ALTERNATIVES

Third Quarter Hedge-Fund Strategy Outlook: K2 Advisors

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In their third-quarter (Q3) 2018 outlook, K2 Advisors' Research and Portfolio Construction teams share their views on rising US interest rates and other macroeconomic factors that could present both challenges and opportunities. They believe offering these insights will help investors better understand the rationale for owning retail mutual funds that invest in hedge strategies.

You're *Still* Gonna Need a Bigger Boat…

Perhaps one of the most popular *K2 Perspectives* we've ever written was the June 2014 issue, where we referenced Roy Scheider's memorable line from the 1975 blockbuster *Jaws*. We thought now, especially given the current state of the markets, would be a good time to revisit the subject.

For us, the infamous *Jaws* line (a brilliant ad lib, by the way) allegorically brings to mind our current situation. While risk assets continue to rally, investors—much like their beleaguered counterparts from the fictional island of Amity—remain cautious, and indeed may be looking for a bigger, or at the very least a better, boat. Perhaps they seek a craft more sturdily constructed to withstand the potential macro risks circling just under the deceptively calm market waters—we know we certainly would.

While things remain relatively tranquil on the surface, macroeconomic concerns—including geopolitical hot spots, growing political uncertainty in Europe, trade wars and major central bank policy divergence—all pose legitimate problems for market stability. In addition, perhaps one the most overlooked concerns today is the threat of continued rising interest rates in the United States…cue the John Williams score. A persistent and potentially dramatic spike in interest rates could represent a metaphorical Great White macro risk for portfolios not well positioned.

Indeed, if rising interest rates eventually do take a bite out of growth, some investors may start to feel a downward market drag. Fortunately the story does not have to end there, and portfolios are not doomed to the fate of the USS Indianapolis. In our view, there does exist a better boat, one constructed not only of equity beta and bond beta, but one built around alpha also.[1] We believe this alpha boat may fare quite well in a rising-rate environment, perhaps even prospering…and living long as well (to mix our movie metaphors).

In our view, if interest rates spike, bonds will naturally suffer some, equities will probably do okay, but we believe the real strength will be in alpha-generating strategies like hedge funds. Statistical analysis of the historical relationship between Treasury yields and alpha support this. The chart below illustrates the historical relationship between HFRI Fund Weighted Composite Index alpha levels and US 5-year Treasury yield levels.

HFRI Fund Weighted Composite Index Alpha at Different Five-Year US Treasury Yield Levels

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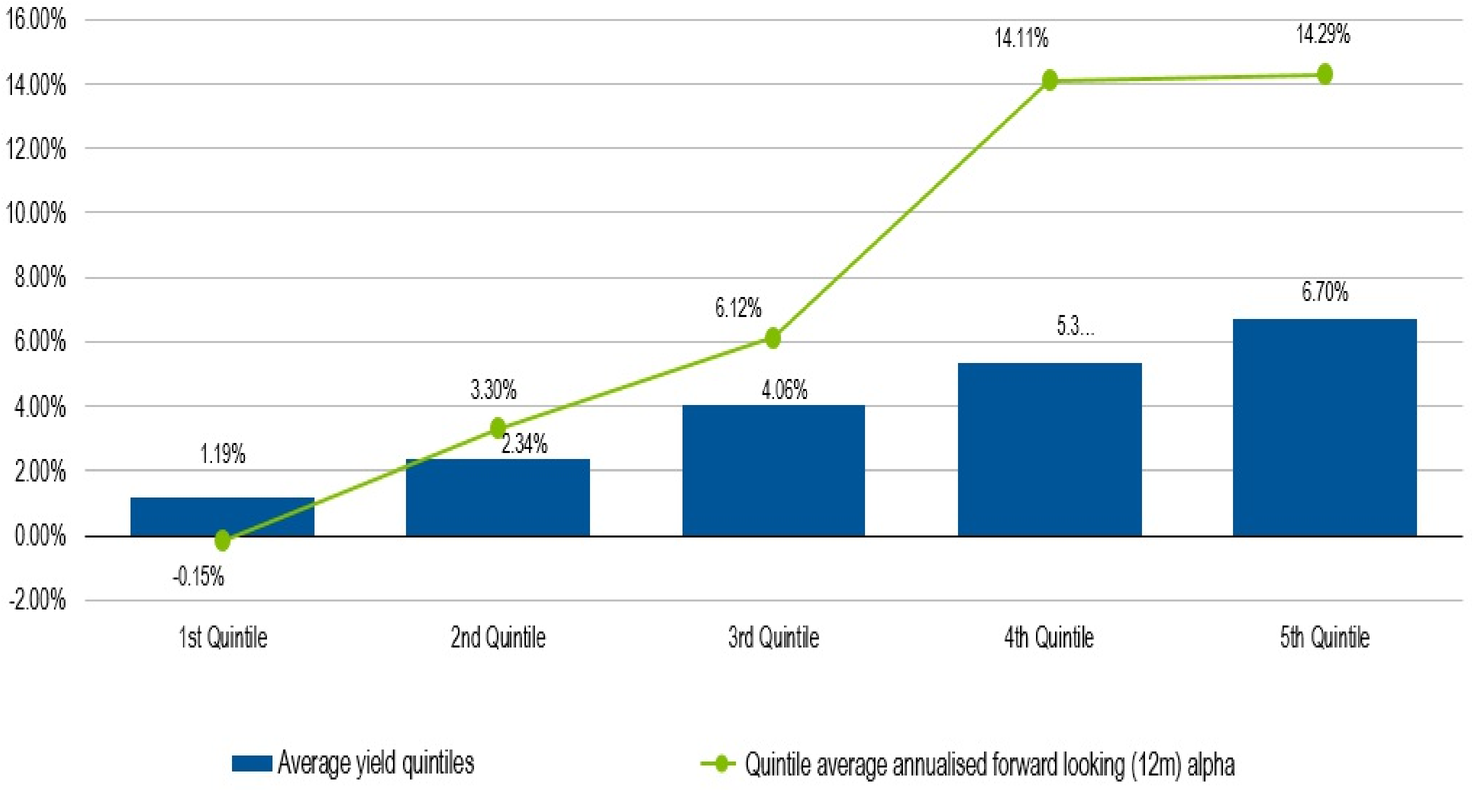
January 31, 1991–May 31, 2018



For illustrative purposes only.

Source: Bloomberg, HFR, and S&P Dow Jones Indices. January 1991 through May 2018. Important data provider notices and terms available at www.franklintempletondatasources.com. Alpha calculated relative to the S&P 500 Index. Alpha is a mathematical value indicating an investment's excess return relative to a benchmark. Measures a manager's value-added relative to a passive strategy, independent of the market movement. The Factor Response Curves show the average performance of the index during the review period in months when the factor falls into the performance quintiles indicated. The blue bars indicate the average performance of the factor over all months when the average performance of the factor falls within the given quintile. The green dots represent Hedge Strategy Alpha (Forward Looking - 12 Month) vs. S&P 500, are measured through May 31, 2018, and are solely based on historical data. Each underlying yield data point has a corresponding hedge fund alpha vs. the S&P 500, where alpha is measured over the subsequent 12 months from the point where the yield is measured (last yield measurement in illustration is as of May 31, 2017). **Past performance is not an indicator or guarantee of future results.** Indices are unmanaged, and one cannot invest directly in an index. They do not reflect any fees, expenses or sales charges. Unlike most asset class indices, HFR Index returns reflect fees and expenses. Source for HFR: Hedge Fund Research, Inc. - www.hedgefundresearch.com. The HFR indices are being used under license from Hedge Fund Research, Inc., which does not endorse or approve of any of the contents on this report.

As you can see, when interest-rate level averages have been at their lowest, represented by the first quintile bar on the left, average alpha levels have also been at their lowest. But as we move from lower yield levels to higher average levels across the five quintiles, we see a corresponding rise in average alpha as well.

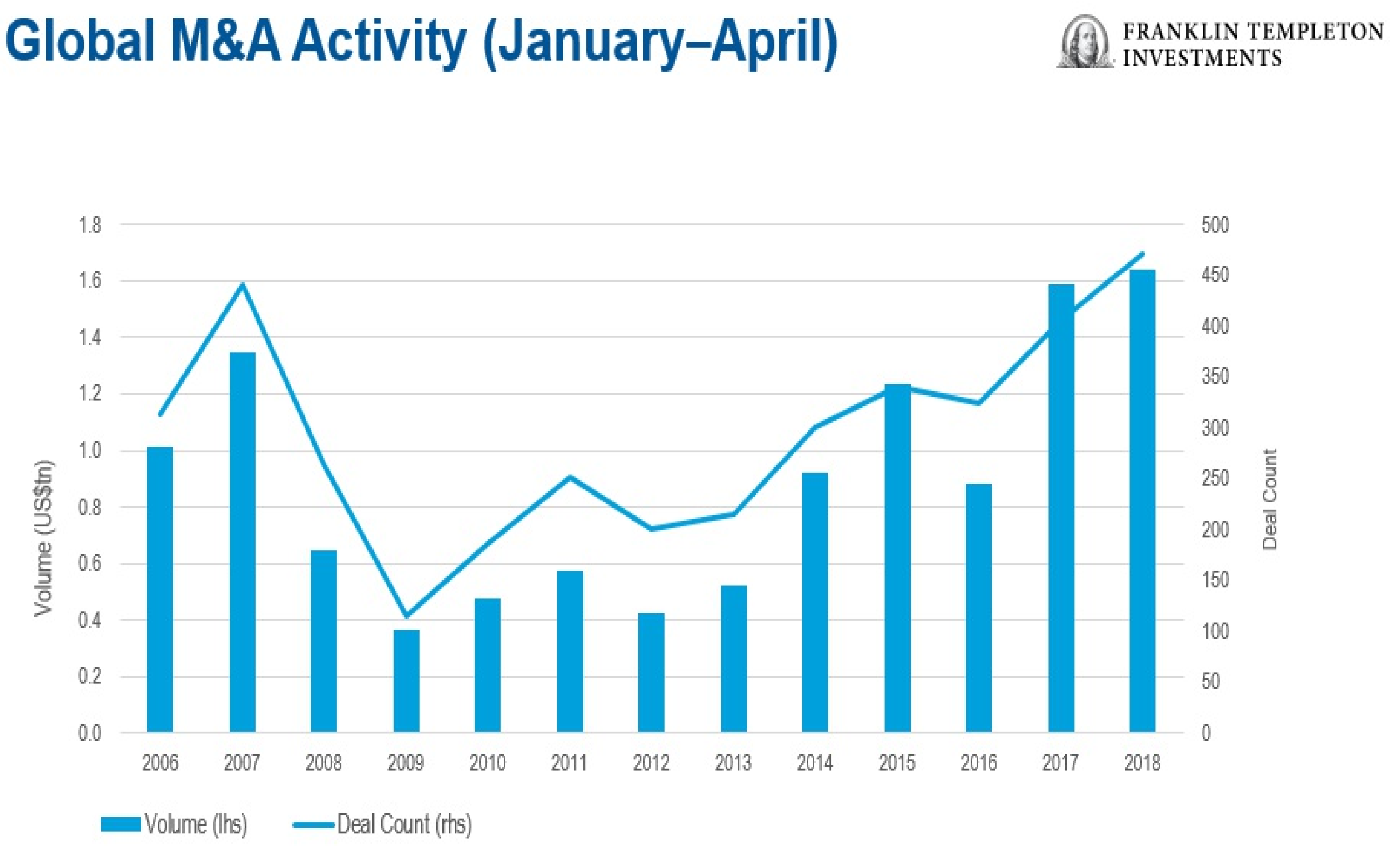
While we know that past performance doesn’t guarantee future results, higher nominal yields of US government bonds, such as five-year Treasuries, have on average historically corresponded with increased average annualised hedge fund alpha capture as well. In our experience, the vast majority of hedge funds are defensive with respect to interest rate risk, while some macro managers see it as a speculative opportunity.

The implication of sharply rising rates for individual and institutional portfolios, particularly for fixed-income investments, could be troublesome as they may be confronted with diminishing returns or potentially significant losses—depending upon duration risk and the magnitude and velocity of any rate rise.

We believe an alpha boat is the best option available to hedge against the eventual attack.

Event Driven

Corporate activity has been strong in 2018, and we believe it will remain that way due to high levels of CEO optimism, tax cuts and cash repatriation. Merger arbitrage spreads remain attractive relative to Treasury yields while special situations and activism will be more equity market dependent.



Source: Bloomberg as at May 1, 2018. Global merger and acquisition (M&A) transactions over US$500mm from January to April.
Past performance is not an indicator or guarantee of future results.

Discretionary Macro

Our theme of diverging central bank policies across major developed and developing markets remains intact, and combined with a busy global political calendar, we believe these actions to be a source of potentially significant market volatility—particularly across rates and currency markets (areas where macro managers traditionally participate actively).

The outlook for emerging markets (EM) in particular is somewhat cautious as we believe those markets to be particularly susceptible to foreign capital flows (often in response to recent performance). This weakness is likely to eventually present an attractive buying opportunity, but we are not yet ready to call the bottom of the EM cycle.

However, we obtain much of our EM exposure through managers who are either highly defensive or actively trading. We believe both approaches are favoured in the current environment over the alternative of being significantly net long.

Long/Short Equity

We maintain a positive outlook for long/short equity managers—particularly those with global perspectives. While US equities continue to benefit from a strong economic tailwind, long/short equity managers are also benefitting from a pickup in equity volatility and dispersion given the unpredictable macro backdrop, recurring headlines of trade wars, and the upcoming mid-term elections. We expect managers to continue to generate alpha in both their long and short books as a result.

12-Month Rolling Volatility

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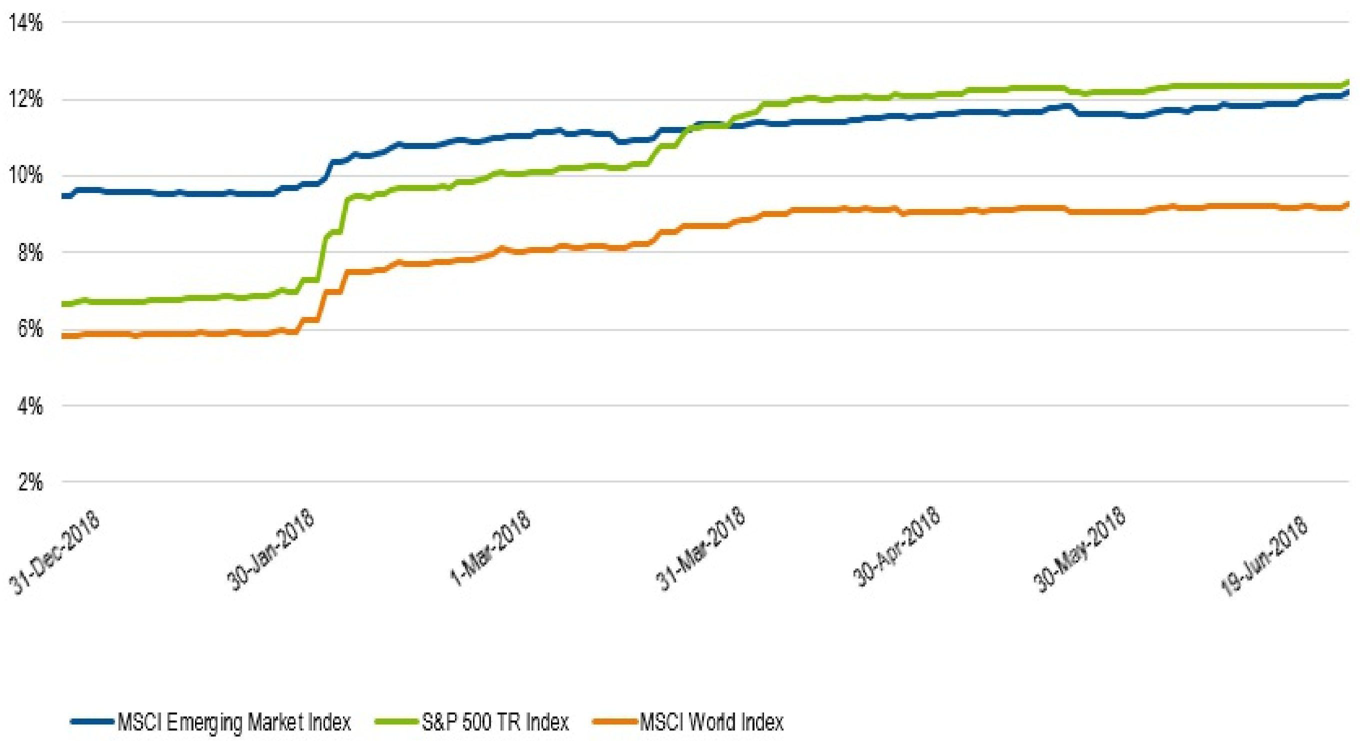
December 31, 2017–June 26, 2018



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All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Hedge funds are complex investments and may not be appropriate for all investors. Investment in these types of hedge-fund strategies is subject to those market risks common to entities investing in all types of securities, including market volatility. There can be no assurance that the investment strategies employed by hedge fund and liquid alternative managers will be successful. It is always possible that any trade could generate a loss if the manager's expectations do not come to pass. Hedge strategy outlooks are determined relative to other hedge strategies and do not represent an opinion regarding absolute expected future performance or risk of any strategy or sub-strategy. Conviction sentiment is determined by the K2 Advisors' Research group based on a variety of factors deemed relevant to the analyst(s) covering the strategy or sub-strategy and may change from time to time in the analyst's sole discretion.

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1. Alpha measures the difference between a fund's actual returns and its expected returns given its risk level as measured by its beta. A positive alpha figure indicates the fund has performed better than its beta would predict. In contrast, a negative alpha indicates a fund has underperformed, given the expectations established by the fund's beta. Some investors see alpha as a measurement of the value added or subtracted by a fund's manager.

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