The Early View

Balancing Euphoria and Diversification: The Hunt for Hedge Fund Alpha

For Institutional investor, qualified investor and financial professional use only. Not for use with retail public.
Please note that the opinions discussed below are solely those of the authors and do not necessarily reflect those of Man Group plc or any of its subsidiaries.
All market data sourced to Bloomberg unless otherwise indicated. All manager data sourced to Man FRM's internal database.

March 2024
Time to read: 7 minutes

Our role as hedge fund allocators requires us to look at markets through an unorthodox lens. We have long since abandoned any hope of predicting market direction, and instead focus on whether the market backdrop has presented, or is likely to present in the future, a fertile hunting ground for hedge fund alpha.

One of our key frustrations for much of last year was speaking to managers who were struggling to generate alpha and finding their explanations of the drivers of their difficulties to be a little weak. Outside of the regional banking crisis in March 2023, which led to sharp losses for some Macro strategies unprepared for the violent rally in bonds, there were relatively few headline reasons for weak alpha. And yet, once one correctly discounts for equity beta and credit spread beta, alpha was thin on the ground for much of 2023. It was surprisingly sparse across a range of strategies, rather than being concentrated in one area.

In counterpoint to this observation, in the first two months of this year alpha was present in a range of strategies and, in some cases, it has been quite abundant. The most common driver here is momentum, in both time series (i.e. trends in markets) and cross-sectional (i.e. securities performing well on a relative basis versus peers continuing to do so) forms.

Momentum loves a consistent narrative, and as scary as it feels sometimes, the prevalent present narrative we see is: 'the economy is fine, the Fed has your back, so buy equities.' Equity markets continued to rally strongly, with the S&P 500 passing recent peaks and the Nikkei 225 finally surpassing its previous high from way back in 1989. Retail investors are increasingly part of the mix. Bitcoin surged back above $60k on continued structural support for the crypto asset class, and the options premium spent on Nvidia stock last month was close to $3bn (given the frenzy around the Q4 earnings announcement), or over 20% of the total US single stock options premium spent in February.

And therein lies the hedge fund allocators biggest challenge. Returns are much stronger this year than last, which is a welcome development, but the momentum exposures which are leading the gains are becoming overextended and borderline euphoric. There's nothing immediately on the macroeconomic agenda for the next few weeks that poses an obvious risk of changing the narrative, and so allocators must now sit with these uncomfortable markets, managing risk prudently, while trying not to kill the golden goose.

But return drivers that all start to correlate to equity market gains are not useful for the hedge fund industry in the long-term - we are supposed to diversify the returns to traditional assets after all. There are a few consolations to the current regime; hedging is cheap and therefore managers need not bear too much reversal risk, and the rally in momentum is leading to widening spreads in valuation between cheap and expensive stocks on a variety of value and quality metrics, potentially storing up interesting alpha opportunities for later in the year.

Key Drivers of Hedge Funds Performance: An Early February Snapshot

Equity Long-Short:

- February was largely a continuation from January, with ELS funds capitalising on strength in global equities for modest monthly gains. Alpha generation did not appear to be as strong as in January, with the average fund capturing about as much upside as net exposure levels would dictate.
- A strong rally in Chinese equities meant that Asian ELS fund performance picked up in February. Upside capture among this cohort funds has been diminished by both lower net exposure and managers maintaining a higher concentration in global equities.
- There was significant net buying of US tech stocks leading up to Nvidia's earnings. Following the report and subsequent tech rally, ELS funds pivoted to heavy net sellers of US tech stocks – both through trimming gains and re-shorting stocks.
- In contrast to the U.S., there have been signs of higher dispersion and lower correlation across European stocks, which is encouraging for managers in the region.

Credit:

- It was a modestly positive month for Corporate Credit managers with relatively muted single name profit drivers against a backdrop of continued spread tightening in US High Yield, higher treasury yields, and active primary markets.
- Convertible bonds saw modest richening. Financial preferreds saw some intra-month volatility post- New York Community Bank (NYCB) earnings miss, with regional bank preferred securities finishing modestly lower on the month.
- Stressed/distressed credits were mostly positive contributors, and managers also made money on rate hedges while portfolio level credit hedges were a detractor.
- Positive returns for Structured Credit managers were largely driven by carry, with spreads largely unchanged on the month.

Event Driven:

- February returns in Event Driven were modestly positive.
- Asia has been a source of strong performance for some managers, with RV HoldCo/OpCo trading and Korean corporate governance themes noteworthy, as well as idiosyncratic Japan soft catalysts. The strong China recovery was a challenge for alpha short positions.
- Strong M&A deal activity in both US and Europe continues to bode well for the strategy, e.g. Capital One announced a $35 billion all-stock acquisition of Discover Financial Services. And in Europe, Novo Holdings made an unsolicited bid to buy Catalent ($10bn).
- The bidding war for Wincanton (a UK logistics company) is heating up, with US-based GXO Logistics topping an offer made by CEVA.
- The AbbVie buyout of ImmunoGen ($10bn deal) concluded ahead of schedule, closing a nice spread, leading to profits for many managers in the space.
- In terms of more negative catalysts, the Federal Trade Commission suing to block the Albertsons/Kroger merger was no great surprise to managers. The Hess/Chevron deal traded down after Exxon claimed some change of control rights on a major underlying asset, however, the industry sentiment is that this is unlikely to derail the deal.

Macro:

- February was a more difficult month for discretionary macro strategies. Longs in Euro rates have suffered losses, as have receiver positions in EM local rates.
- Japanese themes struggled with JGBs moving sideways and JPY selling off.
- In terms of the outlook, managers are now positioning for rate cuts being delayed until at least the second half of the year, and FX exposures are shifting – managers looking for opportunities to short higher-yielders where central banks look committed to delivering material rate cuts, as growth slows and inflation falls.
- On the other hand, trend strategies are performing well, as price trends have continued across commodities, which has helped alternative trend strategies in particular. Managers have built back into fixed income shorts to good effect, while US and Japanese equities continue to be profitable.

On the radar:

- With the Q4 earnings season largely completed, managers' focus now turns back to fundamental data on inflation, jobs and economic growth. The balance between recession risks and inflation risks has implications across a variety of hedge fund exposures, not least whether the recent momentum rally continues.
- Longer term foci include the elections cycle in a number of countries, most notably the US in November. It remains harder than usual to discern the obvious winners and losers from either a Donald Trump or a Joe Biden success, and we are watching closely for a clear picture of how markets might react to either victor.
- Of more immediate political interest is if either candidate pulls out of the race between now and November. Given the primary caucuses are as good as finished now, the most likely route to a change in presidential candidates would be ill health, which cannot be ruled out as a possibility given the age of both men. Equally, given that most alternatives on both sides of the contest poll easily ahead of either incumbent, markets may react strongly to a change of candidates in expectation that the election is then a done deal.

Author

Adam Singleton, CFA
CIO of External Alpha at Man Solutions

Adam Singleton is the CIO of External Alpha at Man Solutions and chairs the External Alpha Investment Committee. He is responsible for the investment policy and oversight of externally invested client portfolios. He also serves on the Man Solutions Risk and Portfolio Committee and Man Solutions Investment Committee. Previously, Adam held various positions across Man Solutions' external manager business, including Head of Investment Solutions, 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 Group 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.

www.man.com/maninstitute

Important Information

This information is communicated and/or distributed by the relevant Man entity identified below (collectively the 'Company') subject to the following conditions and restriction in their respective jurisdictions.

Opinions expressed are those of the author and may not be shared by all personnel of Man Group plc ('Man'). These opinions are subject to change without notice, are for information purposes only and do not constitute an offer or invitation to make an investment in any financial instrument or in any product to which the Company and/or its affiliates provides investment advisory or any other financial services. Any organisations, financial instrument or products described in this material are mentioned for reference purposes only which should not be considered a recommendation for their purchase or sale. Neither the Company nor the authors shall be liable to any person for any action taken on the basis of the information provided. Some statements contained in this material concerning goals, strategies, outlook or other non-historical matters may be forward-looking statements and are based on current indicators and expectations. These forward-looking statements speak only as of the date on which they are made, and the Company undertakes no obligation to update or revise any forward-looking statements. These forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from those contained in the statements. The Company and/or its affiliates may or may not have a position in any financial instrument mentioned and may or may not be actively trading in any such securities. Past performance is not indicative of future results.

Unless stated otherwise this information is communicated by the relevant entity listed below.

Australia: To the extent this material is distributed in Australia it is communicated by Man Investments Australia Limited ABN 47 002 747 480 AFSL 240581, which is regulated by the Australian Securities & Investments Commission (ASIC). This information has been prepared without taking into account anyone's objectives, financial situation or needs.

Austria/Germany/Liechtenstein: To the extent this material is distributed in Austria, Germany and/or Liechtenstein it is communicated by Man (Europe) AG, which is authorised and regulated by the Liechtenstein Financial Market Authority (FMA). Man (Europe) AG is registered in the Principality of Liechtenstein no. FL-0002.420.371-2. Man (Europe) AG is an associated participant in the investor compensation scheme, which is operated by the Deposit Guarantee and Investor Compensation Foundation PCC (FL-0002.039.614-1) and corresponds with EU law. Further information is available on the Foundation's website under www.eas-liechtenstein.li. This material is of a promotional nature.

European Economic Area: Unless indicated otherwise this material is communicated in the European Economic Area by Man Asset Management (Ireland) Limited ('MAMIL') which is registered in Ireland under company number 250493 and has its registered office at 70 Sir John Rogerson's Quay, Grand Canal Dock, Dublin 2, Ireland. MAMIL is authorised and regulated by the Central Bank of Ireland under number C22513.

Hong Kong SAR: To the extent this material is distributed in Hong Kong SAR, this material is communicated by Man Investments (Hong Kong) Limited and has not been reviewed by the Securities and Futures Commission in Hong Kong. This material can only be communicated to intermediaries, and professional clients who are within one of the professional investors exemptions contained in the Securities and Futures Ordinance and must not be relied upon by any other person(s).

Japan: To the extent this material is distributed in Japan it is communicated by Man Group Japan Limited, Financial Instruments Business Operator, Director of Kanto Local Finance Bureau (Financial instruments firms) No. 624 for the purpose of providing information on investment strategies, investment services, etc. provided by Man Group, and is not a disclosure document based on laws and regulations. This material can only be communicated only to professional investors (i.e. specific investors or institutional investors as defined under Financial Instruments Exchange Law) who may have sufficient knowledge and experience of related risks.

Switzerland: To the extent the material is made available in Switzerland the communicating entity is:

- For Clients (as such term is defined in the Swiss Financial Services Act): Man Investments (CH) AG, Huobstrasse 3, 8808 Pfäffikon SZ, Switzerland. Man Investment (CH) AG is regulated by the Swiss Financial Market Supervisory Authority ('FINMA'); and
- For Financial Service Providers (as defined in Art. 3 d. of FINSA, which are not Clients): Man Investments AG, Huobstrasse 3, 8808 Pfäffikon SZ, Switzerland, which is regulated by FINMA.

United Kingdom: Unless indicated otherwise this material is communicated in the United Kingdom by Man Solutions Limited ('MSL') which is a private limited company registered in England and Wales under number 3385362. MSL is authorised and regulated by the UK Financial Conduct Authority (the 'FCA') under number 185637 and has its registered office at Riverbank House, 2 Swan Lane, London, EC4R 3AD, United Kingdom.

United States: To the extent this material is distributed in the United States, it is communicated and distributed by Man Investments, Inc. ('Man Investments'). Man Investments is registered as a broker-dealer with the SEC and is a member of the Financial Industry Regulatory Authority ('FINRA'). Man Investments is also a member of the Securities Investor Protection Corporation ('SIPC'). Man Investments is a wholly owned subsidiary of Man Group plc. The registration and memberships described above in no way imply a certain level of skill or expertise or that the SEC, FINRA or the SIPC have endorsed Man Investments. Man Investments, 1345 Avenue of the Americas, 21st floor, New York, NY 10105.

This material is proprietary information and may not be reproduced or otherwise disseminated in whole or in part without prior written consent. Any data services and information available from public sources used in the creation of this material are believed to be reliable. However accuracy is not warranted or guaranteed. ©Man 2024

MKT011034/ST/GL/W