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Second Quarter Hedge-Fund Strategy Outlook: K2 Advisors

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K2 Advisors seeks to add value through active portfolio management, tactical allocation and diversification across four main hedge strategies: long-short equity, relative value, global macro and event driven. In their second-quarter (Q2) 2017 outlook, K2 Advisors' Research and Portfolio Construction teams share the key market events they have an eye on.

Q2 Outlook: After the Trump Bump

The gap between political expectation and political reality has narrowed a bit in recent weeks, at least as it pertains to the 45th president of the United States. The failure to pass the health care bill delivered a sobering jab to the post-election giddiness intoxicating Wall Street. And while that outcome has produced no shortage of schadenfreude from some corners, a more sanguine view would be that the separation of powers as designed by the Founding Fathers is alive and well in Washington, DC.

The repeal-and-replace effort on health care as well as the rejection of the travel ban have signaled that implementing the agenda laid out by the executive branch will not be simply rubber-stamped by the legislative and judicial branches. For now, however, belief remains that the administration will be successful in implementing the so-called "Big Three"—tax reform, deregulation, and infrastructure spending—and that these initiatives will succeed in galvanizing the US economy and supporting current market valuations.

Stocks enjoyed a three-month rally following Trump's election win. Time will tell whether hope and speculation are rewarded by the reality of governing.

Regardless of what the future holds in terms of political results, from a market standpoint we anticipate more volatility going forward—and this can be a good thing for hedged strategies. Remember, alpha is a byproduct of an inefficient market, and in our view higher volatility is an indication of greater market inefficiency—hence greater opportunity for active investments like hedged strategies to succeed. Clearly Trump's victory did represent a seismic shift, and while markets are discovering where this shift will ultimately lead, we anticipate sharp moves along the way—and in both directions. We also expect measurable dispersion on a sector and security basis. In these circumstances, investment managers with more latitude in trading may be better able to capitalize on price dislocations and trends.

A Brighter Climate in Europe: Long-Short Equity

In Europe, a brighter climate is emerging that bodes well for European markets—and for long-short equity strategies.

First and foremost, the specter of populism may be dissipating. This is a positive development, as the movement threatened to unwind decades of political and economic cooperation in the region. The recent defeat in Holland of populist “Freedom Party” candidate Geert Wilders may prove to be a barometer for Europe as a whole, indicating that perhaps sentiment in the region is shifting. In addition, the majority of polls in France show populist candidate Marine Le Pen lagging. In Germany, Chancellor Angela Merkel’s party and its affiliates continue to outpoll right-wing challengers. These shifts in political currents in the region should help provide support to growth in the region.

Beyond the encouraging political environment, positive economic and technical factors may be a tailwind for Europe as well. Bear in mind, European equities in general have underperformed US equities over the past ten years,[1] and we expect this trend could reverse. We think European equity markets could benefit from favorable valuations, improving earnings growth and global reflation. After years of subpar growth relating to the sovereign debt and banking crises, economic growth and inflation in the region have started to improve.

Furthermore, weakness of the euro and the British pound against the US dollar, combined with market volatility caused by ongoing geopolitical uncertainty, presents managers with additional stock-picking opportunities in the region. Additionally, European companies with a euro or sterling cost base that generate income from stronger currencies (such as the US dollar) should be well- positioned. Lastly, many managers see opportunity in the financial sector, as banks in Europe have worked very hard in recent years to clean up their balance sheets and get stronger. We believe many of these institutions warrant a higher valuation than they currently have.

A Buffer Against Greater Uncertainty: Relative Value

The less directional nature of relative-value strategies remains attractive amidst the greater uncertainty in the markets. With actual volatility at very low levels, the long volatility profile of a relative value strategy has attractive asymmetry as a complement to other investments. In addition, the strategy appears positioned to benefit from increased dispersion, which we view as likely given the changing fiscal policies driven by the new US administration, as well as the evolving political realities in Europe and other jurisdictions.

Lastly, the diverging paths of central banks in the major global economies are expected to present improved directional opportunities. For example, cross-border valuations can be very attractively priced relative to each other, especially given the US Federal Reserve’s posture regarding interest-rate hikes. On the contrary, in Japan and Europe there is still talk of the potential for further easing measures. As a function of this dynamic, we are seeing large movements in foreign exchange and global currencies, again creating tangible long-versus-short trading opportunities for relative value strategies.

Catalysts Remain for Event-Driven Strategies

We believe corporate activity will remain robust in 2017 and potentially increase as the year progresses. The new administration is expected to employ more business-friendly policies (less regulation), especially as it relates to antitrust. There are also two potential tax code changes that could help increase corporate activity—a tax holiday to repatriate overseas cash and a significant reduction in corporate tax rates.

Merger arbitrage remains an attractive strategy for investors seeking relatively steady returns with minimal market correlation. Softer catalyst-driven equity special situations had a mixed 2016 as a result of market volatility and a number of situations reporting negative results. We believe the environment will improve as the market gains clarity on the new administration’s policies, but still believe it’s prudent for managers to reduce beta with proper hedges. Activists will likely continue to target mismanaged companies, but the “quick fixes,” such as buybacks, are playing a less pronounced role. Activists will need more time for strategies to come to fruition when employing a restructuring approach as opposed to financial engineering.

You can learn more about the types of hedge strategies referenced here and others in our prior blog, “Solidifying a Case for Liquid Alts.”

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The identification of attractive investment opportunities is difficult and involves a significant degree of uncertainty and there is no assurance any such alternative investment strategies will be successful. An investment in these strategies is subject to various risks, such as those market risks common to entities investing in all types of securities, including market volatility.

The market values of securities held in the K2 liquid alternatives portfolios will go up or down, sometimes rapidly or unpredictably. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in developing markets involve heightened risks related to the same factors, in addition to those associated with their relatively small size and lesser liquidity. Hedge-strategy outlooks are determined relative to other hedge strategies and do not represent an opinion regarding absolute expected future performance or risk.

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1. Sources: MSCI Europe Index, MSI US Index. The MSCI Europe Index captures large- and mid-cap representation across 15 developed-markets countries in Europe. The MSCI USA Index is designed to measure the performance of the large- and mid-cap segments of the US market. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator or guarantee of future performance.