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The Early View

Beware Known Unknowns

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The Allocator's Paradox

Let us start with a somewhat paradoxical statement, that the clearest downside risks to markets now are the unknowns. It is very much an overused metaphor that when the tide goes out, we get to see who was swimming naked. But it is an apt analogy for living through a period of significantly higher rates after 15 years of easy money. SVB, Signature Bank, and Credit Suisse are the recent shocks, created in part by the higher-rate regime, that were completely missed in advance by market prognosticators.

It is likely there will be more to come since there's little evidence that central bankers have anything else on their minds than controlling inflation. Jerome Powell is still smarting from the 'transitory' narrative misstep and seems more set than ever on staying the course, but we are all guilty of oversimplifying the economic theory here. In the textbooks, higher rates make spending less attractive, increase saving rates, reduce corporate profitability, and increase unemployment – all through imaginary smooth functions like steering a ship to a new bearing over calm seas. In reality, higher rates break things.

The second-order and chaotic effects are the hardest to fathom. Just as the recent bank failures have been, partly, caused by the speed and ease of depositors moving their assets to other banks, there will likely be other shocks which are, by definition, hard to forecast or model. The impact of higher mortgage rates on delinquencies and other consumer behaviour is yet to be fully seen, for example. There will likely be more instances of corporate financial mismanagement that surface in unforeseen ways against a tighter monetary backdrop, particularly if we do enter recession later in the year. Financial markets themselves may show cracks in their structural robustness that could cause contagion into a host of other risks as investors' risk-management blind spots are suddenly brought to light.

As hedge-fund allocators, this uncertainty is double-edged. Risks abound, but so do opportunities. Trend-following hedge funds felt the pain of this unpredictability in March thanks to the bond market's paroxysms (with year-end US rate expectations swinging everywhere from 5.75% to 3.75% over the space of a week[1]). They might feel slightly aggrieved, given that the trends were aligned with central banks tightening monetary policy to control inflation, which hasn't fundamentally changed. But in these unreliable times, getting the fundamentals right but the technicals wrong can be a recipe for, if not disaster, then a generous serving of losses. The opportunity side of the coin comes from picking up the pieces after the hidden risks emerge. These can be fertile times for hedge-fund managers who can quickly assess safety and risks in capital structures, and who have the dry powder to enter positions when others are being forced to exit.

1. Source: Bloomberg; as of 30 March 2023.

Key Drivers of Hedge Funds' Performance: An Early March Snapshot

Equity Long-Short:

- Equity long-short managers were generally down in March, with market-neutral funds outperforming more directional ones.
- Financials sector specialists or any managers with significant exposure to the space saw the most weakness in March. Hedge funds sharply reduced exposure to financials as well as lending-sensitive stocks amid banking turmoil.
- TMT sector specialists and fundamental growth managers fared better in March as investors gravitated towards safety in mega-cap names.

Credit Long-Short:

- Managers with any exposure to financial preferreds (US) and AT1s (Europe) had a very challenging month as there was no place to hide.
- Otherwise, corporate credit managers were generally down more modestly; some with a clear focus on more idiosyncratic risks (for which, read good portfolio-level hedging) were up on the month.
- Convertible bonds were generally cheaper as they lagged the move in Treasuries and credit spreads were wider, and some idiosyncratic cap-arb positions (typically long credit versus short equity) were beneficial.
- Lower-rated (stressed) credits were generally soft, and stubs were modestly weak. SPACs were up a little, and spreads across securitised-products sectors were modestly wider.

Relative Value:

- A negative month for event strategies, mostly due to deal breaks (e.g. Allfunds/Euronext) and merger spread widening early/mid-month (e.g. as the First Horizon/TD deal suffered contagion from the turmoil in financials). Soft catalysts in mid-cap stocks and Asia RV plays were also down.
- There was some helpful positive momentum for merger arb towards month-end, however, including an earlier-than-expected DoJ approval for Signify/CVS, and a surprising partial reversal of the UK CMA's preliminary decision in the $68 billion Microsoft/Activision transaction.
- March saw a solid flow of new deal announcements, the most notable being Pfizer's plans to acquire Seagen for a total enterprise value of approximately $43 billion. Toshiba approved a $15 billion buyout offer from a Japanese private-equity fund, a lower result than the market had originally expected, and there may be competitive pressure still to come.

Systematic Macro:

- March was a particularly difficult month for trend-followers, with considerable pain coming from the reversals in fixed-income markets. Long positions in European equities also detracted from performance, but to a much lesser extent.
- Quant macro strategies were similarly strained, where short positions in US and European bonds drove losses. There was a bit more variation around commodity performance, though, where longs in energies extended losses but gold longs provided a partial offset for some.
- Both trend-followers and systematic macro managers embarked on aggressive risk reductions throughout the month, which brought about some performance stability. They broadly ended March with a neutral position in fixed income, with some trend-followers leaning slightly long.

Discretionary Macro:

- It has been a negative month for discretionary macro strategies, which were broadly positioned for hawkish central-bank rhetoric to continue with net short duration a common theme among portfolios. Losses have been concentrated in directional expressions in the US and Europe, as investors in both regions have repriced policy expectations sharply lower for this cycle, although cross-market themes between US and European rates have performed better (such as long US/short Europe). However, some tactical FX trading in the euro and high-carry currencies (short BRL, MXN) has produced gains, and performance in fixed-income arbitrage appears positive, at the time of writing.
- The volatility and uncertainty in markets triggered a rapid risk reduction across the space. While markets have shown signs of stability in recent days with some risk premium being removed from some of the most volatile markets, risk-taking in the peer group has yet to return to meaningful levels, reflecting low conviction as developments in the banking sector continue to dominate price action in markets.
- Since the onset of the crisis, stronger views involve rejecting the ‘soft landing’ narrative. ‘Risk-off’ themes in equities were less targeted during the de-grossing, while we have seen more yield curve-steepeners added to books as curves broadly begin to revert from deeply inverted levels.

On the Radar:

- In the very short term, the stability of the banking system is paramount. The ability of regulators to calm depositors is of equal importance to the reaction of equity and debt holders of the more fragile banks. Risks can spiral quickly, particularly as many financial institutions have counterparty risk triggers linked to (sometimes relatively illiquid) CDS spread levels.
- Monetary tightness will be watched closely through the next couple of quarters. It is credible that the problems in the banking sector impact the credit impulse in a similar way to one or two rate rises, but then central bank lending and repo facilities may act as monetary stimulus. Investors will be watching how central banks describe and act on interest-rate levels over the next few months in the context of these changes to the banking system.
- Recession risks haven’t gone away. Economic forecasts are still treading something of a tightrope to scrape through 2023 without economic pain. Unforeseen events have every chance of destabilising this precarious balance.
- Hedge-fund managers are waiting to pounce on opportunities arising from any dislocation. Areas of interest are distressed debt, structured credit, and risk transfers.

Author

Adam Singleton, CFA
Head of Investment Solutions, Man FRM

Adam Singleton is Head of Investment Solutions based in London. Adam is responsible for the oversight of the Portfolio Management and Quant Research teams, providing innovative portfolio solutions to the most sophisticated clients of the firm. He is a member of the Man FRM Investment Committee and the Man Solutions Risk and Portfolio Committee. Previously, Adam has held positions in Portfolio Management, as Head of Equity Long-Short manager selection, managing the Investment Risk function within the Risk Management team, as well as fund selection in Relative Value and Specialist Credit strategies. Prior to joining Man FRM in 2005, Adam worked as an analyst within Investment Consulting at Watson Wyatt. Adam holds a BSc in Mathematics from the University of Warwick and is a CFA charterholder.