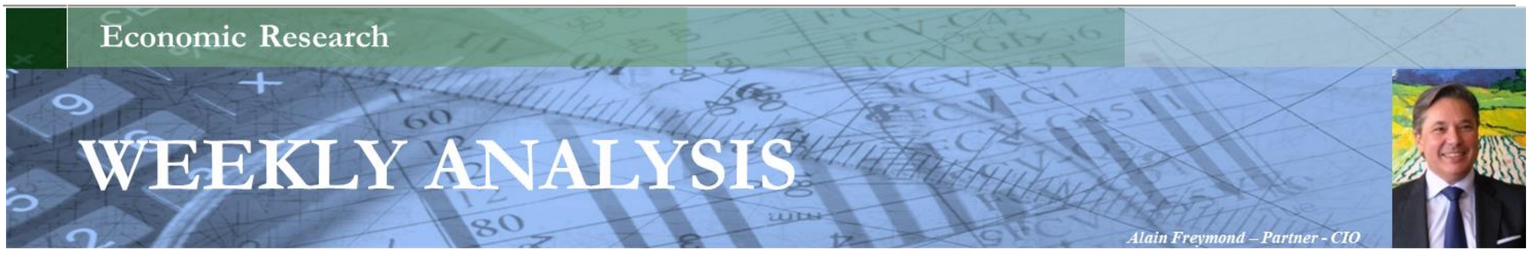
BBGI GROUP Global Investments



29th May 2018

Hedge funds : Which outlook for 2018 after floundering for 10 years?

Alternative investments have not delivered on their promise since the 2008 crisis. Today more than ever, caution is advised. BBGI Alternative + : A different approach to alternative investments.

Key points

- Alternative investments are not the magic bullet investors were expecting in terms of performance and asset de-correlation
- Unsatisfactory performance still manifest in 2018
- However, disappointing performance does not seem to be turning off investors
- Financial markets' special circumstances do not warrant resorting to hedge funds indiscriminately
- Alternative investment fund selection is the key determinant of success
- Swiss institutional investors are disappointed but not quite burnt
- BBGI Alternative + : A different approach to alternative investments

Alternative investments are not the magic bullet investors were expecting in terms of performance and asset de-correlation

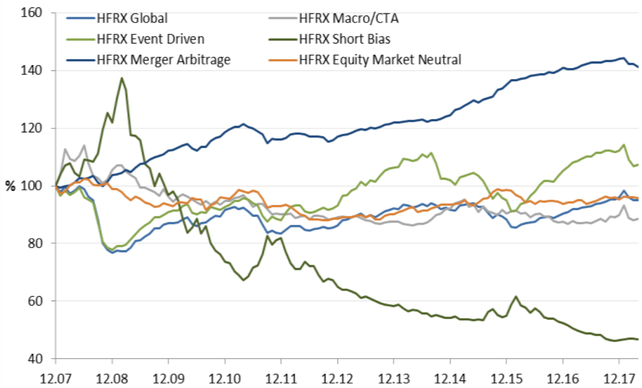
Ten years ago, the onset of the financial crisis in the United States sent a shockwave through the global economy and financial markets. This crisis with no real precedent had myriad consequences, in terms of monetary policy in particular, as well as in terms of the performance of financial assets and investment strategies.

Over the past ten years, after a period of significant uncertainty, investors have gradually regained confidence in financial markets, and in the equities asset class in particular. While annual gains posted between 2008 and 2012 erased the losses incurred in 2008, over the following years investors were able to achieve a 10-year rate of return of +5.0% per year globally (MSCI World equities) and +8.3% per year for the S&P500.

Over the same period, the performance of alternative investments remained negative, declining by -0.5% per year on average.

Many investors who had long believed in the anticipated merits of hedge fund de-correlation now have to face the objective reality that alternative investments did not provide the expected solution to the increase in the volatility of financial assets during this period.

Performance of hedge fund strategies



Sources: Bloomberg, BBGI Group SA

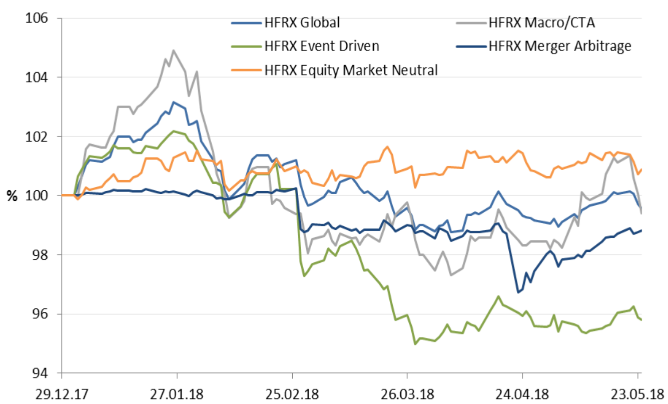
Moreover, this finding with regard to the hedge fund asset class overall is unfortunately corroborated by a more detailed analysis of the results of specific strategies within the sector. Indeed, just as the performance of the hedge fund universe as a whole, as measured by the HFRX Global index in USD, has slipped by -0.49% per year over the past ten years, the performance of the most popular strategies, such as global macro/CTA (-1.18% per year) or equity market neutral (-0.41% per year), has also been negative. Only the merger arbitrage strategy ultimately did well with a positive result of +3.39% per year, ahead of the event driven strategy, which inched up by a mere +0.68% per year.

Unsatisfactory performance still manifest in 2018

Over the first five months of 2018, the performance of hedge funds overall has not improved, providing scant hope of a revival of this asset class, even though volatility was sufficiently present in equity markets to enable active management of risks and opportunities. However, in the context of market fluctuations of over 10% between January highs and April lows, which should clearly have benefitted alternative investments, the Global HFRX index posted a very disappointing performance of -0.45% compared to gains of +2.8% for the S&P500 and +1.6% for the MSCI World equities index.

All strategies were down except for equity market neutral, up +0.94%.

YTD performance of hedge fund strategies



Sources: Bloomberg, BBGI Group SA

One could have hoped for better in terms of de-correlation.

Indeed, given that most strategies lost ground as equities were correcting, it appears that the correlation is in fact fully expressed in periods of decline, which is clearly contrary to the chief perceived advantage of hedge funds.

By comparison, our tactical international absolute return asset management approach in USD remained in positive territory over the entire period, achieving gains of +1.59%, similar to those of international equities, effectively showing an ability to limit risks and losses in periods of market decline and to take advantage of market rebounds while maintaining much lower levels of volatility. Over the long term this approach enables us to smooth out performance during less favourable periods and to participate in periods of growth by seizing on positive trends.

Disappointing performance does not seem to be turning off investors

The examples above thus show that the hedge fund asset class has not demonstrated any benefit in terms of de-correlation and portfolio diversification. Even when analysing the performance of long/short equities or market neutral equities strategies, most of the time we find directional biases such that the strategies actually implemented are clearly skewing upward. Global macro/CTA strategies, which had performed particularly well during the previous decade with gains of nearly +8%, as well as event driven strategies (+6%) both clearly outperformed other approaches, whose performance was barely positive. But these strategies have also lagged since 2008.

Is the underperformance of hedge funds over the past ten years due to a reduction in leverage?

Has the decline at any rate of the average leverage ratio of alternative investment funds curtailed their capacity to generate performance?

Even if it is difficult to effectively measure the impact of leverage on the performance of alternative funds, in the low interest rate environment of the past ten years the cost of leverage was prone to multiplying the potential effects of investment decisions and amplifying the performance of all strategies using it.

This has clearly not been the case, which further calls into question the average level of competence of current actors in this market. It seems like it has been a long time indeed since genuine talents and pioneers of alternative asset management were able to add real value relative to traditional asset management. While the latter seemed to be running out of steam and its capacity for action seemed to weaken, alternative asset management was able to develop dynamic, more aggressive and better performing asset management models. Certainly, delivering superior performance required higher levels of risk and volatility, but the ends often justified the means.

The industrialisation of alternative asset management and its massive development over the past ten years modified the DNA of the actors in the sector. While undoubtedly there are still actors delivering consistent performance that will continue to deserve the enthusiasm of investors seeking alternative performance, given the overall results achieved over the past ten years one can now very clearly call into question the assumption that alternative investments contribute to improving the risk/return relationship of diversified portfolios.

The improvement in overall returns and the decrease in the risk of portfolios that should have been achieved due to the lack of correlation with traditional asset classes have not been demonstrated.

Nevertheless, funds continue to flow into the sector with close to 10 billion in new funds invested in 2017 and around 1.1 billion in Q1 2018. Hedge funds continue to benefit from this quest for the holy grail. However, it appears that these funds have been flowing into rather smaller investment management firms (under 1 billion), which received close to 2.8 billion over the period, to the detriment of larger actors, which experienced fund withdrawals of close to 1.7 billion.

Disappointment is probably fuelling these withdrawals, while new investments are focused on potentially more innovative strategies upon which new hopes are pinned, yet to materialise.

Financial markets' special circumstances do not warrant resorting to hedge funds indiscriminately

Monetary policy will tighten gradually in the United States and other countries in 2018, after an initial period of normalisation. The high current valuation levels of equity markets and insufficient yields in capital markets could boost certain investors' interest in the hedge fund asset class.

An increasing number of investors could indeed be looking for alternative solutions in a context of low interest rates and perhaps already rather rich equity market valuations.

The impulse to give a more prominent role to hedge funds does not make sense unless it is implemented with even more discernment with regard to product selection than would be an equities strategy.

Indeed, in the latter case, passive exposure to equities is already sufficient to generate adequate positive long-term returns, which could be enhanced by an appropriate selection of individual securities or investment funds.

Alternative investment fund selection is the key determinant of success

This is unfortunately not the case in regard to alternative investments, whose overall performance, or that which would have been achieved via passive or index-linked management, has not generated results worthy of note in a decade. Hence, exposure to this asset class should be carefully crafted via a selection of specific funds. As we mentioned, there is no question that the mediocre results of these past few years are due to an absence of discernment and a failure to take positions diverging from the alternative investment indices.

A passive exposure to this asset class will thus not display the same characteristics as an appropriate and evolving selection among the various existing strategies (global macro/CTA, event driven, merger arbitrage, etc.). The same goes for fund selection with regard to the implementation of an alternative investment strategy.

Swiss institutional investors are disappointed but not quite burnt

In the context of pension fund management, institutional investors have introduced this asset class rather substantially into their investment policies, since the amendment of the pension law (OPP 2) in 2009 clearly identified alternative investments as an asset class sufficiently developed to make up a maximum of 15% of pension funds' assets. Rare are those pension funds today that can declare themselves satisfied with their decision to diversify into hedge funds since that date. The temptation remains in 2018 to attempt to more effectively exploit this opportunity, but it is not clear that all are perfectly aware of the performance actually achieved by this asset class overall. For a more comprehensive comparison, moreover, it should be noted that the results mentioned above were achieved by a group of hedge funds that was highly leveraged and whose performance in US dollars would have been more volatile and often more negative had they been expressed in Swiss francs.

However, in a low interest rate environment, the disappointment of institutional investors may not be sufficient to radically change their attitudes towards hedge funds.

We believe that the appetite for absolute return management and other genuine alternatives to traditional assets will likely grow over the next few years.

Non-leveraged tactical allocation management concepts will likely garner more interest, for instance, as will other alternative asset solutions such as private equity or commodities, whose performance in periods of economic expansion should be de-correlated and positive.

BBGI Alternative + : A different approach to alternative investments

With interest rates close to zero in the main currencies except for the US dollar and elevated risks of losses in portfolios' fixed income segment, investors are indeed looking for alternative sources of returns and are further opening their investment strategies to somewhat less traditional forms of investment.

We have responded to these concerns and this pursuit of alternative types of investment by providing our experience and expertise with regard to the selection of concepts and financial products to more efficiently combine the various potential alternative sources of performance generation.

Indeed, we offer the option of rounding out any traditional diversified investment strategy with a service exclusively focused on alternative investments broadly defined. This unique approach to alternative investments transcends the simple notion of hedge funds, integrating other non-traditional assets, in accordance with Swiss pension fund regulations (OPP2) and the investment philosophy of institutional clients, for instance.

This concept thus enables an optimal integration of investment alternatives in a broad sense with the aim of providing professional competencies focused on the selection of non-traditional investment products to facilitate the implementation of a complementary and more effective strategy than one exclusively achieved via hedge funds, free of stress and conflicts of interest.

Diversification optimisation of alternative and non-traditional investments is in this case achieved via a combination of non-correlated investments in private equity, commodities, non-conventional real estate, infrastructure investments, absolute return products, structured products, and hedge funds.

This global approach to alternative investments facilitates the development of an investment strategy in keeping with targeted management objectives and style with the greatest possible level of comfort to integrate new types of investment that will in the future contribute even more effectively to generating the returns expected by investors.

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