Research Paper

Marketable Alternatives Mid-Year Update

by Andrew Furney, CFA, CAIA, Senior Research Analyst – Marketable Alternatives
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Key Observations

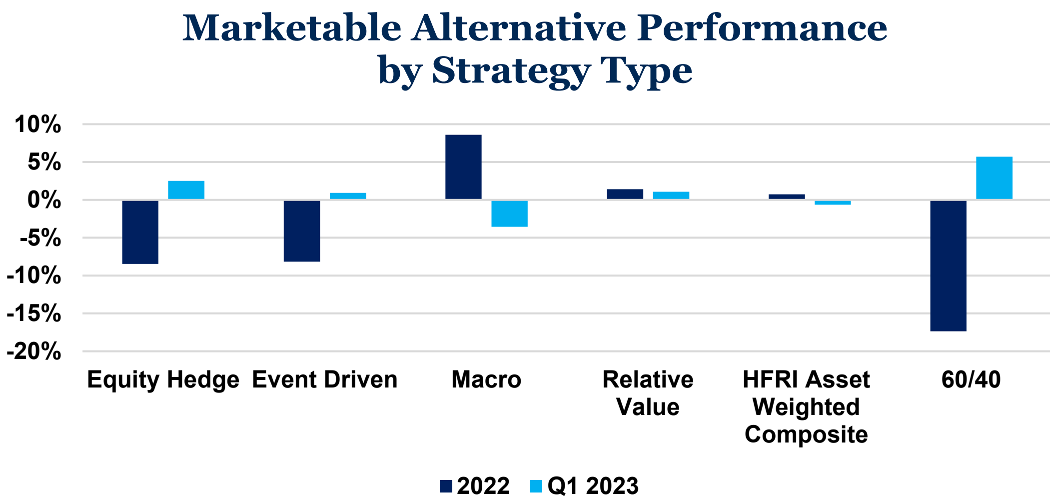
- *Hedge funds shined in 2022 when both equities and fixed income markets experienced sharp declines.*
- *Diversification across various hedge fund managers and strategy types continues to be a key characteristic of successful all-weather marketable alternatives programs.*
- *Strong performance in recent years from multimanager hedge funds resulted in an influx of capital into that space.*
- *Amidst the backdrop of a higher cost of capital, tightening credit and overall market uncertainty, convertible bonds remain a compelling instrument for companies and investors alike.*

A Bright Spot in a Dark Year

Many allocators are happy to see 2022 fade into the distance as they look through the rearview mirror. While 2022 was a challenging year for many investors, hedge funds in general proved to be a bright spot in client portfolios, with the HFRI Asset-Weighted Composite generating a positive return of 0.7%.[1] This is in stark contrast to the declines experienced by both equity and fixed income markets, down 18.1% and 16.2% for the MSCI World and Bloomberg Aggregate respectively [1].

Despite the positive relative performance across the hedge fund industry relative to other asset classes, performance was hardly uniform across all strategy types. Strategies typically associated with higher equity beta profiles such as HFRI Equity Hedge and HFRI Event Driven struggled in 2022 and were down 8.5% and 8.2% respectively. On the other hand, historically less correlated strategies such as Global Macro excelled in large part due to being positioned to benefit from higher interest rates.

[1]Morningstar as of March 31, 2023



Source: HFRI, Morningstar as of March 31, 2023

Through the start of 2023, the script has once again flipped with equity hedge and event driven strategies contributing with positive performance while macro has been a negative contributor[2]. Market history and recent volatility continue to highlight the importance of manager and strategy diversification within a marketable alternatives program seeking all-weather characteristics.

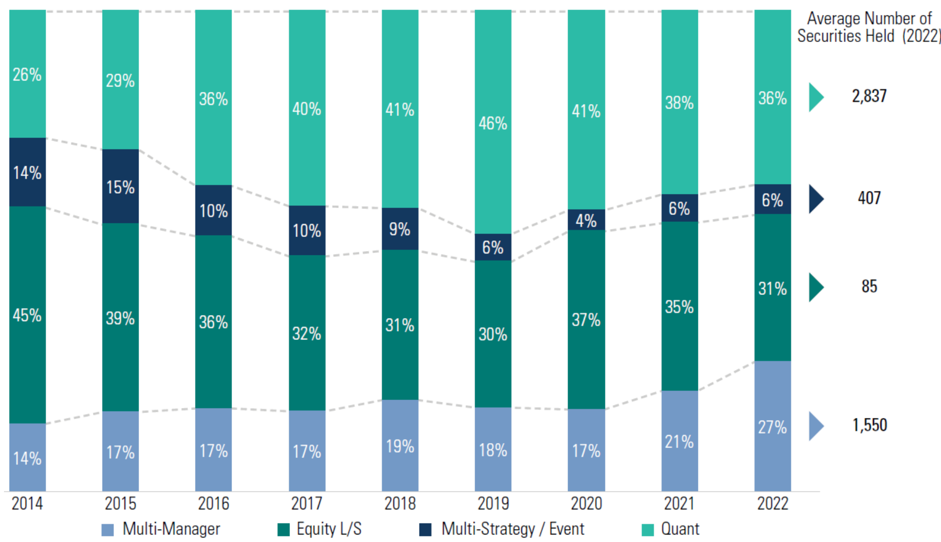
Multimanager Funds – The Elephant(s) in the Room

A core value proposition of hedge funds is the ability to generate uncorrelated alpha and preserve capital during times of market downturn. In this regard, multimanager funds have proven themselves particularly adept at taking full advantage of a key component in risk management: diversification. With the ability to allocate capital to multiple managers, strategies and asset classes, multimanager funds have grown popular with many allocators, often making up a large percentages of hedge fund portfolios. This trend is reflected in the growth of multimanager funds in recent years. According to a Goldman Sachs hedge fund report, multimanager funds have seen their assets grow by around 150% in the last five years, while the rest of the industry grew by just 13%, highlighting the large appetite for the model by allocators [3].

As multimanager funds continue to gain popularity, it is important to assess the evolving impact on the hedge fund industry as a whole. The ripple effect within the industry stemming from the popularity of multimanager funds is not limited to the multi-strategy peers space, as they have become prominent players in the equity market, taking considerable share of total gross equity exposure from traditional standalone equity hedge funds in recent years.

[2]Morningstar as of March 31, 2023
[3]Goldman Sachs – "The Multiplier Effect: The landscape and evolution of the multi-manager hedge fund model" as of December 2022

Share of Gross Market Value within U.S. Equities, 2014-2022



Source: Goldman Sachs – "The Multiplier Effect: The landscape and evolution of the multi-manager hedge fund model." As of December 2022.

Although diversification is undoubtedly a key factor in the success of the multimanager model, the growing number of new launches and fresh capital in recent years has resulted in significant competition for top talent, raising further concerns the space has become overcrowded and may remain so until a hierarchy of winners and losers becomes clearer. As firms spend considerable capital in an attempt to differentiate themselves and attract the limited supply of skilled managers, investors have largely bore the brunt of these costs in the form of higher fees and less investor-friendly terms.

While one could argue these changes provide stability to the asset managers, the impact of higher fees on the long-term value proposition of the model for investors, especially for those allocating to multimanager funds that fall outside the best-in-class peer group, remains to be seen. As a result of these imperfections and uncertainty surrounding the multimanager space, it remains advisable to include multimanager funds as a component of a broader diversified hedge fund portfolio rather than a standalone allocation.

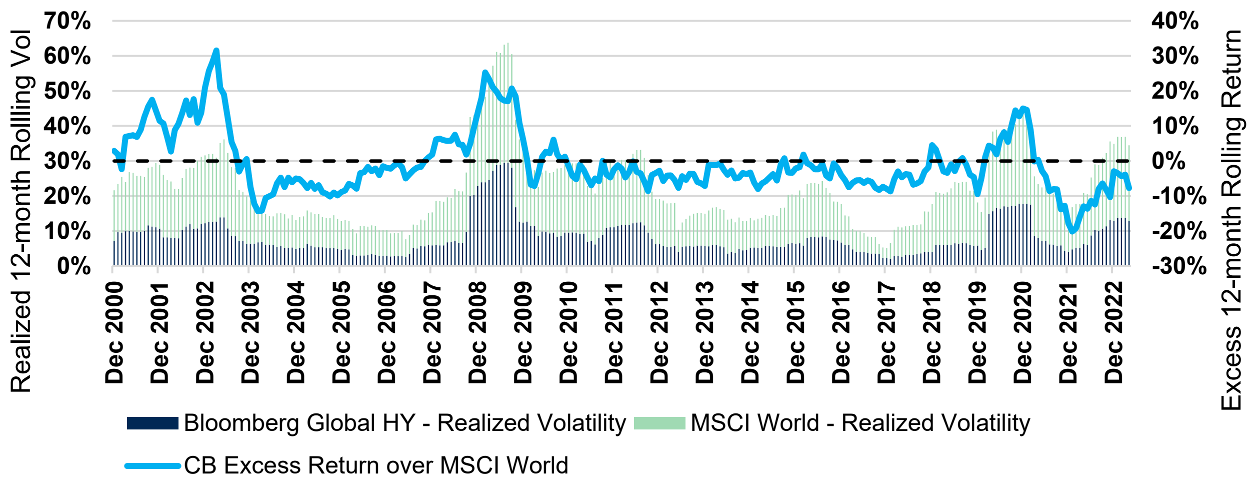
Opportunity Set Spotlight – Convertible Bonds

The Instrument

Convertible bonds are a hybrid security that combines features of both a stock and a bond. These bonds can be considered a combination of a traditional coupon-paying bond with an embedded call option on the issuer's stock that allows the holder to convert the bond into a predetermined number of the issuer's common stock shares. Typically, the option to convert can be exercised at any time during the bond's life and is usually at the bondholder's discretion.

The conversion feature of convertible bonds provides investors with the potential for equity upside if the issuer's stock price rises while offering downside protection in the form of the bond's fixed-income features, such as coupon payments and principal repayment. As a result, convertible bonds can be an attractive investment opportunity for those seeking a balance between income and capital appreciation. Despite these positive attributes and the fact that convertible bonds have proven historically valuable in times of high market volatility, prolonged periods of material underperformance relative to equities also highlight the challenges of passive, buy-and-hold and unhedged approaches to investing in the space.

Convertible Bonds Tend to Outperform Global Equities in High Volatility Regimes



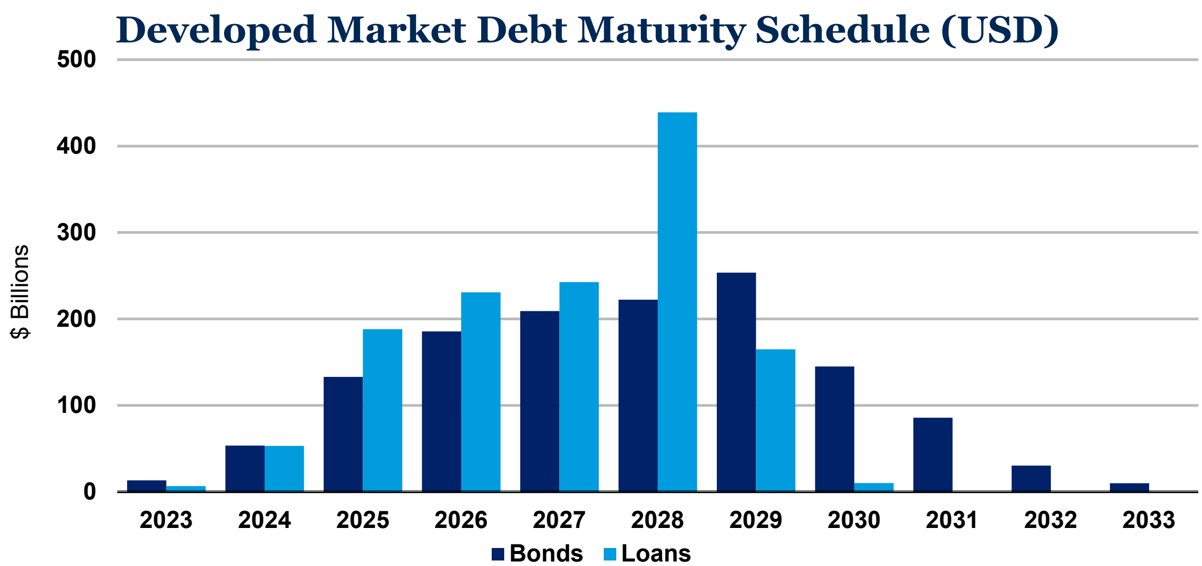
Source: Morningstar as of April 30, 2023. All Measurements are 12-month rolling periods.

From the borrower's perspective, convertible bonds often have lower coupons than traditional corporate bonds, as the conversion option provides an added benefit to the investor. This lower cost of financing for the issuer can make convertible bonds an attractive source of funding relative to traditional debt or equity offerings, particularly in times of high interest rates, high equity and rate volatility, or periods when the willingness to extend credit by lenders is limited.

The Market Backdrop

Convertible bonds are shaping up to be a compelling investment opportunity for investors in the current market. As a result of the recent Fed rate hikes and the rapid pace at which they occurred, companies are continuing to explore avenues to reduce their cost of capital. Although traditional high-yield and young growth companies that lack other financing options are expected to continue as the primary issuers of convertible bonds, the market has already witnessed non-traditional issuers take advantage of this flexible financing tool in an effort to cut costs in recent months. In 2023, numerous highly-rated investment-grade companies have issued convertible bonds, capitalizing on the opportunity to secure funding at a lower interest rate than available through a conventional bond offering[4].

While convertible issuance was muted in 2022, the combination of higher rates and large amounts of debt expected to mature in the coming years, we believe, results in a compelling backdrop for an uptick in convertible bond issuance and a broadening alpha opportunity set for managers with expertise in the space.

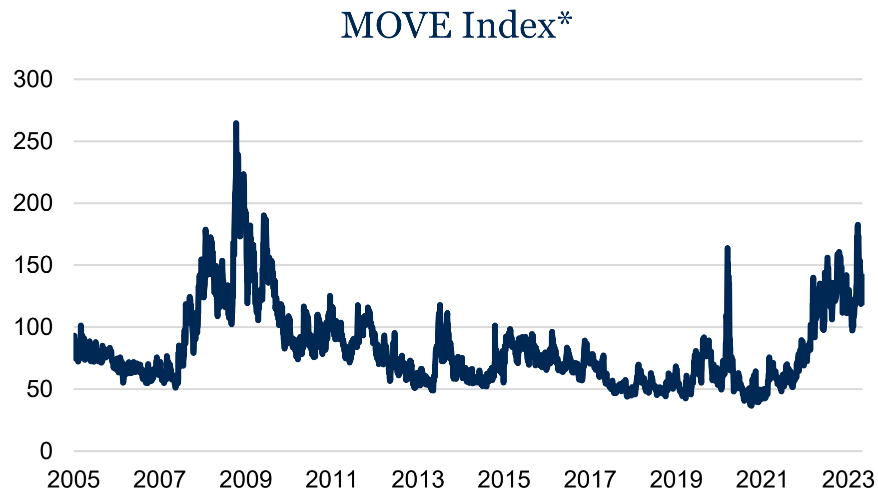


Source: BofA Global Research, ICE Data Indices LLC as of April 30, 2023.

Although the role convertible bonds will play in the restructuring of this maturing debt is yet to be determined, their attractive features may prove to be a valuable lifeline for some issuers. In today's higher rate environment, companies that delay refinancing in hopes of securing more favorable rates may be playing a risky game.

Considering the embedded connection to equity and rate volatility within the convertible bond structure, fluctuations in these markets also have the potential to introduce off-the-run trading opportunities across various issuers which are beyond the capabilities of a passive or long only allocation to the space. As we highlighted in our First Quarter Update, interest rate volatility has been drastic as markets wrestle with plotting the future path of interest rates - a fact underscored by recent shifts in the MOVE Index, a widely used measure of expectations for interest rate volatility.

[4]Reuters – "Analysis: Some highly rated US companies take unusual funding route as rates rise". February 2023



*Full MOVE Index name is ICE BofAML MOVE Index. Source: Yahoo Finance. As of April 28, 2023.

If rate path uncertainty continues to impact corporate credit and equity markets, hedge funds with relative value and convertible bond expertise are uniquely positioned to capitalize on the convertible bond opportunity set. Considering the difficulties associated with timing a passive exposure to the space over the long-term, exposure through a multi-strategy hedge fund or credit specialist hedge fund with the ability to invest in converts opportunistically allows for exposure to the space when it becomes particularly attractive without the need for attempts at successful timing. More importantly, the hedge fund structure equips the manager with the ability to go long and short and allows the manager to hedge undesirable risk exposures and isolate alpha opportunities more effectively.

In Closing

With a rising interest rate, higher for longer, or a hard pivot scenario, each presenting its challenges for allocators, convertible bonds offer unique characteristics that make them particularly appealing to companies and investors in various plausible outcomes. Regardless of what happens in markets, an allocation to a hedge fund manager with convertible bond capabilities and expertise can complement a diversified hedge fund program. Furthermore, access to the space through a hedge fund mandate removes the necessity for market timing and can offer opportunistic exposure to alpha opportunities within the convertible bond universe while minimizing exposures to undesirable risks - attributes we believe to be more attractive than buy and hold or long only alternatives.

For more information on marketable alternatives, please contact any of the professionals at Fiducient Advisors.

About the Author

Andrew Furney, CFA, CAIA
Senior Research Analyst – Marketable Alternatives

As a member of the Marketable Alternatives Research Team, Andrew is responsible for performing due diligence on marketable alternative managers for potential inclusion in client portfolios. Prior to joining the firm in 2018, Andrew was a Senior Portfolio Accountant at Parametric Portfolio Associates where he was accountable for leading audits, monitoring trading risks and preparing daily analyses. Before his career in finance, Andrew was an NFL kicker for the New York Jets. He received a Bachelor of Arts, double majoring in Finance and Marketing, from Washington State University. Andrew is a CFA® charterholder and a Chartered Alternative Investment Analyst (CAIA®). With his free time, Andrew enjoys photography, traveling, reading, hiking and is a Washington State Cougars superfan.

Disclosures and Definitions

Comparisons to any indices referenced herein are for illustrative purposes only and are not meant to imply that actual returns or volatility will be similar to the indices. Indices cannot be invested in directly. Unmanaged index returns assume reinvestment of any and all distributions and do not reflect our fees or expenses.

- **MSCI World** captures large and mid-cap representation across 23 Developed Markets countries. With 1,645 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
- **Bloomberg U.S. Aggregate Index** covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.
- **Bloomberg Global High Yield TR USD** is a multi-currency flagship measure of the global high yield debt market. The index represents the union of the US High Yield, the Pan-European High Yield, and Emerging Markets (EM) Hard Currency High Yield Indices.
- **Refinitive Global Convertible Bond TR USD** is designed to provide a broad measure of the performance of the investable, global convertible bond market.
- **The HFRI Asset Weighted Composite Index** is a global, asset-weighted index comprised of single-manager funds that report to HFR Database. Constituent funds report monthly net of all fees performance in US Dollar and have a minimum of $50 Million under management or $10 Million under management and a twelve (12) month track record of active performance. The HFRI Asset Weighted Composite Index does not include Funds of Hedge Funds. The constituent funds of the HFRI Asset Weighted Composite Index are weighted according to the AUM reported by each fund for the prior month.
- **HFRI Equity Hedge (Total) Index - Asset Weighted Index** includes investment managers who maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. EH managers would typically maintain at least 50% exposure to, and may in some cases be entirely invested in, equities, both long and short. The constituent funds of the HFRI Equity Hedge (Total) Index - Asset Weighted are weighted according to the AUM reported by each fund for prior month.
- **HFRI Event-Driven (Total) Index - Asset Weighted Index** includes Investment Managers who maintain positions in companies currently or prospectively involved in corporate transactions of a wide variety including but not limited to mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated, and frequently involve additional derivative securities. Event Driven exposure includes a combination of sensitivities to equity markets, credit markets and idiosyncratic, company specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative), with the realization of the thesis predicated on a specific development exogenous to the existing capital structure. The constituent funds of the HFRI Event-Driven (Total) Index - Asset Weighted are weighted according to the AUM reported by each fund for prior month.

- **HFRI Macro (Total) Index - Asset Weighted Index** includes Investment Managers which trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top down and bottom up theses, quantitative and fundamental approaches and long and short term holding periods. Although some strategies employ RV techniques, Macro strategies are distinct from RV strategies in that the primary investment thesis is predicated on predicted or future movements in the underlying instruments, rather than realization of a valuation discrepancy between securities. In a similar way, while both Macro and equity hedge managers may hold equity securities, the overriding investment thesis is predicated on the impact movements in underlying macroeconomic variables may have on security prices, as opposes to EH, in which the fundamental characteristics on the company are the most significant are integral to investment thesis. The constituent funds of the HFRI Macro (Total) Index - Asset Weighted are weighted according to the AUM reported by each fund for prior month.
- **HFRI Relative Value (Total) Index - Asset Weighted Index** includes Investment Managers who maintain positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative or other security types. Fixed income strategies are typically quantitatively driven to measure the existing relationship between instruments and, in some cases, identify attractive positions in which the risk adjusted spread between these instruments represents an attractive opportunity for the investment manager. RV position may be involved in corporate transactions also, but as opposed to ED exposures, the investment thesis is predicated on realization of a pricing discrepancy between related securities, as opposed to the outcome of the corporate transaction. The constituent funds of the HFRI Relative Value (Total) Index - Asset Weighted are weighted according to the AUM reported by each fund for prior month.
- **ICE BofAML MOVE Index** is a widely used measure of expectations for interest rate volatility, tracks the movement in U.S. Treasury yield volatility implied by current prices of 1-month OTC options.

Material Risks Disclosures

Marketable Alternatives involves higher risk and is suitable only for sophisticated investors. Along with traditional market risks, marketable alternatives are also subject to higher fees, lower liquidity and the potential for leverage that may amplify volatility or the potential for loss of capital. Additionally, short selling involved certain risks including, but not limited to additional costs, and the potential for unlimited loss on certain short sale positions.