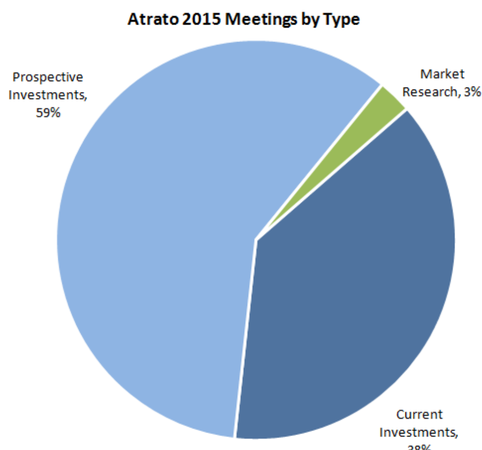
Dispatch from the Research Desk

2015 Review & Outlook

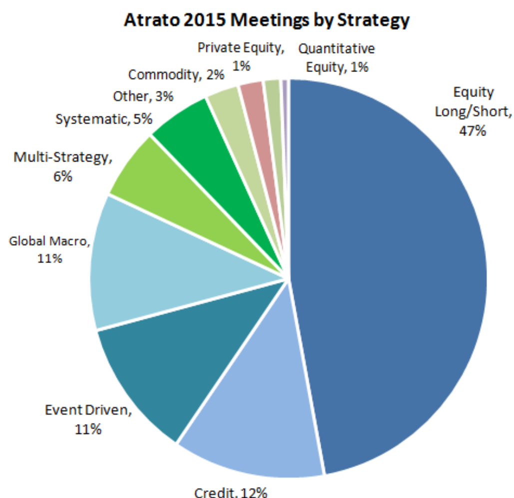
ATRATO ADVISORS®

Research Calendar

During 2015, Atrato Advisors conducted 1,132 calls and meetings within the alternative investment industry that approximately broke down as follows:



As Atrato Advisors mandate is to tailor custom hedge fund solutions based on client-specific risk/reward, style and strategy preferences, the research desk met with 613 different management companies in 2015, including 122 managers that were either active investments or directed research mandates.



The breakdown of meetings by strategy is indicative of the breadth of strategy coverage undertaken by the research desk on a continuous basis. It is also indicative of client allocation preferences and the marketing/performance environment for certain strategies. For example, while the opportunity set and capital flows to HY corporate and distressed managers was limited, the research desk focused on alternative credit strategies that were either less liquid (direct lending) or non-corporate (peer-to-peer lending to consumers). The breadth of coverage also included a large proportion of 2015's emerging managers.

Thematic Viewpoints

While investing in hedge funds is generally not about static one-dimensional positions or themes, there are typically a few large macro and fundamental considerations that impact a variety of different types of managers. In the paragraphs below, we have highlighted some of the notable macro factors, idiosyncratic events and manager positions that overly influenced returns in 2015. In addition, the outlook provides a sense for what factors may be prevalent in 2016 and how different managers are positioned to take advantage or avoid them.

Developed Market Equities

Review: The year began with continued positive flows into equities, though investors were less bullish about near-term upside given the length of the US bull market and higher valuations. In addition, the trend of USD-strength was expected to weigh materially on earnings. At the same time, growth in Europe was accelerating and the anticipated announcement of QE by the ECB in January had investors positioned with a long European bias relative to US equities. This positioning outperformed for the first three quarters of 2015 (with notable underperformance in May) before reversing in the sharp US market rally over the fourth quarter. While some managers were caught in this relative positioning mismatch, September and October were also extremely challenging months for hedge funds as popular and crowded specialty pharma (Valeant), cable roll-up (Altice) and solar YieldCos (SunEdison) came under significant fundamental and technical pressures for a variety of reasons. As a result of coincident and outsized losses across these positions, most managers de-risked their portfolios at least marginally and then underperformed markets through the end of the year.

Outlook: The outlook for 2016 echoes that of 2015, as relatively high valuations in the US imply that returns on a go-forward basis will likely underperform recent and historical averages. There is a wide debate about the opportunity set in growth vs value stocks. Growth-oriented managers that generally outperformed last year tended to enter 2016 with more optimistic positioning and more net exposure. Conversely, value-oriented managers that generally underperformed in 2015 entered the year more cautious in terms of net and gross. Being believers in value over the long-term, we are looking for concentrated and value-oriented managers with only moderate net exposure to perform well this year on the back of idiosyncratic outperformance. In addition to fundamentals, technicals are also likely to become more favorable in Europe around the announcement of additional QE (expected March 2016). Nevertheless, directionality is hard to favor in the eighth year of a bull market.

China/Asia

Review: While fears of a China hard landing have been mentioned for years, market participants were generally excited about the

Hong Kong-Shanghai Connect and the longer-term structural opening of markets to benchmark/index capital. This excitement bubbled over in mainland China where rampant margin speculation drove valuations to bubble levels. From trough-to-peak during 2014 and 2015, the Shanghai Composite and Shenzhen Composite appreciated by +159.5% and +211.8%, respectively, in CNY. After peaking on June 12, the markets lost almost -50% before bottoming in late summer. The drastic market declines in China caused government intervention that eroded both local and global investor confidence as concerns about a China hard landing grew. While conditions improved into year-end, fundamental concerns never truly abated and pan-Asia equity managers rebalanced portfolios to place greater weight on Indian and Japanese opportunities. This environment challenged long-biased managers who adjusted exposure towards US or Cayman-listed Chinese companies. The volatile environment was particularly fruitful for relative value strategies allocated to A-H share dislocations, ETF relative value trades, and block sales, as noted in our June Dispatch.

Outlook: Chinese equity markets began 2016 in bleak fashion, as indices traded into bear market territory despite expectations of GDP growth remaining in the 6-7% range. Some of the major issues are confidence and money flows, which are not fundamental concerns on a standalone basis, but can evolve into systemic problems if scarcity of capital causes liquidity and then solvency issues. An estimated $550 billion fled China in the first 10 months of 2015 and likely continues hereafter. These capital flows caused the PBOC's foreign exchange reserves to fall by $513 billion in 2015 as it attempted to support the CNY. The potentially damaging feedback loop of technical flows on fundamentals leads to our view of China as a high-risk allocation near-term, even if the sell-off appears overdone on fundamentals. In Chinese equities, many managers believe the young consumer will spend more than previous generations, which means the consumer and e-commerce sectors will remain focus points for longs while old economy sectors will be focus points for shorts. Macro managers are staying tactical with respect to China, with an emphasis on GDP, PBOC and currency news flow.

Currencies

Review: Market participants expected USD strength against EUR and JPY due to anticipated monetary policy divergence. Most managers were also short Emerging Market currencies due to continued commodity price weakness related to the slowdown in Chinese industrial production. While those trends remained consistent throughout the year, the de-pegging of the CHF against the EUR by the SNB surprised markets, as the sharp appreciation of the CHF (+15.7% against the USD, +17.9% against the EUR) caused massive losses within a number of banks and hedge funds (Comac and Everest in particular). Markets also reacted strongly to the PBOC changing the CNY peg from the USD to a 13-currency trade weighted basket. This caused the CNY to experience its largest one day decline in over two decades (-1.86%). More so than just the absolute move was the signal that it sent to market participants who viewed it as confirmation of their concerns about fundamental economic weakness.

Outlook: Despite the substantial appreciation of the USD against other currencies over the past two years (USD Index: +12.8% in 2014, +9.3% in 2015), continued economic growth, low energy prices, and a central bank that appears likely to continue hiking rates well ahead of other major central banks (4 hikes projected for 2016) suggest continued appreciation. Positioning has continued to favor EUR shorts with an expectation of material pre-positioning ahead of the March ECB meeting. Additional European QE is likely, particularly as low energy prices keep inflationary pressures extraordinarily low. In emerging markets, we have begun to hear about more optimistic and tactical long trading based on low inflation and growth potential. In particular, certain Latin American countries like Mexico look extremely cheap on a real effective exchange rate basis and a credit boom is expected to fuel growth since credit penetration remains substantially lower than in most Asian economies.

Energy

Review: Coming into 2015, we generally preferred to avoid allocating to the energy sector, particularly avoiding illiquid par lending strategies while emphasizing low net equity energy strategies with long high quality and short low quality portfolios. While this worked to some degree for most of 2015, managers focused on quality of reserves but not leverage generated outsized negative returns in November and December as credit factors dominated returns. Allocations to stressed energy credits that some managers made in the spring of 2015 as oil prices appeared to be recovering were universally ill-timed investments. Thereafter, illiquidity and heightened macro risk prevented managers from allocating capital. However, as we noted in our November Dispatch, we began to identify purchases of MLPs and energy-related equities towards the end of the year in sector specific and opportunistic portfolios. In addition, some Event-Driven Multi-Strategy managers allocated capital away from underperforming special situation equities and into subordinated debt of E&P companies they expected to remain solvent for at least 24 months at current prices. This shift occurred as the securities traded to levels where the coupon is expected to cover the cost basis prior to default, providing for highly asymmetric upside if oil prices recover in the near-term (par recovery) or low energy prices cause default (anticipated equity control).

Outlook: The outlook for energy prices has never been as contentious amongst hedge fund managers as it was at the time of this writing. Some managers expect near-term price

appreciation due to higher than expected demand (1.75/mbd in 2015 up from expectations of 1.4-1.5/mbd at the start of the year) and lower than realized global inventories. Others expect further deterioration to $20/bbl assuming the global supply glut is exacerbated by Iranian supply coming to market. We have also heard that the continued decline in prices should be causing deferred oil prices to steepen rather than flatten as the lack of current CapEx will cause prices to be structurally elevated for years once inventories have been consumed. Others suggest that deferred prices should remain flat because any spot appreciation would be met with producer hedging to lock in prices. As a result of this confusion, we have focused primarily on tactical commodity traders and low net equity energy funds, although we have identified a few fundamental and long-biased opportunities to build gradually as well.

Volatility/Credit

Review: Given the length of the bull market post Global Financial Crisis and a host of other concerns, the expectation of greater volatility was one of relative consensus (Average VIX 2013: 14.2, 2014: 14.18, 2015: 16.67). However, as is typically the case, the sources of volatility caught market participants by surprise at various points in the year (January: CHF de-pegging, April & May: global sovereign bond sell-off, August: CNY devaluation & first market correction in four years (-11.1% in 5 days)). The August volatility spike was particularly notable, as the VIX surpassed 40 for the first time since 2011. Volatility managers thrived in this environment as global index volatility relative value and single name equity dispersion strategies did particularly well.

While equity market volatility is easily observable, the dislocation that occurred in credit markets was material and notable. The illiquid credit market conditions highlight a market with growing risk aversion and a lack of buyers, as brokerages have phased out their principal risk-taking bond trading desks. The suspension and liquidation of one of Third Avenue's high yield mutual funds in December was an excellent example of the prevalent illiquid conditions. Stress broadly occurred in the lowest quality portions of the market (CCC High Yield Bond index declined -15.0%, CCC Leveraged Loans declined -8.4%). While many securities have traded to distressed levels, lack of defaulted opportunities sidelined investor flows.

Outlook: While the current spike in volatility appears overblown, diverging monetary policy, low energy prices, and strained fiscal budgets and economic growth in commodity-centric economies has increased the overall stress in the system. 2016 should witness a material pickup in the number of commodity-related corporate defaults and illiquidity issues in the credit markets could be exacerbated by fundamentals in the face of rate hikes in the US. While it is unlikely that volatility will remain elevated for most of the year, periods of strain are likely to be acute and centered on capital availability and changes of sentiment, particularly around crowded positioning.

Mergers & Acquisitions

Review: Markets were optimistic for the M&A cycle in 2015, as 2014 had the most announced transactions and greatest private equity activity since 2007. According to Dealogic, deal activity in 2015 increased 37% to surpass $5 trillion for the first time ever. Volume was driven by 69 $10b+ deals and 10 $50b+ deals. Healthcare was the most targeted industry and included Pfizer's proposed $160 billion merger with Allergan, the second largest M&A deal announced on record. Nevertheless, investors feared tail risks in deals, as regulatory risks came to the forefront (Cigna/Aetna, Comcast/Time Warner Cable, Staples/Office Depot) and idiosyncratic events caught investors by surprise. One such idiosyncratic event was Energy Transfer Equity's bid for Williams Cos, which had already bid on its subsidiary, Williams Partners LP, and was held short in arbitrage portfolios. Despite the volatility of merger spreads during 2015, allocations to the strategy increased in a large majority of Event-Driven Multi-Strategy funds.

Outlook: As a result of the regulatory and idiosyncratic issues noted above, merger arbitrage spreads have traded at the most attractive levels in years. In addition to wide spreads, managers have noted that price action in spreads has become less linear, as they tend to tighten only when certain conditions occur, rather than with time as expected. Particularly for the first half of 2016, merger arbitrage opportunities will be meaningful contributors to event-driven portfolio returns and volatility.

As always, if you would like any additional information on Atrato's manager meetings or would like to discuss the implications of thematic viewpoints on portfolio construction, please don't hesitate to contact us. Thanks for reading.

Warm Regards,

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Partner, Director of Research

About Atrato Advisors

Atrato Advisors (www.atratoadvisors.com) is a boutique consulting firm that provides highly individualized research and advisory solutions to the hedge fund investor community. We work with a number of institutions including family offices, wealth management firms, asset managers, foundations and endowments looking to expand the scope and depth of their hedge fund coverage, partnering with them on sourcing, portfolio construction, manager research and/or operational due diligence.

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