exposure to the Momentum risk factor, which appears poorly suited for the current environment.

Market Neutral L/S experienced diverging fates in the past three months, but on average their performance has been disappointing, as it was already last year. This contributes towards explaining outflows from the strategy in 2020 and raises question marks going forward. Risk premia strategies, which in some cases can be associated with Market Neutral L/S, also struggled. On a positive note, multi-strategy platforms and offshore Market Neutral L/S strategies fared better last year.

Our views on the strategy remain quite defensive for two main reasons. First, Market Neutral L/S is a defensive strategy by nature, which is less attractive as the global economy heads towards a recovery. Equity valuations are rich, and the strategy will help protect portfolios if the market rally reverses. However, this source of risk appears manageable in 2021 although we don't exclude regular bouts of volatility as bond yields normalize at a higher level. Second, our estimates suggest the Market Neutral L/S and in particular, quantitative approaches, display a significant long bias towards the Momentum risk factor in equities. Although the attractive excess returns generated by this risk premium have long been documented in the academic literature, we find its correlation to the Value risk premium close to all-time lows at present. Momentum strategies in equities remain especially short financials and energy sectors. With bond yields starting to edge higher, the Momentum risk factor in equities appears vulnerable and may deliver minimal returns in the midterm. Although Market neutral L/S strategies have diversified this source of risk by gaining exposure to Value stocks, the returns of such strategies might continue to disappoint for some time, in relative terms, even if we adjust for volatility.

### Lately Market Neutral L/S strategies have increased their bias towards momentum stocks




* Alpha contribution and R-squared based on a regression of Market Neutral L/S vs. Market Neutral U.S. risk factors (daily returns): value, momentum, size, quality, anti-beta. Sources: Dow Jones, Bloomberg, Macrobond, Lyxor AM

## Hedge Fund Performance: Merger Arbitrage Takes The Lead

**Lyxor UCITS Peer Group Performance**

| | MTD | YTD |
|---|---|---|
| MSCI World | 5.9% | 5.1% |
| Event-Driven: Merger Arbitrage | 1.4% | 2.4% |
| L/S Equity Directional | 3.8% | 2.1% |
| CTAs | 3.1% | 2.0% |
| Global Lyxor UCITS Peer Group | 2.0% | 1.5% |
| Event-Driven: Special Situations | 2.7% | 1.4% |
| Risk Premia | 1.1% | 1.0% |
| L/S Credit | 0.7% | 1.0% |
| L/S Equity Market Neutral | 0.6% | 0.9% |
| Global Macro | 1.2% | 0.8% |
| Bloomberg Barclays Global Aggregate Bond Index | -0.5% | -1.0% |

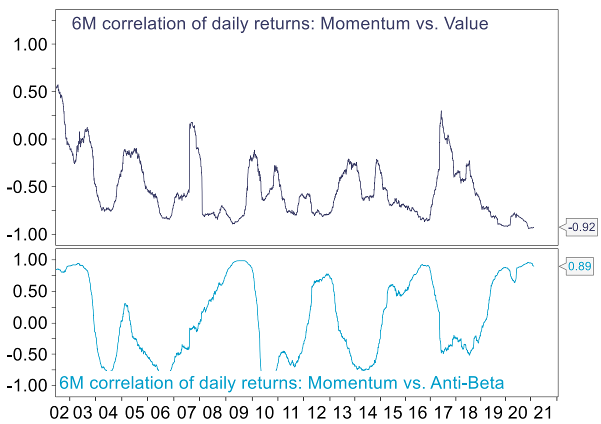
MTD and YTD as of Feb. 12th. Source: Bloomberg, Lyxor AM

Risk assets experienced a strong rebound in recent weeks, which benefitted Directional L/S (+3.8%) and Special Situation (+2.7%) strategies on a month-to-date basis. CTAs also posted solid returns during the same period, up +3.1%. On a negative note, Market Neutral L/S keep underperforming and was only up +0.6%.

On a year-to-date basis, Merger Arbitrage remains the best performing strategy (+2.4%) in a context where SPACs experienced a sharp rebound (+17.9% for the IPOX SPAC Index year-to-date).

Global Macro strategies underperformed so far year-to-date (+0.8%) as EM-focused Macro strategies were virtually flat (+0.2%) and Systematic Macro returns were minimal (+0.5%).

## Momentum Correlation to Value Stocks is Deeply Negative



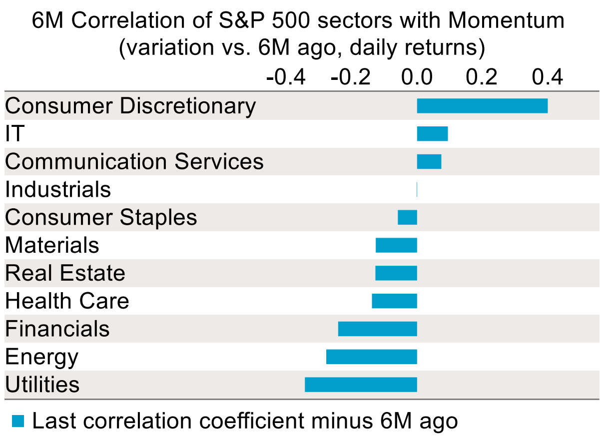

Market Neutral U.S. risk factors. Source: Dow Jones, Bloomberg, Macrobond, Lyxor AM

The correlation of Momentum returns with defensive risk factors such as Quality and Anti-Beta remains quite elevated, which suggests that Momentum remains a defensive risk factor at present.

Meanwhile, the correlation of Momentum with cyclical risk factors such as Size and Value is deeply negative, which corroborates the defensive features of Momentum.

From a sector perspective, the negative correlation of Momentum vs. Value corroborates the sector analysis performed in the previous page, which showed that Momentum was negatively correlated to Financials and Energy returns, and to a lower extent by Industrials and Materials returns.

## Momentum Has Started to Reflect Better Economic Prospects




Sector returns net of S&P 500. Market Neutral U.S. risk factors. Source: Dow Jones, Bloomberg, Macrobond, Lyxor AM

The change in the correlation regime with equity sectors in recent months illustrates the dynamic features of the Momentum risk factor. In the bar chart to the left we look at the difference between the correlation coefficient now and six-months ago.

The higher correlation coefficient with Consumer Discretionary and IT as well as the lower correlation coefficient with Utilities signal Momentum has started to reflect better economic prospects.

However, the (negative) correlation with financials and energy has further decreased, which suggests that Momentum is increasingly vulnerable to a rebound in such sectors, which has started to take shape recently. With vaccination campaigns on track to accelerate in Q2-2021 as additional vaccines are becoming available, better economic prospects and higher Treasury yields may continue to support such sectors and pose hurdles to Momentum.

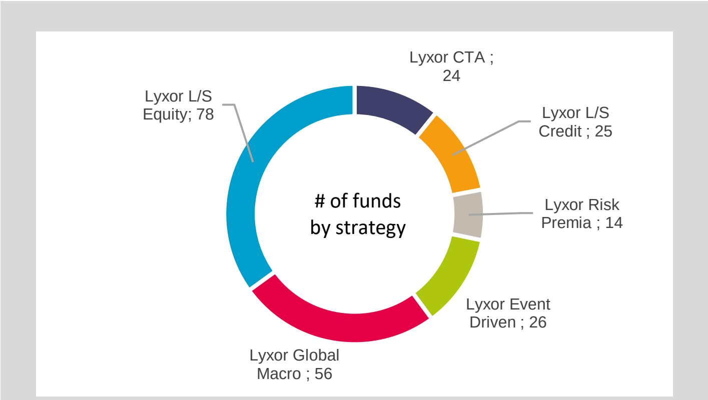
## METHODOLOGICAL APPENDIX

The information contained in this report on the performance of 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



As of February, 2021

- 223 strategies across the main categories in the industry
- USD 182 billion of assets under management

### Criteria of inclusion

The criteria of inclusion are fourfold:

i) We only include UCITS strategies;

ii) Assessment by Lyxor's Hedge Fund selection team based on funds' materials or manager interaction;

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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