

Research & Commentary

FRM Early View

January 2012

Markets summary

- There was a broad-based rally in equity markets in January. Small caps outperformed large caps during the month and growth stocks rallied more so than value stocks. Emerging market equities produced particularly strong gains, reversing some of the losses from last year.
- Government bond markets produced muted returns as risk sentiment turned more positive through the month. The US yield curve flattened and 10 year bond yields fell following the dovish statements from the Fed regarding keeping rates low.
- Commodity performance was mixed. Precious metals rallied strongly with gold and copper rallying by 10% each and silver prices increasing by 19.2%. Oil prices continued to be volatile as EU and US imposed sanctions on Iran troubled supply dynamics; the brent-WTI spread widened through the month as brent rallied by 3.4% and WTI fell by 0.4%.
- Credit markets were buoyant in January and the ML HY Master II Index posted a gain of 2.9%. The market rally was aided by the short squeeze during the month and the flurry of high yield new issuance.
- In FX, the USD weakened against the major currencies in a reversal to the strengthening in December; the DXY Index fell 1.1% for the month. Emerging Market currencies appreciated in aggregate and the JP EM Currency Index ended the month 5.7% higher.

How did this affect hedge funds?

- Hedge fund industry performance has been broadly positive in January. The HFRX Global Hedge Fund Index posted a gain of 1.7%.
- All of the headline strategies made money during the month. Equity Long-Short managers produced some of the best returns: long-bias managers generally did well and some trading-oriented managers produced decent gains after having shifted their books to a net long bias going into the rally.
- Technical strategies continued to produce strong returns. In particular, short-term Systematic Trading managers were among the top performers. Alpha Capture strategies also fared well as contributor-based models benefitted from the positive momentum and increased trading activity.
- Overall risk positioning across hedge funds remained light with most discretionary managers continuing to be cautious of macro risks and opting to keep books small. A number of managers partially covered short equity positions to stem losses as the month progressed.
- As one might expect, hedges and short-bias strategies had a difficult month and suffered losses in January.

Chart 1: NAHB/Wells Fargo Housing Market Index (HMI)



Source: NAHB, Jan 1985 – Jan 2012.

Market outlook

The start of 2012 has been more benign to risk assets than most market participants had been expecting and has in some cases been better than perhaps warranted by recent newsflow. This reflects, in part, the bearish positioning at the start of the year and is indicative of portfolio adjustments which could yet continue for some time.

The macroeconomic backdrop has improved over the course of January and looking ahead there are several reasons why the environment may continue to be favourable for risk assets. In the US, the economic data releases have mostly surprised on the upside. For example, there have been signs of a tentative uplift in the housing market with home sales starting to increase and builder confidence indices (as shown in chart 1) beginning to gather momentum.

In China, concerns over a hard landing have been subsiding as inflation continues to fall (4.1% as at December) and growth becomes more stable (8.5% consensus GDP growth estimate for 2012). While we note that the available policy tools are yet to be fully deployed, we remain uncertain about the effectiveness of these tools in coping with weaker overseas demand and the challenges in the property market. Nevertheless, at the margin we think that the outlook on China is more positive.

Our outlook for Europe has been that it will 'muddle-through' the various issues it is facing, and events in January have been consistent with this view. Constructive factors so far this year include the ECB's long-term refinancing operation (LTRO) which has improved the funding conditions for European banks through three-year loans at 1% on generous collateral requirements; the successful auctions of sovereign debt (which had been a major risk); and the tightening of sovereign yields.

The collective, and selectively positive, newsflow across the three major economies could quite easily drive upward price adjustments for some time to come. Further quantitative easing from the Fed and the BOE, together with a definite extension of the LTROs by the ECB (which are expected to have an even larger take-up by banks on 29 February) lend support to a risk-on environment.

The more positive macro risk conditions, sharp decline in volatility and increase in dispersion have been partly attributable to the mixed bag of company-specific news. Many companies are still sitting on high levels of cash; high yield issuance has been strong; deal activity has been muted; and results reported thus far from the fourth quarter earnings season have been varied.

We are not, however, losing sight of the bigger picture. The recovery in the US has been weak and the Budget Office has revised its GDP forecast downward to 2% for 2012, citing high unemployment and the budget deficit as reasons for sluggish growth. Although the improvement in funding and liquidity in the Eurozone is positive for economic growth in the region, the ongoing fiscal contraction is likely to remain the dominant influence, particularly in the second half of the year. The outlook, therefore, for a sustained recovery remains troubled.

Hedge fund outlook

At the end of last year, our outlook for 2012 markets was that they would be similar to 2011 – marked by elevated volatility, low liquidity, low dispersion and a lack of strong directional trends. In this environment, hedge funds as a whole were not able to produce returns. This raises the question of whether or not hedge funds will do better in 2012, and specifically which strategies. As outlined earlier in this document, a more positive risk environment may be emerging, which should help a number of strategies. In addition, there are five other areas that warrant discussion.

1. **Market positioning:** the investment community currently has low levels of risk following the large wave of position clearance in 2011. This would appear to be the case across all types of investors. CTAs, for example, are operating at unusually low levels of margin to equity. This position clearance was a large contributor to the wide-ranging, choppy, but broadly directionless character of the markets in the second half of 2011. In a world that has been oscillating between risk-on and risk-off, it seems that there is little room for further risk aversion at the beginning of this year since selling pressure from investors is a lesser concern due to reduced risk levels across the board.
2. **Risk assets are cheaper:** there are some pockets of opportunity in select risk assets. For example, non-agency RMBS, emerging markets and convertible bonds all offer interesting opportunities as a result of the strong sell-off in 2011. These opportunities do not necessarily simply correlate with broader equity markets. For example, RMBS markets, which were subject to significant technical factors in 2011 causing performance to decorrelate from equity markets in general, now offer attractive yields across a range of possible macro environments.
3. **Level of financial activity:** near-crisis conditions in the second half of 2011 interrupted the pipeline of corporate events and credit issuance. Since then, significant policy steps have been taken to shore up effective operation of financial markets and this in turn should support the resumption of corporate activity. This increase in activity is likely to be directly beneficial

for a number of strategies, such as Event and Credit Arbitrage, but is also a tailwind for hedge funds involved in liquidity provision as shifts in supply/demand dynamics become even more favourable.

4. **Portfolio positioning:** since the beginning of 2009 we have believed that Relative Value and Arbitrage strategies, especially those which produce returns through liquidity provision, would outperform other strategies in the post-crisis environment. These strategies are especially suited to produce returns in directionless markets, and the pullback of investment banking from proprietary trading and market making has meant less competition for profitable trades. Should the 2012 market environment be similar to

2011, portfolios which emphasize managers who are non-directional in nature and produce returns through liquidity provision should continue to outperform.

5. **Adaptability:** following the period of sustained recovery from the second quarter of 2009 to the first half of 2011, we saw a sharp adjustment in the financial environment in August 2011. Quality hedge funds, by their nature, should be adaptable. The adjustment, however, from processes and exposures that are suited to the first period to those that are more appropriate for the second period, takes time. Our sense is that hedge fund returns will now recover as managers become acclimatised. We are already seeing specific evidence of this as managers adjust their portfolios and investment strategies.



Strategy summary for January 2012

Strategy type	Estimated return for January*	Comments
Directional Trading	+	<ul style="list-style-type: none">• Systematic Trading managers generated small gains in January and benefited from the trending market environment. Gains were, however, limited by overall low net exposures at the beginning of the month. Most managers gradually increased their long exposure and ended the month in a more pro-risk position. The largest contributors to returns were long exposure to equities and energy and short exposure to agriculture.• Discretionary Traders produced mixed returns. Most managers cautiously added to risk levels during the month while risk assets rallied. Managers who held short duration trades and were generally less bearish made money while managers who were reluctant to add to risk levels lagged.
Equity Long-Short	+	<ul style="list-style-type: none">• Most managers ended the month in positive territory despite the factor reversal during the month. The biggest losers last month were the winners in January: long-bias managers generated the best returns. The notable outperformers were those who held deep-value names which recovered strongly in the rally.• A number of trading-oriented managers in Europe deliberately kept their books small going into the end of the month in anticipation of worse-than-expected corporate newsflow in the upcoming reporting season.
Specialist Credit	+	<ul style="list-style-type: none">• Early estimates suggest that the average Specialist Credit manager will end the month with positive performance. Long-bias managers, as expected, are likely to post the strongest returns, followed by trading-oriented managers who tactically moved their books to take advantage of the market rally.• Managers trading in less liquid issues are likely to be the laggards in January as the rally was concentrated in cyclical, lower quality and higher liquidity names. Short positions in European sovereigns and financials continued to be a detractor in January.
Relative Value	+	<ul style="list-style-type: none">• Relative Value managers made money in December. In Statistical Arbitrage, both technical and fundamental-based managers produced positive performance. Alpha Capture strategies had a particularly strong month; this was unsurprising given the expected seasonal increase in trading activity.• Event Arbitrage managers also made money and benefitted from spread tightening in some of the larger deals. One of the popular trades held by hedge funds which contributed to returns in January was the proposed deal between two US Aerospace companies (United Technologies and Goodrich Corp).• Managers specialised in Convertible Bond Arbitrage took advantage of the improvement in valuations in the asset class in January. The average manager posted a return of 2.0% (HFRX CBA Index as at 27 January).

*Note: estimated return reflects our opinion of the probable outcome across each strategy in the wider market.

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