The Early View

What Could Go Wrong?

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I have seldom felt so nervous. The hedge fund industry has recorded a strong first quarter, with almost all strategies enjoying a particularly fertile period of performance. Markets seem convinced that the major developed economies have been able to stave off inflation through monetary tightening without choking off economic growth. Most active managers that we speak to have surprisingly positive outlooks for expected returns over the next 6-12 months, and not just because the going has been easy for the past few weeks. Potential rate cuts and healthy market dislocations are leading to expectations of good quality alpha generation across the hedge fund industry. So, good performance year to date and lots of reasons to be positive for the rest of the year. As any British sports fan will readily report, it's the hope that kills you.

If one goes looking for a harbinger of what could go wrong, it's hard to get much past the risk of crowding in active strategies. Momentum in all its forms has done well since the start of the year, suggesting that winning trades keep on winning, which is either driven by or leads to crowding (the iterative nature of trends and crowding makes it sometimes hard to disentangle cause and effect). Of course, crowding isn't new, but neither is it a particularly easy thing to measure effectively, and is thereby tricky to avoid as an allocator. And it becomes particularly painful when crowded exposures unwind quickly, especially when the redemption pressure exceeds the regular liquidity for the securities.

Most hedge funds take one of two approaches when it comes to crowding. Route one is to follow the crowd, after all, there is wisdom in crowds most of the time. Trend-following strategies make an art of timing the entry and exit of essentially crowded trades in the macroeconomic sphere. And while here there tends to be ample liquidity to avoid the worst crowding reversals, one only needs to look at the sharp reversals in government bonds in March 2023 to see the risks that can rise from crowded positioning in even the most liquid markets. More pertinently, the current parabolic price action in the value of cocoa futures is another troubling observation of the impact of crowding from fast money in less-liquid securities.

Route two is to hedge the crowding risk, trying to find different winning trades to one's peers. This approach is fraught with risk. Most of the larger equity market neutral hedge fund platforms will happily inform investors that they have no discernible exposure to factors such as cross-sectional momentum, and that their risk models show they have largely idiosyncratic risk. This should give little solace since crowding, by definition, is dynamic and when a broad enough section of the industry thinks about risk in the same way, then 'crowding in idiosyncratic risk' is a real concern, no matter how oxymoronic it sounds.

And so, we sit at an uncomfortable nexus of apparent ease for generating returns for the hedge fund industry and nebulous anxiety over the risks of crowding. The hedge fund industry is more concentrated in bigger players and platform models than at any point in the past. Each of these participants is no doubt better at managing risks than in previous technical market events, but few have a sufficient vantage point to properly model systemic risks. In our view, there is good cause right now to be wary of excessive leverage and a benefit to keeping exposures liquid. Both can allow the prudent investor to continue to ride the good times if alpha generation stays strong, but keeps them on the front foot if and when the narrative changes.

Key Drivers of Hedge Funds Performance: An Early March Snapshot

Equity Long-Short:

- March was a good month for Equity Long-Short (ELS) performance across all regions, capping off a strong Q1. However, alpha generation was a little more mixed in March, with stronger performance from long positions.
- The momentum factor remained in focus with continued positive performance through most of March. There were signs of reversal in the final week of the month, with the short leg of the momentum trade rallying, causing some losses.
- Average net exposure levels for ELS funds across regions sit in the top quartile (over a multi-year period), suggesting funds are more willing to keep risk and beta on, as well as riding their winners. There seems to be more complacency in markets around macro factors, both (a) allowing for share prices to be increasingly driven by micro/fundamental factors and (b) driving a more risk-on tone across the space.
- We've noted a marked increase in exposure to European stocks, driven less so by local (Europe-based) ELS managers and more so by global ELS managers who have increased exposure to the region. As noted last month, there has been higher dispersion across European stocks relative to other regions. Additionally, despite a recent pickup in performance, valuations remain low versus US stocks in particular.

Credit:

- Mostly a positive month across broader credit/equity markets as well corporate/structured credit managers. Managers profited from a meaningful pick-up in convertible bond new issuance led by refinancing activity.
- Capital Structure Arbitrage and High Yield Long-Short strategies were also positive contributors as the broad corporate credit markets continued to trade well and primary markets were wide open.
- Financial Preferred enjoyed gains after some primary issuance came at attractive levels, resulting in tighter secondary markets. There was also some call activity in the sector.
- Positive returns for Structured Credit managers were largely driven by carry, along with some modest spread tightening.

Event Driven:

- March was broadly positive across global Event strategies. It was another active month in M&A, however there were no new megadeals as seen earlier in the year. Equitrans Midstream/EQT was a $6 billion deal announced.
- Merger spread indices contracted after the dislocated Spirit Airlines/JetBlue deal was terminated early in the month.
- Notable pharma deals that closed in March included Karuna/Bristol-Myers and Cymabay/Gilead. Network International and Morphosys also received important antitrust approvals. A bidding war for UK paper packaging company DS Smith is developing between International Paper and Mondi.

- The politically sensitive acquisition of US Steel by Nippon was set back after President Biden positioned himself against the transaction.
- European Special Situations experienced a volatile month with market squeezes, but a good number of catalysts played out for specialist managers.
- In Asian markets, Relative Value strategies like China AH trading and cross-border arbitrage performed positively. Selective catalysts did well to withstand the volatile China market.

Macro:

- March was a positive month for Discretionary Macro strategies. Long fixed income exposure in Europe and Latin America have added, supported by an expectation that global central banks will deliver on rate cuts this year. Japanese exposure continues to frustrate traders however, as long Japanese yen positions detracted despite the Bank of Japan's historic move away from its negative interest rate policy and yield curve control. We have also seen a recovery in certain popular fixed income arbitrage trades in the US and Europe.
- It's also been a positive month for trend-following strategies. Traditional approaches continued to profit in equities as indices reached new highs, driven by growing optimism that rate cuts by major central banks are fast approaching. The positive trend in cocoa prices has also continued while longs in crude oil have been additive. Alternative trend-followers modestly trail their Traditional counterparts – positive returns have been driven by long equity exposure and a received bias in emerging market sovereign fixed income. However, the reversal in European emissions markets has weighed on returns in the space.
- March has been another positive month for diversified Systematic Macro programmes. Like Trend strategies, a bullish stance in equities has been a strong contributor to returns. Shorts in the Swiss franc have also been profitable following the Swiss National Bank's surprise rate cut, and dovish central bank meetings on both sides of the Atlantic proved to be a tailwind for long positions in fixed income and gold.

On the radar:

- Over the short term, we are watching for any change to the dominant risk-on narrative across markets. Expectations for inflation data continue to be benign, and therefore a spike in inflation expectations (or realised data) seems to be the most likely path to a reassessment of market risks.
- The credit default cycle has been fairly orderly and uneventful thus far, despite a now prolonged period of higher rates. The expected significant need for refinancing of corporate paper between now and 2026 may put further pressure on weak companies, leading to further defaults and a wider credit premium.
- Longer term, we remain focused on the risks to markets from geopolitical events, not least the unpredictability of major elections this year, but also any deterioration in the conflicts currently taking place around the world.

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