# Hedge Fund Strategy Outlook

April 2018

599 Lexington Avenue, 37th Floor
New York, New York 10022

# HEDGE FUND STRATEGY OUTLOOK

Report as of: April 30, 2018


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# HEDGE FUND INDUSTRY COMMENTARY

## Performance & Perspectives

### Event Driven

A strong start to the year gave way to a choppier February and March for event driven managers as they faced swings in market volatility, mostly rising rates, and signs of stress in the funding markets. Credit managers, whether they are long-biased or more hedged, largely outperformed equity-oriented event managers. Among the latter, we saw mixed results from managers' hedges – in some cases, they worked as intended, while in others, managers struggled with the right ratios, the right names, or the right instruments. Several idiosyncratic events had varying impacts throughout the quarter, though many of them were masked by the fluctuations in markets and in sentiment.

### Long/Short Equity

Long/short equity managers posted positive returns in Q1 (average of +0.6% YTD) per Aksia's Monitored Funds Composite (MFC). Based on the composite, opportunistic (long-biased) managers surprisingly generated positive returns despite the decline in global equity markets. Low net managers generated flat to positive returns (average of +0.8%). Growth managers largely outperformed value managers in January and February. However, value managers have retraced some of their losses and appear to be heading into the second quarter on a strong footing. Some multi-PMs firms struggled in Q1 as they got caught in factor reversals. Among specialists, energy managers were significantly down in Q1, while healthcare managers generated decent returns.

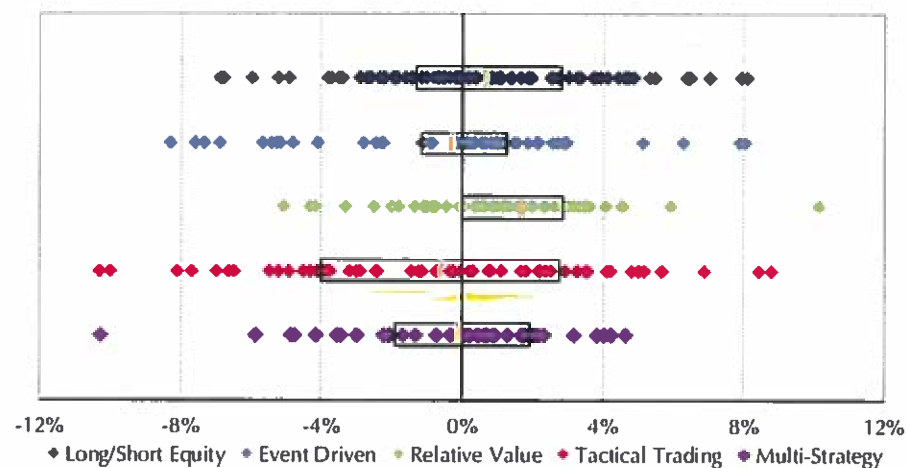
### Relative Value

The Monitored Fund Composite for fixed income arbitrage funds was up 1.7% in Q1. As has been true over the past couple of years, continental Europe RV has generally been the largest driver of attribution. Quantitative strategies had a positive Q1, driven by a strong March, overcoming a difficult period during the volatility shock in early February. Insurance-linked securities (ILS) strategies have generally performed on par with expectations as we approach risk season for U.S. Wind. There have been PnL movements related to loss reserve updates related to the 2017 events (PCS loss revision updates have experienced volatility related to Irma & Harvey)

### Tactical Trading

CTAs were knocked around in Q1, with a good month (January) followed by a poor month (February), both driven largely by sharp moves in equities. Through the end of Q1, the SocGen Trend Index was down -3.88%, and the SocGen CTA Index was down -2.81%. There was significant dispersion among managers, though we believe the causes were mostly idiosyncratic rather than easily broken down by signal speed. Like many strategies, global macro got off to a strong start in January as market action lined up with several key positions. Funds generated PnL on short U.S. rates at both the front and long ends, long cheap upside equity gamma, and long EM rates, credit, and FX. While February and March were choppier, many managers monetized gains in equity index calls before the early February correction, and Eurodollar shorts proved resilient. EM specialists generally did a good job of holding onto their gains from "risk-on" trades.

Figure 1: **Aksia Monitored Funds – 2018 YTD Performance**




Source: Aksia Monitored Fund Composite (MFC). Please see notes at the end of this report for a definition/methodology of the MFC. Each point represents one fund's cumulative performance as a consituent of the MFC in the referenced time period. Rectangles span the middle 50% of individual constituent returns, with the gold line representing the overall sector composite return. Returns outside of -12% to 12% range are not pictured.

Past performance is not indicative of future results and should not be taken as an indication or guarantee of any future performance or prediction.

# HEDGE FUND INDUSTRY COMMENTARY

## Aksia Top Down Themes

Our three top down HF industry themes remain unchanged. Each theme is long term and not easy to achieve quickly within a portfolio. What the themes have in common is they can each help reduce exposure to the most common type of hedge fund ("communia sepe fiscus"), which we can sum up as:

- U.S. or Europe focus
- Open ended, typically quarterly liquidity
- Trading markets dominated by other professionals, passive portfolios, and computerized trading

## Theme #1 – Closed-End and Contingent Capital Structures for Hedge Fund Strategies

We continue to like (and look for) drawdown style closed-ended structures around hedge fund strategies. With open-ended fund structures, across every sector Aksia monitors, less liquid funds outperform more liquid funds. Taking that one step further, we believe drawdown closed-ended funds can offer even better performance than open-ended fund structures, and usually lower fees. In the limited instances where the same manager runs the same strategy in an open versus closed-end fund, the closed end fund tends to outperform. Tenor of these vehicles varies but is typically 3 or 4 years. There have been interesting fund raises recently in contingent dislocation credit, insurance, and activist strategies.

## Theme #2 – Asia Low Net / Trading Against Retail

Alpha is a zero-sum game. So, would you rather your money be trading against other professionals and computer algorithms, or against retail investors? At 3-years old this theme is still in its adolescence. Given the growing size of greater China markets and the continued dominance of retail driven trading activity, we expect to keep this theme for many years. We believe Aksia has a talented Asia manager research team now and we are working on expanding our Asia research team further.

The two main ways to play this theme are:

i) Hong Kong based relative value and multi-strategy managers (e.g., the post 2008 spinouts from the banks); and
ii) Lower net exposure long/short equity managers focused on the greater China region.

These days AUMs are building up in Asia, especially with the HK based multi-strategy managers. One concern we have is rising exposures to BB and lower rated (or unrated) credit within some of these multi-strategy managers. This theme is not intended to be very directional and we advise allocators to think carefully and cautiously about the managers with the highest proportional credit balance sheets relative to NAV.

The nirvana for this theme would be trading directly against domestic Chinese retail in the onshore markets in a low net exposure manner. The reality has been, so far, that it is nearly impossible to short domestically, and the limited borrow available is held by offshore investors (mainly hedge funds) through the Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect. Not sure these are the folks you want to be trading against (shorting what they go long). All that may change with the May and August 2018 2-step inclusion process which will take China A-shares from 0% to 5% of their market cap included in the MSCI indices. This is not huge, but it should offer a wider array of shorts and more stable stock borrow. It's early days, but I think getting in early to low net long/short equity in China may be the best alpha opportunity today.

## Theme #3 – Spread Out into Emerging Markets

We like emerging market focused strategies both because of the dispersion of markets/economies and because (we believe) hedge fund AUM is quite small relative to the size of these markets. Unfortunately, there is a shortage of institutional quality EM-focused managers with proven shorting skills. Given the paucity of managers it is impractical for this to be a large part of your portfolio but nevertheless it offers diversification away from *communia sepe fiscus*. Aksia has been working hard to stay ahead of the curve researching EM managers and with the size of these markets continuing to grow (EM sovereign debt now approaching $9 trillion) we do not expect to let up any time soon).

## Momentum Dashboard

Investor momentum bias has been well documented in long-only asset classes by academics, including a nifty recent paper titled "Does Past Performance Matter in Investment Manager Selection" in the summer 2017 Journal of Portfolio Management. Almost all the academic studies we are aware of look at registered funds (i.e., mutual funds) because that is where the clean data is available, and hence illustrate more retail type asset flows. At Aksia we have done our own hedge fund industry studies of both strategy AUM flows and of investor subscribe/redeem decision momentum. Our work shows that both strategy and manager momentum bias are present in the hedge fund industry and that both tend to detract from returns.

*Important Disclaimer & Prayer:* Everything in the above paragraph is obvious. Most of us see the momentum bias both in the industry, and in our own feelings and decisions about managers and strategies. We try to lean against it, but it is difficult and we need strength.

To help us all lean against momentum bias, we have put together an unscientific momentum bias scoreboard for hedge fund strategies. This was a fun project. We brainstormed six momentum indicators. If you happen to think of a good indicator to add or replace one of the below six, please call me.

1. Recent strategy AUM changes (Aksia monitored funds, netting out performance impact)
2. Last 18 months strategy performance (Aksia monitored funds)
3. Investor subscription activity that Aksia is aware of (not AUM weighted)
4. Changes in proportion of number of funds per strategy in HFRI (marketers tend to put funds into databases when demand is hot)
5. Prime Broker Investor Surveys (changes in interest from respective PB's prior survey)
6. Crowded / uncrowded room observations from recent industry conferences (anecdotal; not scientific)

For each indicator we scaled the signal strengths to between +2.0 (strong positive momentum) and -2.0 strong negative momentum) and then averaged the scores to come up with overall scores for each strategy.

How to read the table:

| | |
|---|---|
| Positive/higher numbers & redder colors: | Warning! positive momentum |
| Numbers near zero & neutral color: | Little signal strength |
| Negative/lower numbers & greener colors: | Interesting…strategy is out of fashion |

| | Momentum Bias… |
|---|---|
| **Long/Short Equity** | |
| Fundamental Growth | 1.0 |
| Fundamental Value | 2.0 |
| Low Net | -0.1 |
| Multi-PM | 0.3 |
| Opportunistic | 0.5 |
| Specialist | -0.3 |
| **Event Driven** | |
| Activist | -1.3 |
| Event & Merger | -1.4 |
| Event Credit | -2.0 |
| Performing Credit | -1.4 |
| **Relative Value** | |
| Fixed Income Arbitrage | 1.0 |
| Insurance Linked | 1.7 |
| Long/Short Credit | -0.7 |
| Quantitative Strategies | -0.7 |
| Structured Credit | -0.9 |
| Volatility | -0.3 |
| **Tactical Trading** | |
| CTA | -1.8 |
| Global Macro | -1.4 |
| **Multi-Strategy** | |
| Multi Risk Premia | 1.5 |
| Multi-Strategy | -1.5 |
| Risk Parity | -1.1 |

Looking at the results, a few things stand out to me:

- Beware of jumping into the multi-risk premia feeding frenzy today
- Folks feel like they missed the equity rally
- The industry's love/hate affair with CTAs/global macro is in the hate phase
- Nobody likes event driven… could be a great contrarian bet

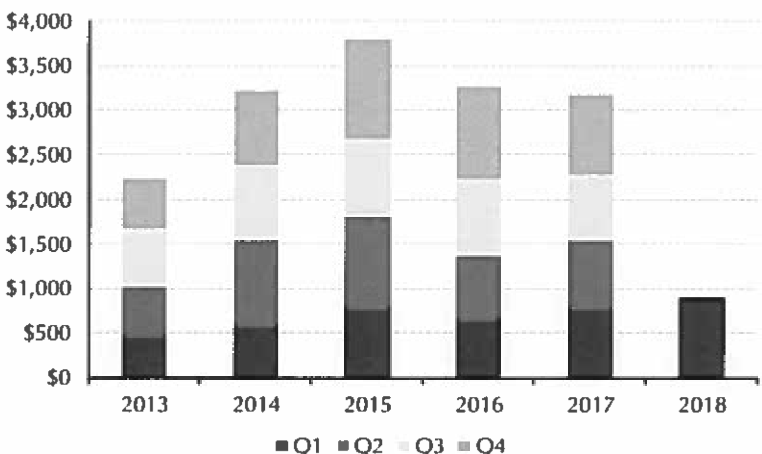
… Jim Vos

# EVENT DRIVEN

## Event & Merger

Coming into this year, our thesis was that U.S. merger activity would be strong, and we would see the return of mega deals. Q1 served as an early confirmation of this in that global deal activity by dollar volume was at an all-time high ($891 billion of deals, up 17% from Q1 2017, including 14 deals greater than $10 billion).[1] We expect a heightened level of activity to continue, and if the AT&T / Time Warner deal approved, we expect the number of large, vertical mergers to increase.

Figure 2: **Global Merger Volume (in $bn)**

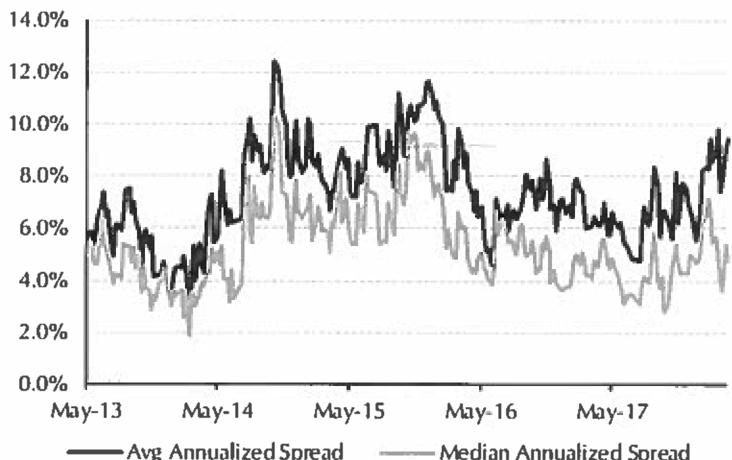



Source: Mergermarket, Global & Regional M&A Report Q1 2018

We believe the current environment for merger arbitrage is attractive, with spreads pushed wider by increased supply relative to demand, broad market volatility, and political rhetoric that may have implications for approvals, timelines, and divestitures.

We continue to favor a market-based approach to merger arbitrage, as the broader availability of spread (as reflected in the average spread) can generate interesting returns. However, we also see some value in the large, high profile deals that sit atop many managers' portfolios given the timeline to expected completion, the spread remaining, and the downside in the event of a break.

Figure 3: **Average vs. Median Annualized Spread (0% to 30%)**




Source: Bloomberg, UBS Special Situations, data as of Mar 30, 2018

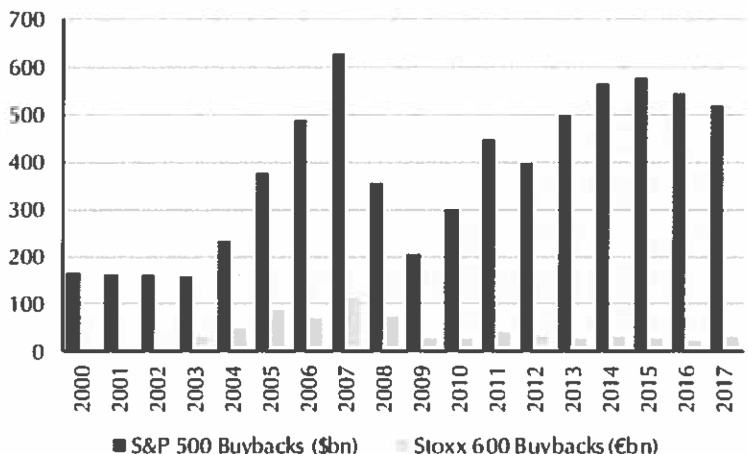
We also have a constructive view on the European event & merger opportunity set. In previous Strategy Outlooks, we have highlighted the attractive funding environment, in which companies can take advantage of cheap funding to exploit cost of capital differentials to enhance earnings accretion. We believe this remains a core driver of M&A volumes.

[1] MergerMarket, Global & Regional M&A Report Q1 2018

# EVENT DRIVEN

Another theme that we expect to be a persistent driver of corporate activity over the longer-term is the increasing prevalence of activism in Europe. Traditionally, company management teams in the U.S. have focused more acutely on driving shareholder returns than their European counterparts. This is evidenced in the below chart which shows that although European corporates have considerable scope to use buybacks as a means to generate shareholder value, however, they have preferred to grow earnings organically. A number of factors, such as CEO compensation in the U.S. typically being tied to share performance, may qualitatively explain this divergence.

Figure 4: **Relative Buybacks: U.S. vs. Europe**




Source: Bloomberg, Aksia, data as of Dec 31, 2017

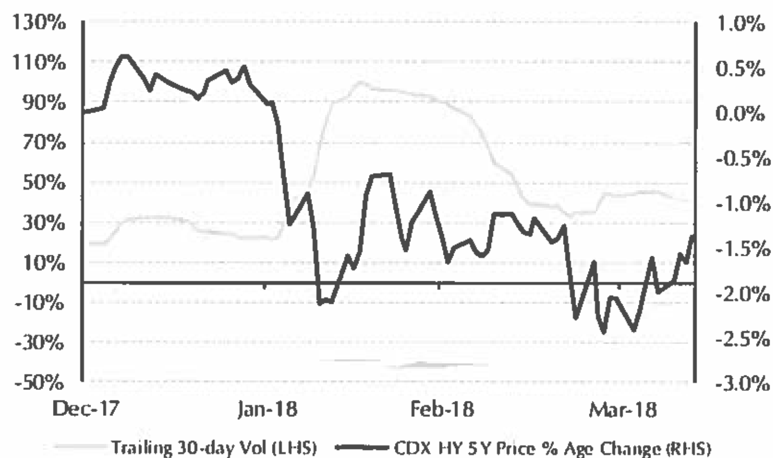
However, recently announced transactions (e.g., M&A, divestitures, and spin-offs) and anecdotal stories of anxious company boards suggest that this status quo may be challenged. Favourable relative valuations between the U.S. and Europe (long-term P/E of 26x and 20x respectively) have attracted well-known U.S.-based activist managers, and a new generation of management, typically educated in contemporary financial frameworks, are taking over. Importantly, in Europe, minority shareholder rights are reasonably well-protected, making the need to have a significant presence on a company's shareholder register in order to influence corporate governance less salient in Europe. Furthermore, we believe that the fragmented market and culturally diverse ownership bases may create a supportive environment for managers to specialise in different approaches, regions of focus, and target company size.

Combined with a softening of economic policy uncertainty which is now back down to pre-Brexit levels, we think the case for European-focused activist strategies is strong and the knock-on implications for increased corporate activity is positive.

## Event Credit

Equity markets have drawn most of the spotlight in the beginning of 2018, while credit market volatility has stayed fairly low. There were some notable events, including the long-awaited bankruptcy filings from iHeart, Claire's, and Toys 'R' Us, and a period where rising 10Y yields caused some worry, but the broader high yield market is only down about 2% and the pickup in volatility in February has largely subsided.

Figured 5: **5Y High Yield Credit Default Swaps**

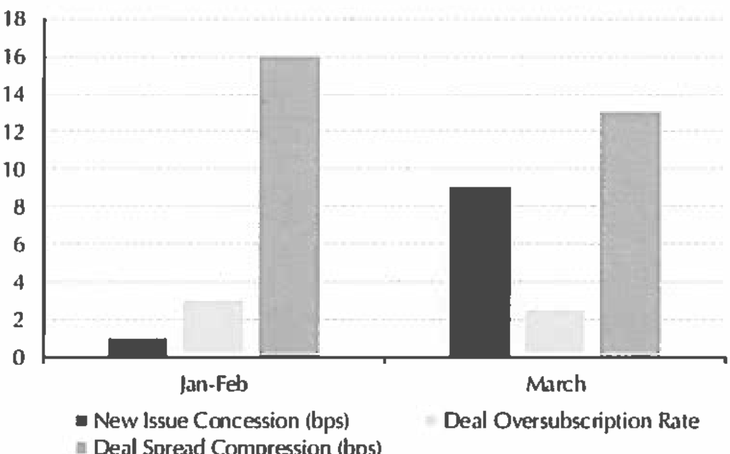



Source: Bloomberg, Aksia, data as of Mar 30, 2017

# EVENT DRIVEN

However, we believe there are signs that the market volatility has had an impact on the psyche of credit investors. Sure, there are still large issuances that come to the market with strong demand (CVS's issuance for its purchase of Aetna was 3x oversubscribed), but we have observed that in a lot of cases, companies have had to make concessions to get their deals done.

Figure 6: IG Issuers Relinquish Pricing Leverage to Investors

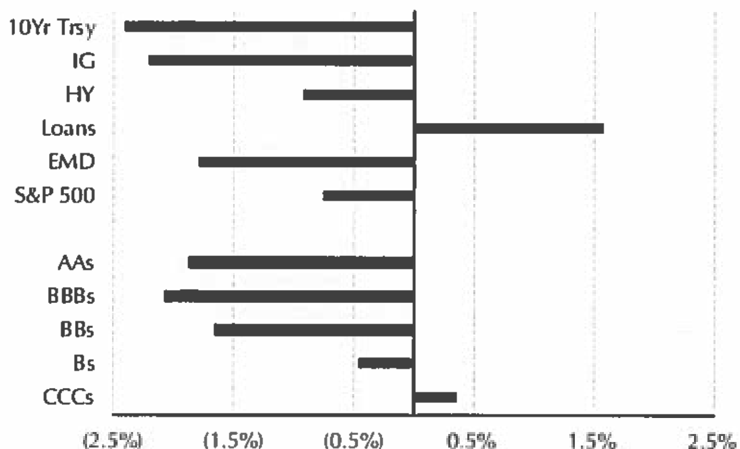



Source: Bloomberg, "Borrowers Lose Leverage As Corporate Bond Buyers Grab the Reins", Apr 3, 2018

We continue to believe it makes sense to reduce long-biased credit hedge fund exposure. The yield on speculative debt rated triple-B down through the lower end of high yield is minimal and when factoring in the growth of the market from years of low interest rates, we do not believe investors are being well-compensated for being long corporate credit risk. We are seeing managers become more defensive, and incorporate a greater number of capital structure arbitrage and outright short ideas into their portfolios. Part of this may be attributable to the lower opportunity cost of maintaining a short book, and that volatility may have not yet made its way into the credit markets.

We have also been focusing our research efforts on strategies that are more nimble and defensive, particularly trading oriented, hedged and convertible arbitrage managers within the long/short credit universe. As markets become choppier, we expect more opportunities around new issuance, technical dislocation, and retail flows in/out from high yield. These strategies have been largely out of favor for the last few years, but there may be reason to believe that will change.

Figure 7: YTD Credit Q1 Returns



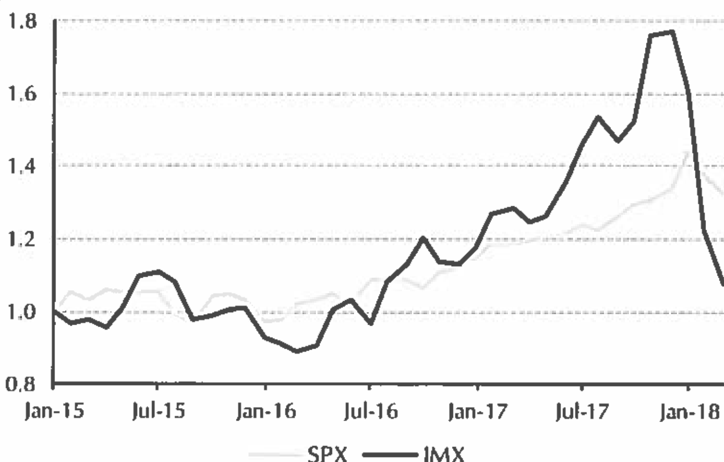

Source: Bloomberg, Aksia, data as of Mar 31, 2018

# LONG/SHORT EQUITY

## Factor Performance

"Value" factor equities (as opposed to managers) have underperformed "growth" factor equities year to date, but have seen an uptick as volatility has returned to markets. Investor sentiment (particularly among retail investors) has soured, as indicated by sentiment indices such as the Investor Movement Index (IMX; a proprietary, behavior-based index maintained by TD Ameritrade). We think this may have been a factor that has weighed on recent performance of momentum stocks.

Figure 8: **Investor Movement Index vs. S&P 500 Growth**




Source: Bloomberg, Aksia, data as of Mar 30, 2018

We have also seen dispersion in sector returns: despite volatility in the large, bellwether technology stocks, information technology has been the best performing sector in the S&P 500 this year, while telecom services, consumer staples, energy, and materials have been the worst. The spread between the top performing and worst performing sectors this year has been in the double digits.

## Back to Basics

Since the global financial crisis, the environment has benefited from momentum-oriented, leveraged long/short equity strategies, particularly the multi-risk taker platforms. With low and declining volatility and steadily rising equity markets, investors can apply a significant amount of leverage to a tightly risk-managed portfolio and potentially enhance risk-adjusted returns. However, as rates start to climb, financing may become less attractive, and with the return of volatility, tight risk hedging may become more expensive. Pro-momentum strategies may become a bit more challenged and hamstrung in this environment.

We think it is time for a greater focus on managers that can capitalize on volatility. "Back to basics" managers are those who:

- Can behave opportunistically (less specialized) and make limited use of leverage (dry powder on hand);
- Will not be forced to risk manage during factor rotations (no mechanical stop losses);
- Have the confidence to add to positions during periods of dislocation.

We would, of course, expect more volatility from these managers relative to more trading-oriented and multi-PM managers. However, we expect better results from these managers in the mid- to long-term though and suspect that the "free lunch" of momentum driven investing is coming to an end.

# LONG/SHORT EQUITY

## Shorting Stocks for Fun and Profit

In a more volatile and higher interest rate regime, short selling may shine. Profits from short-selling tend to be cyclical, episodic, and mean-reverting. Some of the cyclical headwinds may have abated and even turned into tailwinds:

- Market valuations are generally high, and there are likely more targets for managers who look for accounting irregularities.
- Rising interest rates may create stress on lower-quality borrowers, making financial engineering harder.
- Short borrow rates are at lows, and some managers have reported even earning a positive carry.
- Competition has decreased dramatically. We have observed that few short-biased managers remain, short interest is low, and passive ETFs have replaced active short-selling strategies.
- Reversal of a strong USD may allow FX headwinds to turn into tailwinds.

### *Admitted Drawbacks to Shorting Stocks*

Short selling is generally fraught with difficulty, and financial history provides more vignettes of failure than success. Short selling is not a mere mirror image of long investing—not in the sense of financial productivity, market structure, nor in the temperament required of the manager. Certain features make it inherently difficult, begining with the asymmetry of limited potential profits and unbounded potential losses. Shorting is a time-consuming, resource-demanding effort, yet is hard to monetize given the usually smaller position sizes and total exposure. The cost of capital or implied equity carry that productive businesses earn creates a headwind on the short side. In addition, since the growth of the hedge fund industry, short selling has been a competetive enterprise, with skewed demand and crowding into the obvious targets creating "hard to borrow" stocks that present costly borrow-rates to overcome. Given the logistics of borrowing securities and margin posted, a short may be "called" at the whim of the owner or prime broker at precisely the wrong time, crystallizing losses.

Short selling is also typically a more speculative activity. Short sellers are typically dependent on catalysts, on the market's capitalization on earnings discontinuities, or on the market "agreeing" with its thesis (exceptions may include bankruptcies and delistings). On the other hand, long investors are only required to be correct on their thesis and are usually less concerned about the "market's view."

The path dependency inherent in short-selling is another thorn to be contended with. A stock dropping 50% in the future alone is generally not enough to guarantee profit. If the stock doubles or triples in the period between, the short seller will have more than just volatility to contend with. Occasionally, it has been reported that short sellers have lost money in aggregate shorting stocks despite being correct not only on their theses, but also on outcome.

The growth of price-insensitive passive investing and indexation may have created further headwinds to fundamental short sellers.

### *So Why Bother Shorting?*

We think that if done correctly, for the right reasons, and in congruence with certain investor expectations, short selling can be valuable directly and indirectly to LPs.

One reason is simply to generate absolute returns. While not frequently seen, some managers with the temperament suited for the task have generated positive returns since inception. Many managers have generated consistent short alpha, and in flat or down markets, the persistence of this alpha could result in positive absolute returns.

Additionally, fundamental managers can hedge specific risks in longs through idiosyncratic shorts that are more than just hedges (i.e., a cheap long that stands on its own but is exposed to unknowable factor X, paired against two shorts that stand on their own as good shorts because of declining fundamentals and a high valuation, but also happen to be exposed to factor X). Shorting may also allow a manager to monetize its research more opportunistically when it encounters potential shorts to augment returns while investigating longs.

# LONG/SHORT EQUITY

A short book can also be managed as a superior-to-cash hedge. A book of asymmetric shorts can be harvested during periods of market stress, and can allow the manager to play offense on the long side (for this to be true, we note that the manager should be able and willing to shift net exposure).

Last, while some look to bonds and other assets to reduce correlation to equities, we observe that there are few things that reduce correlation to equities as well as a book of short equities. We prefer when this is a side effect, and not the primary purpose of running a short book.

## Opportunities Abroad: Japan

Given their stellar performance in 2017, emerging markets are a hot topic this year. Conversely, Japan is a region which has been less discussed by investors, despite what we believe to be an equally compelling opportunity set.

Today, Japan offers:

- A Deep and Liquid Equity Market: with over $5 trillion in total market capitalization, Japan is the third largest equity market in the world. And unlike China, Japan has a sophisticated stock loan system, meaning there is also liquidity on the short side.

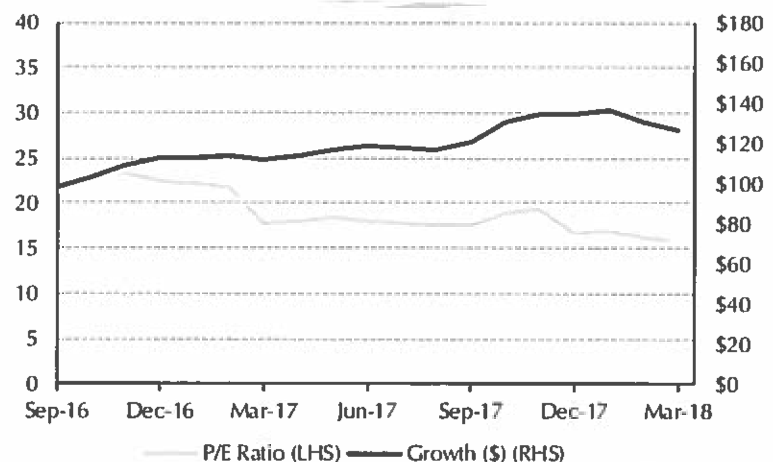
- Less Competition: Active institutional equity investors focused on Japan have been decimated over the past two decades. Due to poor performance, numerous managers have been forced to close their doors. The sell-side has also faced similar headwinds from regulation and limited budgets.

- Local Markets: Japan is a relationship-driven economy and a grasp of stakeholder motivations is one essential factor to successfully navigating the market. It can be difficult for foreign investors or generalists to enter.

- Economic Tailwind: Since the introduction of Abenomics, economic growth has been accelerating; unemployment rates are shrinking, earning forecasts are rising, and trade flows are increasing.

- No Love: Despite equities going up in 2017 (Nikkei +19%), the market has actually gotten cheaper. P/E's have collapsed from 22x at the beginning on 2017 to 16x as of Mar 31, 2018. Foreigners reportedly sold more than ¥1.2 trillion of Japanese equities in March 2018 alone, marking the 11th consecutive week of foreign outflows.[2]

Figure 9: The Nikkei 225 Index




Source: Bloomberg, Aksia, data as of Mar 30, 2018

[2] Japan Exchange Group (JPX)

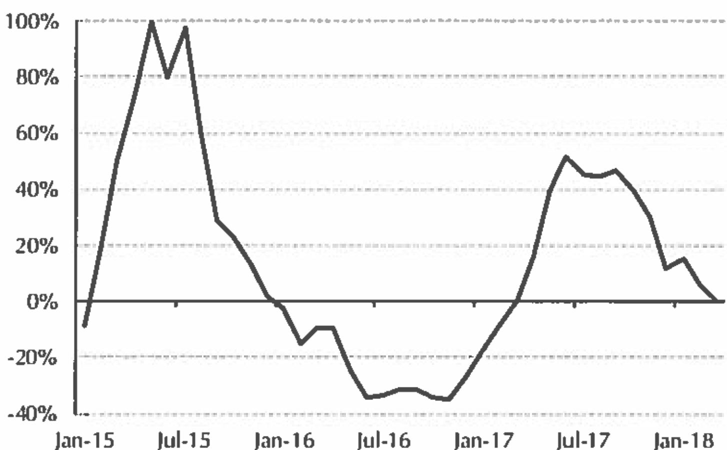
# LONG/SHORT EQUITY

## Europe

The performance of European long/short equity managers this year has remained generally strong, despite the headwind of a negative overall European equity market. Although managers generally remain bullish on the opportunities for shorting stocks, we have seen that most of the excess returns this year have come from long exposures. An important driver of this has been the renewed pick-up in M&A activity in the European mid-cap sector, with numerous offers for stocks in managers' long books coming at a material premium to market price. We see no reason for this driver of returns to fade soon, for the reasons set out in the event driven section of this report.

We believe that another support to recent alpha generation has been the absence of significant top-down market drivers, meaning that idiosyncratic stock specific factors have been more important in determining price action than broad moves. The efficiency of European equity markets has suffered from the disrupting influence of large waves of liquidity coming in and out in recent years, as shown in the chart, and it is only in the past 6-9 months that there seems to have been more stability.

Figure 10: **6-Month Inflows / Outflows to the Three Leading European Stock ETFs**




Source: Bloomberg, Aksia, data as of Mar 30, 2018

This stability has been underpinned by economic fundamentals and market indifference to political risk. Although it has moderated recently, the European growth outlook remains broadly positive, and is not out of step with the rest of the world. It is also interesting to note how indifferent markets have been to the result of the Italian election in March, given that politics have in recent years had the potential to upset investors' appetite for European assets. In Italy, more than 60% of the vote was taken by anti-establishment parties whose fiscal policies are likely to put them at loggerheads with the EU sooner or later. Rightly or not, European markets are reacting much less skittishly to political risk than they have in recent years.

## Some Inside Baseball: Long/Short Equity Alpha Analysis

Understanding and quantifying the historical alpha generated is important when analyzing the track record for a long/short equity manager. Returns should be placed in the context of the risk taken and leverage utilized, as well the historical environment. However, calculating alpha can be a subjective endeavor and managers present their data in disparate forms. It's quite possible to form a mistaken opinion on manager skill starting from what seems like reasonable comparisons that are actually apples-to-oranges. Below we outline a simplistic approach to how investors can handicap how much of a manager's returns are attributable to the manager's skill (versus market exposure).

The first step is asking the manager for data. Typically, we request 1) the long exposure and short exposure for each month and 2) the attribution of the long book and short book for each month. The alpha metric is relative to a benchmark, which should represent the manager's investable universe and can be a proxy for a passive allocation (opportunity cost).

The most straightforward way of approaching alpha is to approximate the manager's return on invested capital (ROIC). To find the ROIC of the long book, take the long attribution for each month, divide that by the respective exposure and annualize that figure. ROIC can directly be compared to the index return and attempts to isolate a manager's stock picking ability. It

# LONG/SHORT EQUITY

attempts to answer the question, "for every dollar the manager invested, what was the return?," stripping out the effects of leverage and timing.

However, managers do flex their exposures in response to the perceived opportunity set. We can incorporate this into our alpha analysis by adjusting the index. For each month, we weight the index return to match the manager's long exposure in that month. This normalizes the index for the amount of risk (e.g. leverage) the manager is utilizing, which can then be compared to the actual contribution of the long book. Identical calculations should be run on the short side. The residual return is the fund's beta (net exposure multiplied by the benchmark return). It is also possible to use historical beta as a proxy for risk instead of exposures.

The end result allows us to break out the manager's gross returns into a long alpha, short alpha, and beta components. We make minor adjustments to account for the use of monthly returns and to correct for accounting (figures in the example below may not add up perfectly).

Example Manager Alpha Decomposition

| EXPOSURE ADJUSTED ALPHA (ANNUALIZED) | | | | | |
|---|---|---|---|---|---|
| | Levered Return | Average Exposure | Index Return | Exp. Adj. Index Return | Alpha Contribution |
| Long Book | 19.51% | 87.25% | 8.50% | 7.76% | 11.06% |
| | | | | | + |
| Short Book | -7.72% | 62.33% | -8.72% | -5.15% | -2.73% |
| | | | | | + |
| Beta (Net) | --- | 24.92% | 8.50% | --- | 2.81% |
| | | | | | = |
| | | | | Gross Return | 11.15% |

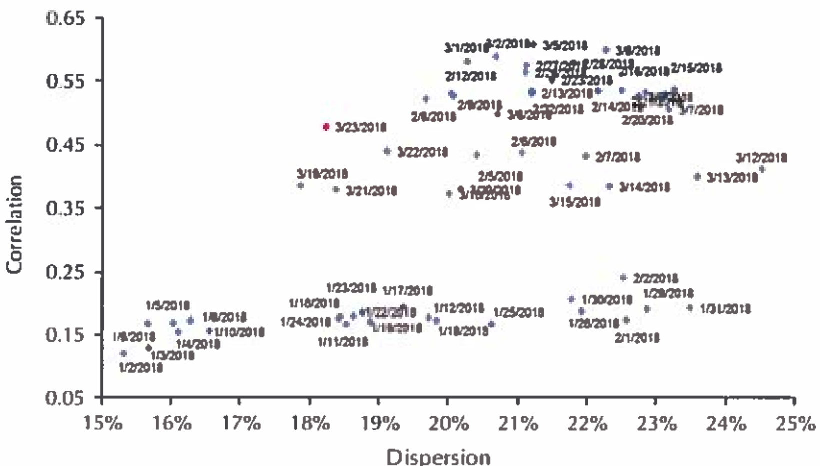
Source: Aksia

# RELATIVE VALUE

## Quantitative Strategies

We believe that the near-term outlook for faster-moving, liquidity provision strategies is more compelling than in prior years. Increased market volatility in February and March has manifested itself in short-term dispersion and correlation (rolling 21-day, see Figure 11). Additionally, market volatility has resulted in an uptick in volume. Per Tabb Forum, in Feb 2018, industry average daily volume was 8.3 billion shares compared to 6.9 billion YoY in Feb 2017. The prior environment of historically low market volatility and volume, alongside low dispersion (note the bottom left data points in Figure 11 during the early part of January 2018), was adverse for liquidity provision.

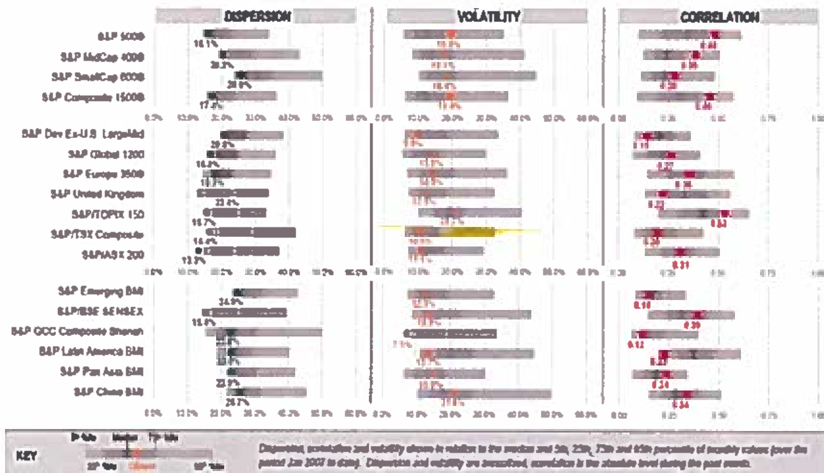
Figure 11: **S&P 500 Rolling 21-Day Dispersion vs. Correlation**




Source: S&P Dow Jones Indices LLC, data from Dec 31, 2017 through Mar 23, 2018.

Over the longer-term, we believe the market environment should be more muted, especially for long-term fundamental market neutral strategies. Although slightly higher, dispersion in most developed regions (the UK is an exception) remains below the median since 1990. An offset to this dynamic has been a relatively stable risk factor regime.

Figure 12: **S&P Dow Jones Index Dashboard: Dispersion, Volatility & Correlation**




Source: S&P Dow Jones Indices LLC, Index Dashboard: Dispersion, Volatility & Correlation, Mar 31, 2018

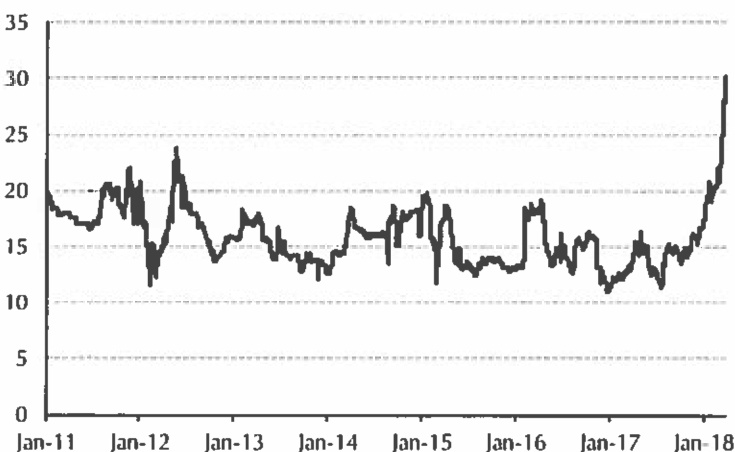
# RELATIVE VALUE

## Fixed Income Arbitrage

In fixed income arbitrage, a notable new development is the unveiling of the Secured Overnight Financing Rate ("SOFR") in early April. This is the proposed replacement for LIBOR, which will be phased out in 2021. Futures will begin trading in May 2018, and CME/LCH are racing to offer SOFR referenced swaps clearing by Q3 2018. On top of recent LIBOR/LIBOR-OIS volatility, with increased T-bill issuance and U.S. tax reform, it looks to be an interesting period in front end rates.

As an analogue for the introduction of SOFR, we can look to the UK, where the proposed LIBOR replacement is SONIA. As SONIA is a pre-existing benchmark, it is already highly liquid. Despite that depth, the volatility and directionality of the spread has been dramatic over the past few months. Anecdotally, most managers we have spoken to believe that speculators have been driving the move by attempting to get in front of "real money" switching from receiving LIBOR to receiving SONIA, rather than actual institutional flows.

Figure 13: SONIA-LIBOR 30Y




Source: Bloomberg, Aksia, data as of Mar 30, 2018

While these developments may create interesting opportunity sets, they are likely to be more "macro RV" in nature, with more directionality than strategies such as cash bonds vs. futures. As such, it may favor managers with greater tolerance for macro RV risk, and PMs with former swap desk expertise. However, it may also result in a different risk/return profile. Unlike cash bonds vs. futures, which have a quarterly catalyst and thus a reasonably high hit rate if held to completion, unsuccessful front end rates positions can have higher chance of permanent losses (i.e., more similar to wrong way macro trades). In theory, this would result in higher absolute return potential and somewhat lower sharpe, in a strategy which is potentially less crowded than cash bonds vs. futures trading.

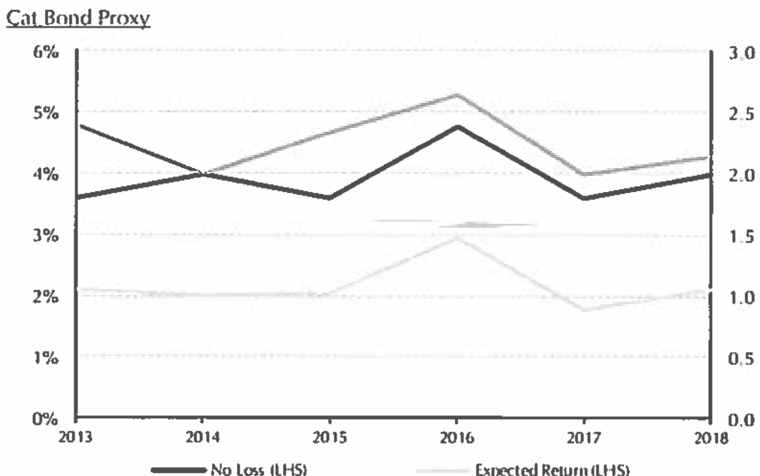
# RELATIVE VALUE

## Reinsurance

Pricing for 2018 has been more attractive than years past, but as noted, not enough to warrant a full risk sizing. In the following charts (Figures 14-16), we put together instrument proxies based on actual manager portfolio metrics since 2013. Our data shows that 2018 multiples are back to 2014-2015 levels. In cases like the retro proxy, we view pricing in conjuction with the evolution of tail (e.g. in this specific case, although the multiples are back to 2013 levels, the tail is riskier, which would call for a haircut during the sizing process). Cat bonds were less impacted relative to private structures in 2017, which has transpired in a flat curve. Many of the YTD issuances, including U.S. covers, have fallen at the lower end of pricing guidance.

Preliminary hurricane season forecasts by the Colorado State University suggest a slightly above average season, primarily driven by a low liklihood of an El Nino. An offset is average to below average sea surface temperatures (SSTs) in the Atlantic Basin. According to the CSU report, a comparative analysis of conditions suggests characteristics akin to 1960, 1996, 2006, and 2011. Further updates will come on May 31, then July 2.

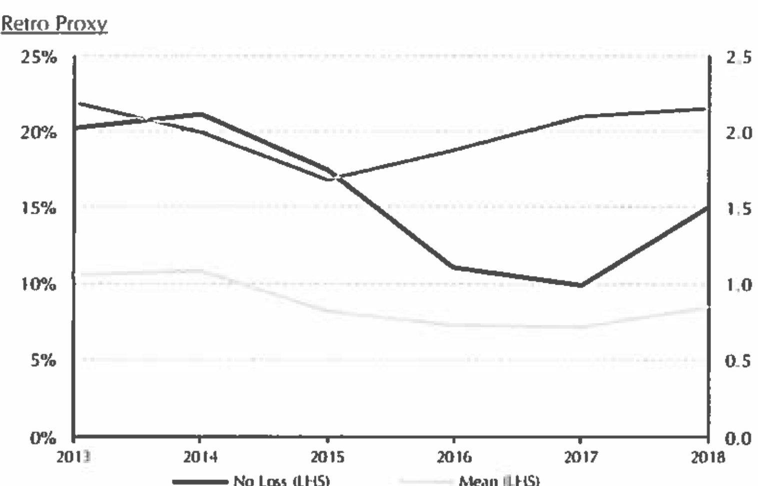
Cat Bond Proxy




Source: Aksia, data as of Jan 31, 2018

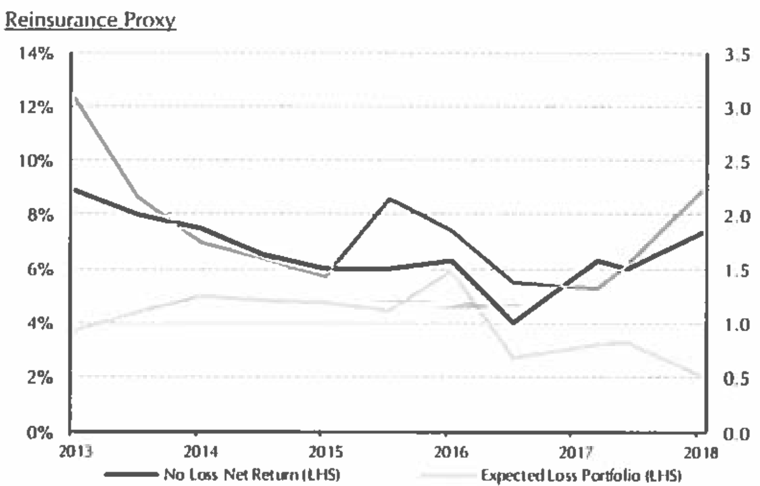
Figures 14 – 16: **Reinsurance Instrument Pricing Proxies, 2013-2018**

Retro Proxy




Source: Aksia, data as of Jan 31, 2018

Reinsurance Proxy

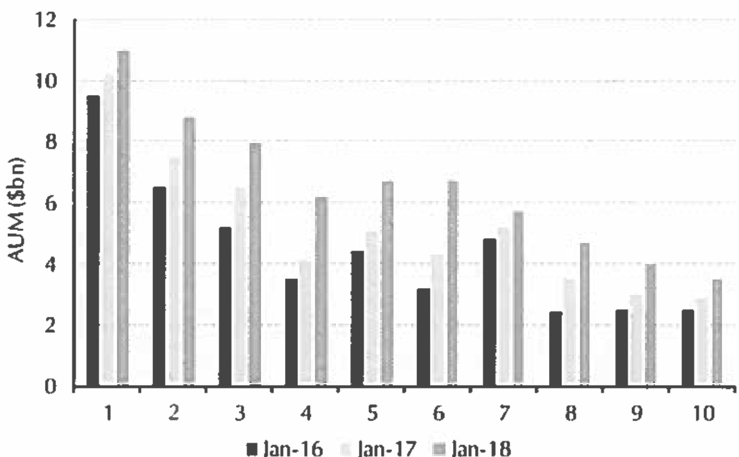



Source: Aksia, data as of Jan 31, 2018

# RELATIVE VALUE

On the whole, our expectation is for mid-year renewals for OTC structures to follow January 2018 pricing. This results in a continuation of our higher conviction risk-adjusted return view of the asset class relative to prior years. However, considerations should be made for sizing and risk appetite in an overall portfolio. In addition, we advise investors to maintain flexibility for upsizing allocations during a true hard market, more so in light of what remains a well capitalized sector. According to Trading Risk, the 10 largest ILS managers total ~$64bn in capital, inclusive of cat bonds (Figure 17).

Figure 17: **AUM Growth of 10 Largest ILS Managers**




Source: Trading Risk, ILS Investor Guide, H1 2018

There have been a couple of notable acquisitions YTD (AIG – Validus; AXA – XL Group; Aspen hired investment bankers for a potential sale), bringing primary carriers back into the reinsurance risk supply chain. A flexible, large balance sheet is essential to shape a portfolio across risk tranches. The concept of the "Magic Circle," which became in vogue 4-5 years ago, is even more important now for a business that vies to be sustainable over the long-term.

*Run-Off Opportunities*

We have mentioned run-off opportunities in some prior Strategy Outlooks as another means of gaining exposure to reinsurance. In brief, run-off strategies involve the purchase of legacy, run-off (re)insurance portfolios, essentially in the business of getting out of business. The purchaser typically seeks to profit by purchasing at a discount to NAV, expense and claims management, finality via commutation, reinsurance recoveries, etc. There may be high barriers to entry due to complexity, long-term capital requirements, and origination channels being specialized.

A significant benefit to traditional reinsurance ("live" covers) is that run-off is arguably counter-cyclical to the "live" opportunity set. It may become in demand when there is consolidation (see acquisitions previously mentioned; merging firms re-assessing certain lines of business, moving away from non-core, less profitable segments), and pressure on earnings and cost management (a soft market environment for "live" businesses brings focus on avenues to improve ROE and operating expense ratios). The confluence of market forces is generally rounded out by regulatory pressures (e.g., capital charges against lines of business).

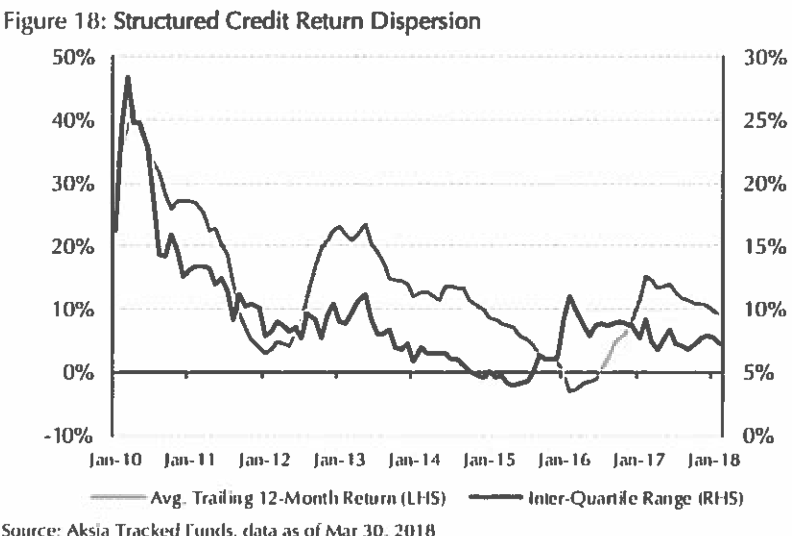
For allocators interested in discussing further, we have come across a few compelling opportunities in both property & casualty and life run-off. As a function of the duration of liabilities, structures tend to be closed-ended in nature.

# RELATIVE VALUE

## Structured Credit

Returns for funds tracked by Aksia through the first quarter of the year ranged from -0.9% to 7.8% with a broad set of underlying performance drivers. Performance was skewed highly positive with only two managers posting a negative number through March. Manager performance generally exceeded what would be implied by past corporate credit benchmark performance.

Figure 18: **Structured Credit Return Dispersion**




Source: Aksia Tracked Funds, data as of Mar 30, 2018

Structured credit markets were insulated from this year's first quarter equity market volatility. Although, as expected, higher spread duration "beta" assets traded off as market weakness moved to corporate high yield.

As we mentioned in our previous Strategy Outlook, while re-deployment continues to be challenging, we have observed that managers are still deploying capital through legacy event driven opportunities while in some cases increasing allocations to less liquid investments or to liquid index-based relative value trading books. Both circumstances lead to the potential for past volatility to be less predictive of forward volatility and for increased monitoring requirements for LPs.

In the case of introducing lending or origination strategies into liquid fund portfolios, we believe that LPs should encourage managers to maintain discipline relative to investor-liquidity terms and provide more granular transparency on portfolio liquidity relative to what is available in standard transparency reports or annual financials. In the case of managers adding relative value trading strategies that pro forma look to reduce aggregate portfolio volatility, we believe LPs should understand how the manager is incorporating these strategies into its existing risk management framework, including measuring basis risk.

*CLO Risk Retention Update*

On February 9th, the U.S. Court of Appeals for the District of Columbia Circuit ruled in favor of the LSTA and overturned the existing risk retention rules as they apply to open-market CLOs. Since that date the en banc review request deadline has come and gone with the last remaining chance for appeal to the U.S. Supreme Court falling during the second week of May (though the expectation is that the agencies will not appear).

Though the initial rule was widely seen by CLO managers as inappropriately applied to an asset class that did not suffer (in their view) from the same alignment-of-interest problems as other securitized asset types, the largest CLO managers were able to leverage existing institutional distribution channels to develop a CLO risk retention products and educate an entire new population of equity buyers. The result, for many managers within the top 50 in outstanding issuance, was the ability to raise locked-up capital with expected terms of 10+ years at a management fee concession that ranged from 10-15% on average.

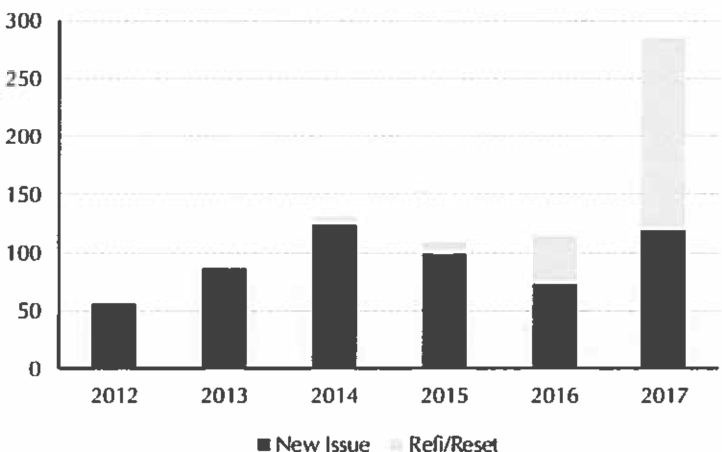
We estimate that the rule resulted in at least $7.5 billion in equity capital raised in U.S. risk retention funds while Citi puts the number at approximately $11 billion. Based on early conversations with these managers, we expect that the majority of these vehicles will remain in place with the only potential reduction in equity coming from managers that reduce their stake in a C-MOA/MOA structure now that the standard 12-20% is no longer required. In addition, we continue to see new managers continue to come to market with single manager vehicles given institutional demand for these types of funds. As most of the first generation of risk retention funds were raised in the 2015-2017 period, with a

# RELATIVE VALUE

typical 3-4 year investment period, we will start to see what numbers return to market around 2018-2021.

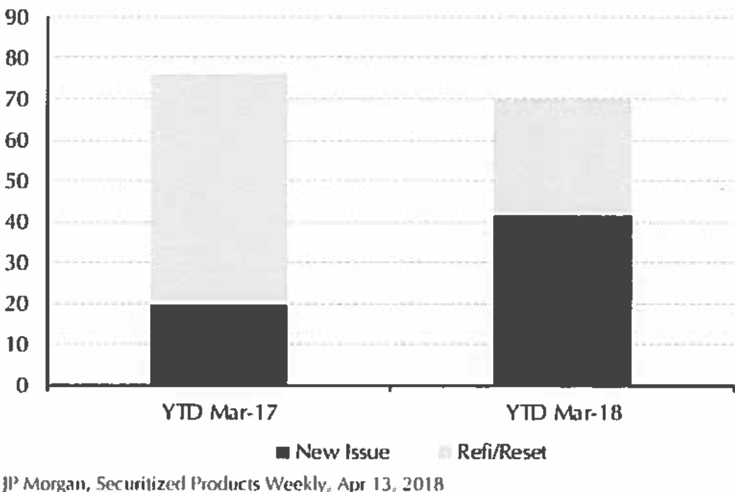
In the short term, the sell side's view of the impact of the reversal of risk retention is generally for 1) higher 2018 new issue volume, driven by increased refi volumes and managers without risk retention capital returning to market; 2) flat to wider spreads in mezzanine as new managers grow the new issue pipeline; and 3) a reduction in dual-compliant issuance.

Figure 19: U.S. CLO Issuance ($Bn)




Source: JP Morgan, Securitized Products Weekly, Apr 13, 2018

Figure 20: U.S. CLO Issuance ($Bn) through March of 2017 vs. 2018




Source: JP Morgan, Securitized Products Weekly, Apr 13, 2018

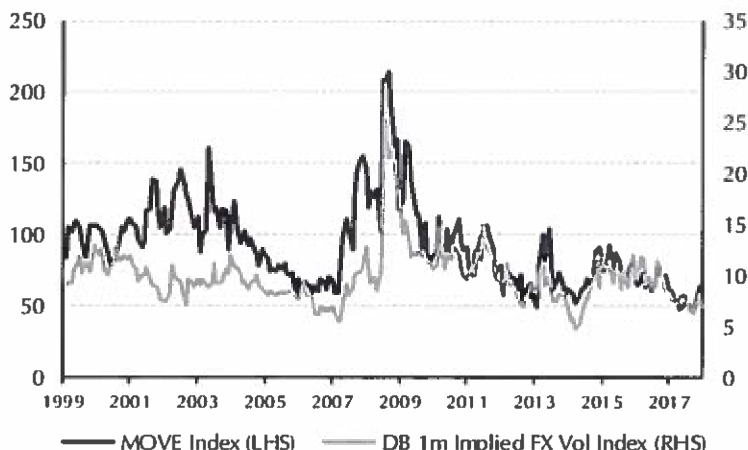
Away from the short-term potential impact of the rule change, we think the early indication that the reversal has not caused managers to abandon the strategy may mean that regardless of regulatory environment, a significant percentage of the long-term holder base of institutional CLO equity has changed for good. Alongside the market acceptance of the refi/reset option, CLOs may increasingly appear to look like quasi-permanent capital for owning broadly syndicated leverage loans.

# TACTICAL TRADING

## Global Macro

In general, major central bank balance sheets continue to expand in aggregate, but the Fed's is now in contraction. Perhaps the Q1 upsurge in equity volatility and widening of LIBOR-OIS has been a shot across the bow in response to localized tightening in the U.S. Indeed, it is likely that dollar liquidity conditions punch above their weight in global markets because of the dollar's status as the world's main reserve currency. However, the rebound in equity volatility has not had much bearing on rates and FX volatility, which remain at historically depressed levels (Figure 21).

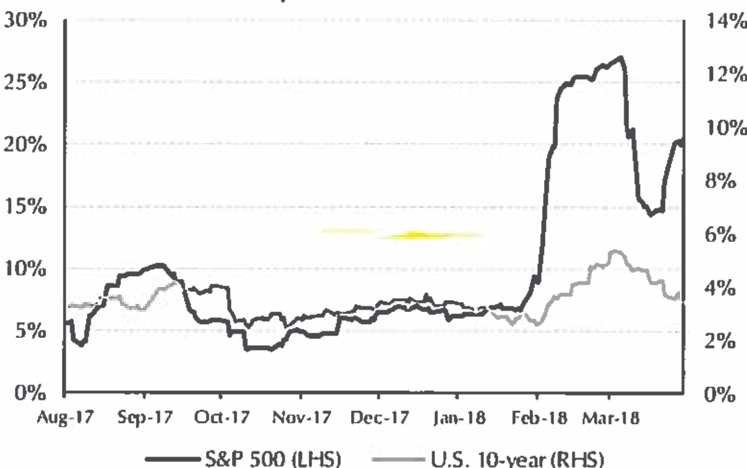
Figure 21: **MOVE Index and DB 1M Implied FX Volatility Index, 1998-Present**




Source: Bloomberg, Aksia, data as of Mar 30, 2018

If the rates-equity volatility divergence (see Figure 22) is resolved by an increase in rates volatility, macro managers should benefit.

Figure 22: **Realized 1M Volatility of S&P 500 vs. U.S. 10Y Note (Annualized)**




Source: Bloomberg, Aksia, data as of Mar 30, 2018

After six years of advocating an underweight, we think that portfolios should have more balanced exposure between G10 and emerging markets macro. The opportunity set for G10 has plenty of room to become more compelling this year as the normalization of market volatility will likely spread to their core markets. This does not reflect a diminished view of emerging markets macro, where we retain a high level of conviction, but merely that the improving outlook for trading in major markets weakens the rationale for favoring emerging over developed markets over global macro.

# TACTICAL TRADING

## CTAs

We have previously written about CTAs trading alternative markets, which are primarily OTC/non-cleared derivatives. These markets seem to add value to CTA portfolios, whether due to less crowding or simply by increasing diversification. Domestic Chinese assets opening up further to foreign investors is a potentially exciting recent development in this area. It is a possibility that the recently issued PFM licenses (which only allow foreign investment managers to open funds for domestic investors) are an indication that offshore investors will eventually be allowed to purchase onshore assets and derivatives directly. In the meantime, there are managers who offer investment vehicles for onshore Chinese investors, as well as offshore CTAs which have been able to tap the market through bespoke arrangements with Chinese banks.

Figure 23: **Average Monthly Volume of Chinese Onshore Commodities Compared to Global Commodities Since October 2017**

In USD ($Bn)

| Base Metals & Industrials | | Agricultural | | Energy | |
|---|---|---|---|---|---|
| Deformed Bar - SHF | $542 | Soybeans - CBT | $259 | Crude - WTI - NYM | $1,548 |
| Iron Ore - DCE | $441 | Corn - CBT | $140 | Crude - Brent - ICE | $1,202 |
| Copper - SHF | $360 | Soy Meal - DCE | $116 | Gasoil - ICE | $368 |
| Nickel - SHF | $277 | Soybean Meal - CBT | $88 | Heating Oil - NYM | $319 |
| Zinc - SHF | $243 | Sugar - ZCE | $70 | Coke - DCE | $301 |
| Rubber - SHF | $223 | Live Cattle - CME | $64 | Natural Gas - NYM | $295 |
| Copper - CMX | $209 | Soy Oil - DCE | $63 | RBOB Gasoline - NYN | $295 |
| Aluminum - LME | $154 | Wheat - CBT | $63 | Coking Coal - DCE | $111 |
| Zinc - LME | $133 | Palm Oil - DCE | $59 | Methanol - ZCE | $100 |
| Aluminium - SHF | $113 | Soybean Oil - CBT | $52 | Thermal Coal - ZCE | $59 |
| Hot Rolled Coil - SHF | $106 | Rapeseed Meal - ZCE | $43 | **Precious Metals** | |
| Nickel - LME | $74 | Coffee "C" - NYB | $40 | Gold - CMX | $952 |
| Purified Terephthalic Ac | $68 | Cotton - ZCE | $39 | Silver - CMX | $166 |
| Polypropylene - DCE | $62 | Sugar - NYB | $38 | Gold - SHF | $104 |
| Polyethylene - DCE | $58 | Corn - DCE | $30 | Silver - SHF | $61 |
| PVC - DCE | $46 | Cotton No. 2 - NYB | $29 | Platinum - NYM | $21 |
| Bitumen - SHF | $35 | Lean Hogs - CME | $26 | Palladium - NYM | $11 |
| Lead - LME | $33 | Feeder Cattle - CME | $21 | | |
| Glass - ZCE | $29 | Cocoa - NYB | $21 | | |
| Ferrosilicon - ZCE | $29 | Soybeans - DCE | $17 | | |
| Lead - SHF | $24 | Corn Starch - DCE | $16 | | |
| Silicon Manganese - ZCE | $23 | | | | |
| Tin - SHF | $7 | | | | |

USD Adjusted for Volatility ($Bn)

| Base Metals & Industrials | | Agricultural | | Energy | |
|---|---|---|---|---|---|
| Deformed Bar - SHF | $246 | Soybeans - CBT | $34 | Crude - WTI - NYM | $336 |
| Iron Ore - DCE | $209 | Corn - CBT | $24 | Crude - Brent - ICE | $249 |
| Rubber - SHF | $97 | Soy Meal - DCE | $24 | Natural Gas - NYN | $119 |
| Zinc - SHF | $49 | Soy Oil - DCE | $22 | RBOB Gasoline - N | $96 |
| Copper - SHF | $47 | Wheat - CBT | $17 | Coke - DCE | $87 |
| Nickel - SHF | $45 | Palm Oil - DCE | $16 | Gasoil - ICE | $69 |
| Copper - CMX | $32 | Soybean Meal - CB | $14 | Heating Oil - NYM | $60 |
| Hot Rolled Coil - SHF | $24 | Live Cattle - CME | $14 | Methanol - ZCE | $35 |
| Aluminum - LME | $23 | Sugar - NYB | $13 | Coking Coal - DCE | $32 |
| Zinc - LME | $22 | Sugar - ZCE | $11 | Thermal Coal - ZCI | $14 |
| Polypropylene - DCE | $19 | Coffee "C" - NYB | $9 | **Precious Metals** | |
| Nickel - LME | $18 | Rapeseed Meal - Zt | $9 | Gold - CMX | $88 |
| Aluminium - SHF | $18 | Soybean Oil - CBT | $8 | Silver - CMX | $29 |
| Bitumen - SHF | $16 | Lean Hogs - CME | $8 | Gold - SHF | $13 |
| Polyethylene - DCE | $15 | Corn - DCE | $7 | Silver - SHF | $10 |
| Purified Terephthalic A | $15 | Cotton - ZCE | $6 | Platinum - NYM | $3 |
| PVC - DCE | $11 | Cocoa - NYB | $6 | Palladium - NYM | $3 |
| Glass - ZCE | $9 | Cotton No. 2 - NYB | $5 | | |
| Silicon Manganese - Z( | $7 | Corn Starch - DCE | $5 | | |
| Lead - LME | $7 | Soybeans - DCE | $5 | | |
| Ferrosilicon - ZCE | $7 | Feeder Cattle - CMI | $4 | | |
| Lead - SHF | $6 | | | | |
| Tin - SHF | $1 | | | | |

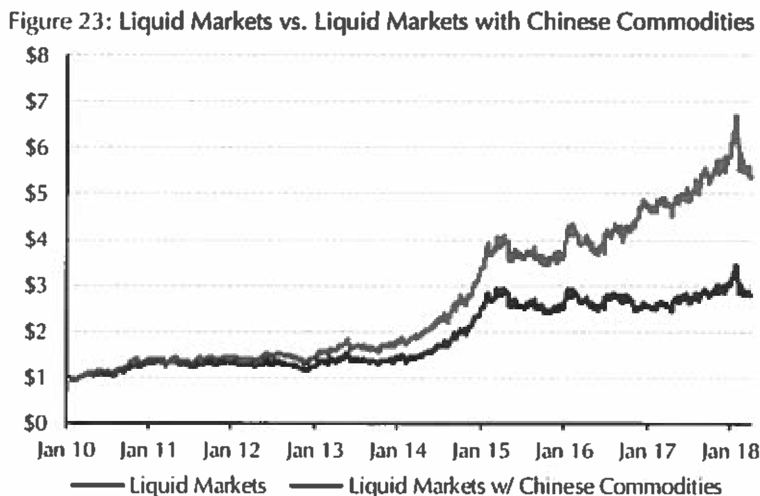
Source: Bloomberg, Aksia. All trading volumes are converted back to USD and we combined industrial materials (which are not technically "base metals") into the same category. We used data starting October 2017 because the Chinese government attempted to decrease futures speculation by retail investors in Q3 2017, which caused a drop in volume. USD Adjusted for Volatility is USD Volume x Volatility (%) of the underlying commodity market.

# TACTICAL TRADING

Chinese commodities add breadth to a CTA portfolio, with contracts such as Polyethylene, Glass, and Palm Oil, some of which may be traded elsewhere but are not particularly liquid. And despite the Chinese government attempting to limit speculators by pushing exchanges to increase margin requirements and transaction fees, trading volumes are still significant. In Figure 23, we compared volume and volatility adjusted volume (both converted to US Dollar) of some of the most liquid commodity markets globally against Chinese contracts (green highlights indicating onshore China).

When back testing returns for a simple trend following model on liquid markets, and liquid markets with Chinese commodities, the results indicated a significant simulated performance differential over the past few years. That said, we generally suggest caution around back-tested performance, and additionally note that we applied the same per contract transaction fees and slippage across all assets, which may not be reflective of live trading in Chinese commodities (while highly liquid, there were recent increases in exchange fees in an attempt to slow down retail speculators).

Figure 23: **Liquid Markets vs. Liquid Markets with Chinese Commodities**




Source: Bloomberg, Aksia, data as of Mar 30, 2018

# MULTI-STRATEGY

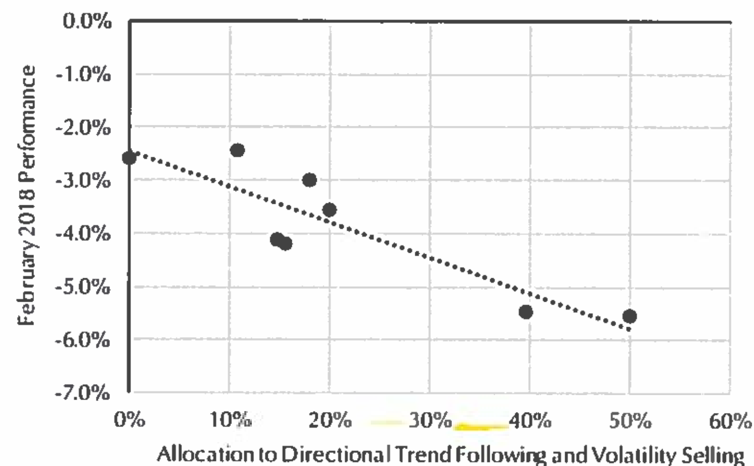
## Liquid Alts – Multi Risk Premia Performance Drivers

The first quarter of 2018 was a difficult one for multi risk premia strategies, particularly during February, when the SG Multi Alternative Risk Premia Index was down -3.0%. For a strategy that is often thought of as a diversifier, it is disappointing to see multi risk premia struggle during an equity market reversal. To understand the forces behind this, it is important to consider the underlying risk premia factor exposures. Most of the factors in a "multi risk premia" portfolio tend to be constructed in a market neutral fashion, such as single-name equity styles or relative value carry trades. While these factors may not always successfully diversify during an equity downturn, they did generally avoid large losses in February.

What generally drove underperformance in multi risk premia strategies were the factors that are not designed to be market neutral at all times – namely, directional trend following and volatility selling. While trend following may have low correlation to traditional asset classes over the long run, it takes directional bets at any given point in time. Going into the month of February, equity trends had been strongly positive, so trend following sleeves within multi risk premia portfolios had long equity exposure. Meanwhile, volatility selling sleeves are, by definition, short volatility (through selling options or volatility futures).

To illustrate the impact of these exposures, Figure 24 plots the relationship between each manager's ex-ante risk allocation to these factors (directional trend following and volatility selling) and its performance during the month of February.

Figure 24: **Multi Risk Premia Allocations vs. February Performance**




Source: Aksia Multi Risk Premia Monitored Funds

The relationship is fairly strong ($R^2$ of 78%), as managers with larger allocations to directional trend following and volatility selling suffered worse in February. The takeaway is not that these factors are detrimental for a multi risk premia strategy, but that portfolio construction plays a large role in month-to-month performance dispersion. When selecting a multi risk premia strategy, it is important to understand the amount of risk coming from directional factors, since these factors can help contribute to a higher return objective but at the cost of more variable correlations to traditional asset classes.

# MULTI-STRATEGY

## Coming to Terms with Pass-Through Expenses (Revisited)

While pass-through expense structures can be a hard pill to swallow, there are some aspects of pass-through fee structures that may be worth paying for. In particular, as discussed in previous Strategy Outlooks, pass-through ("PT") managers tend to outperform their non-pass-through ("NPT") peers, net of fees. This quarter, we revisit this topic and attempt to analyze *why* this is the case by asking several questions about characteristics of the return streams. The tables below summarize the average statistics for a sample of PT versus NPT managers over the last five years (2013 – present).

*Do PT managers have scale benefits?*

| Total | NPT | PT |
|---|---|---|
| Sample Size | 9 | 5 |
| Average AUM ($mm) | 4,028 | 10,749 |

Yes, while scale is a qualitative concept that is difficult to quantify, PT managers tend to have larger asset bases than NPT peers. We believe that achieving economies of scale (in various forms), at a minimum, requires a certain firm size. Given their larger AUM, PT managers can hire more people which improves diversification at the PM level. They are also able to dedicate more resources and capital towards building out sophisticated risk systems and financing arrangements We believe investors in PT managers may benefit from substantial investment and infrastructure-related synergies (which can translate to PnL) that many smaller managers may lack.

*Do PT managers have higher volatility?*

| Total | NPT | PT |
|---|---|---|
| Ann. Return | 7.03% | 10.91% |
| Ann. Vol | 3.79% | 4.66% |
| Sharpe Ratio | 1.88 | 2.46 |

Marginally. The volatility of PT managers is nearly identical to their NPT counterparts and yet the average Sharpe Ratio is higher, which may indicate an effective use of leverage.

*How do drawdowns and return distributions compare?*

| | NPT | PT |
|---|---|---|
| Max Drawdown | 3.92% | 4.47% |
| Positive Months | 45 | 49 |
| Negative Months | 16 | 12 |
| Batting Average | 3.19 | 4.21 |
| Average Positive Return | 1.06% | 1.36% |
| Average Negative Return | -0.78% | -0.95% |
| Slugging % | 1.37 | 1.51 |

During the five-year period, although PT managers had slightly higher drawdowns, they also had higher batting averages (defined as number of positive months divided by number of negative months) than their NPT peers. Similarly, and perhaps more importantly, returns during positive months tended to outweigh losses during negative months, resulting in a higher average slugging percentage (defined as % positive return divided by % negative return) and contributing to PnL over time.

# MULTI-STRATEGY

*Are PT managers more sensitive to broader markets?*

| | NPT | PT |
|---|---|---|
| Correlation (S&P 500 TR) | 0.18 | 0.12 |
| Correlation (MSCI World) | 0.20 | 0.16 |
| Beta (S&P 500 TR) | 0.06 | 0.06 |
| Beta (MSCI World) | 0.06 | 0.08 |

PT managers tend to have lower correlations (and similar betas) to benchmarks. This may in part be attributed to their willingness to fire PMs who do not adhere to risk guidelines (limited market exposure, limited factor exposure, etc.) and to the degree of diversification, that these large-scale platforms have.

All else equal, we are generally support of lower fees; however, we continue to believe that in certain cases, the pass-through structure gives managers certain advantages that result in higher net returns, and a higher quality return stream.

# OPERATIONAL DUE DILIGENCE

## Have Our Agents Been Compromised?

In Part II of our piece on fund directors, we examine the question of true independence.

In theory, independent fund directors are the watchmen over alternative funds: they are the agents of investors tasked with oversight of investment managers and service providers. Since investors' voting rights are typically limited to exceptional events, they ultimately rely on directors to safeguard their interests in the ongoing management of their investments. Directors' responsibilities may include risk mitigation, approval of fund valuations, and authorizing investors' access to their capital. Alternative fund directors' fiduciary obligations are typically legally to investors (shareholders), rather than the fund itself. Fiduciaries are required to exercise care, skill, and diligence in their oversight, and act with loyalty, honesty and good faith, in the best interests of investors.

In practice, many independent directors may merely "rubber stamp" managers' decisions with minimal challenges. While the scope of directors' authority varies by jurisdiction, the reality is that the balance of power frequently remains in the managers' favor, and there are no consistent governance standards or a central governing body holding independent directors accountable.

*Threats to Directors' Independence:*

1. Influence of the Manager

While directors owe their fiduciary duty to investors, it is the managers who are responsible for their initial appointment. This creates an incentive for directors to maintain strong relationships with managers with the aim of being reappointed in the future or selected as directors of the managers' other funds.

Full-time directors and directorship firms rely on the income from directorships. While the majority of directors have a diversified suite of clients, some directors receive the majority of their fees from numerous fund directorships with one or two large fund managers. In addition, some directorship firms provide multiple directors to each fund, potentially decreasing the diversity of collective skill of the board. These firms may also provide managers with ancillary services such as risk management, legal and regulatory consulting services, providing them with further revenue streams from the manager. Directors or firms that have economic dependence on managers cause conflicts of interest to exist.

2. The nature of the relationship

Independent directors of alternative funds should be free of relationships (business or otherwise) that could prevent them from making decisions in the best interests of investors. Although familial relationships between directors and the manager are very rarely seen post-Weavering, it is not uncommon for ex-colleagues/business partners or friends of the manager to act as fund directors. Law firms and administrators infrequently supply their employees to sit on fund boards; however, managers regularly look to other business contacts such as accounting firms for director recommendations.

Through Aksia's review of offering documents, we frequently encounter directors serving on the boards of the fund(s) and the management company simultaneously. This naturally presents a conflict of interest.

3. Lack of competence

In order to act independently and in the best interests of investors, directors need relevant qualifications, experience and the capacity to engage in independent thought. If directors are dependent upon others to explain complexities or are influenced to arrive at particular decisions due to a lack of competence, this diminishes their independence. Currently, there are no minimum qualification requirements for independent directors, although an increasing number of educational institutions offer corporate governance-specific qualifications or accreditations. The best directorship training may equip directors to understand their fiduciary duties, but alone it does not provide the knowledge and experience required for directors to understand the complexities of alternative funds, including the nature and valuation of underlying investments.

To act competently, independent directors must also have the resources and capacity to attend to their duties to fund investors. Directors are

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entitled to regular reporting from managers and open lines of communication, but if managers offer limited transparency and availability, directors' capacity to oversee them can be compromised. Independent directors may also lack capacity due to having insufficient time to discharge their oversight duties effectively, perhaps due to managers not providing information in a timely fashion, or directors having competing commitments (e.g., multiple other directorships).

4. Director's attitude

Independent directors may possess fantastic professional backgrounds but lack the right attitude or tenacity to safeguard investors' best interests. Semi-retired professionals are a good example of directors who are highly qualified, with a wealth of relevant experience, yet may use directorships as an easy wind down into retirement. An independent director who Aksia spoke with bemoaned the experienced and highly-regarded passive directors who, in spite of their impressive resumes, just agree with everyone else instead of doing their jobs well.

5. Composition of the board

Greater diversity at the board level is also needed to encourage independent thinking. Multiple independent directors from the same corporate services firm may bring the same 'house view' and act in concert where they are appointed to the same fund.

A board that does not have a majority of independent directors will not have a voting majority and could be subject to the control of the manager. Since managers are not legally required to organize the appointment of a majority of (or in some cases any) independent directors, there is a risk that they structure fund boards that are more aligned with managers than investors.

There are many ways directors' independence can be compromised, limiting the effectiveness of fund boards in supervising managers. Directors' resumes alone do not ensure they are equipped to act as fully independent and active agents of fund investors. For the time being, it is still the manager who effectively appoints a fund's independent directors, and thereby ultimately controls whether a fund's directors are passive rubber stampers or engaged fiduciaries. In time, perhaps investor pressure for higher quality and further reaching corporate governance, and/or greater regulatory requirements for independence, will improve how independent directors are appointed. In the meantime, however, just because an investor sees that a manager has in place an "independent board" does not mean they should take comfort that their interests will be defended.

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