Lupus alpha

Absolute Return and Alternative Funds in Germany

Liquid alternatives in the first half of 2023: significant outflows despite positive performance

The abrupt turnaround in interest rates since mid-2022 prompted investors to increasingly favour traditional fixed-income investments. At the same time, outflows from UCITS-compliant hedge fund strategies increased. These strategies reported a positive performance of 1.96% on average and are convincing in the medium term with a significant reduction in drawdowns.

About the Study

Since 2008, Lupus alpha has been evaluating the universe of absolute return and alternative funds on the basis of data from Refinitiv. The Study covers UCITS-compliant funds with an active management approach that are authorised for distribution in Germany. The Study focuses on market size, development and composition, performance in the investment segment and individual strategies, as well as key risk figures. It evaluates the three levels of aggregation – the overall universe, strategies within the universe, and funds within the strategies – and distinguishes between 14 strategies. The Alt. Long/Short Equity strategy, for example, is made up of 108 funds.

SUMMARY

Investors continued to make withdrawals from the UCITS-compliant hedge fund strategy segment in 2023. Outflows surged to EUR 19.4 billion as of 30 June, already surpassing the previous year's total outflows (EUR 17.6 billion) by the mid-year mark. It is now clear that the return of higher interest rates is shifting the focus back onto traditional fixed-income investments. This is also evident in the Deutsche Bundesbank's press release on the acquisition of financial assets, which highlights "historically high reallocations" to fixed-income investments and bonds during the first quarter of 2023. The absolute return segment suffered a particularly significant drop in volumes, recording the largest outflows in absolute terms during the first half of the year (approximately EUR 4.92 billion) despite a positive average performance.

Amid a generally extremely positive market environment, the performance of 1.96% recorded by liquid alternatives strategies was roughly on a par with government and corporate bonds, lagged well behind equities, and clearly outperformed unregulated hedge funds (0.63%). As the best-performing asset class at -1.49% in 2022, this segment helped to stabilise investor portfolios.

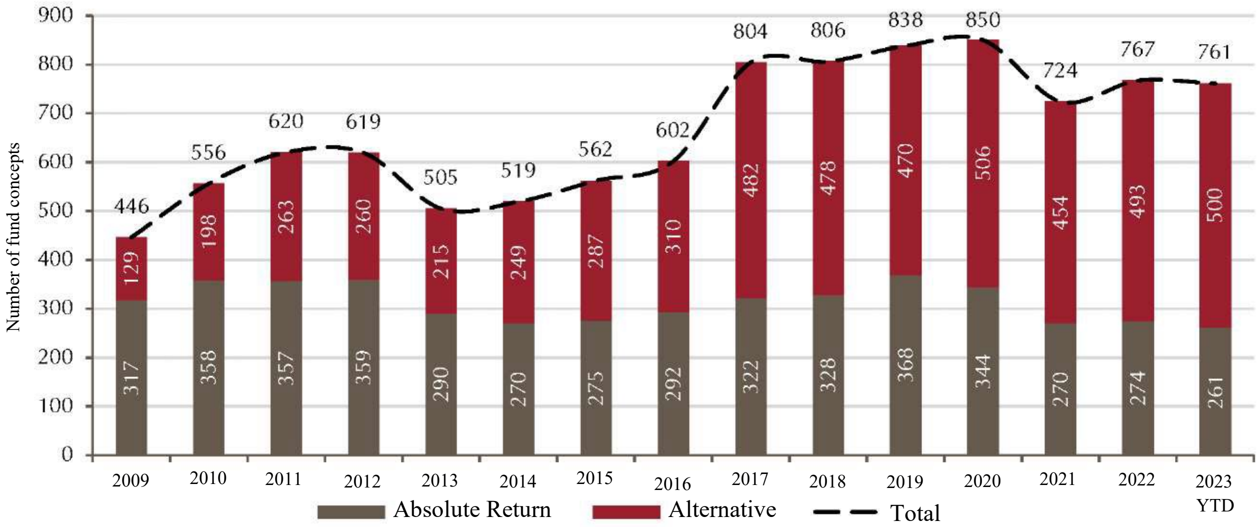
Most strategies in this segment deliver convincing performance over a five-year period by recording significantly lower volatility compared to equities of between 5% and 15%, a feat achieved by the majority of both fixed-income and other strategies without a focus on bonds. In addition, liquid alternatives have often saved their investors from painful drawdowns, with almost three-quarters of these funds limiting their maximum losses to 20% over the past five years despite the coronavirus crisis and war in Ukraine. In the medium term, the risk-return characteristics of this segment mean it is positioned between equities and bonds.

MARKET DEVELOPMENT

Number of fund concepts on offer remains constant

The number of fund concepts on offer in this segment remains largely unchanged compared to 2022 at 761 (2022: 767). The number of absolute return concepts fell to 261, the lowest figure since the Study began in 2008. By contrast, alternative concepts experienced modest growth to reach the 500 mark once again, with only 2020 boasting more alternative concepts (506) since the start of the Study.

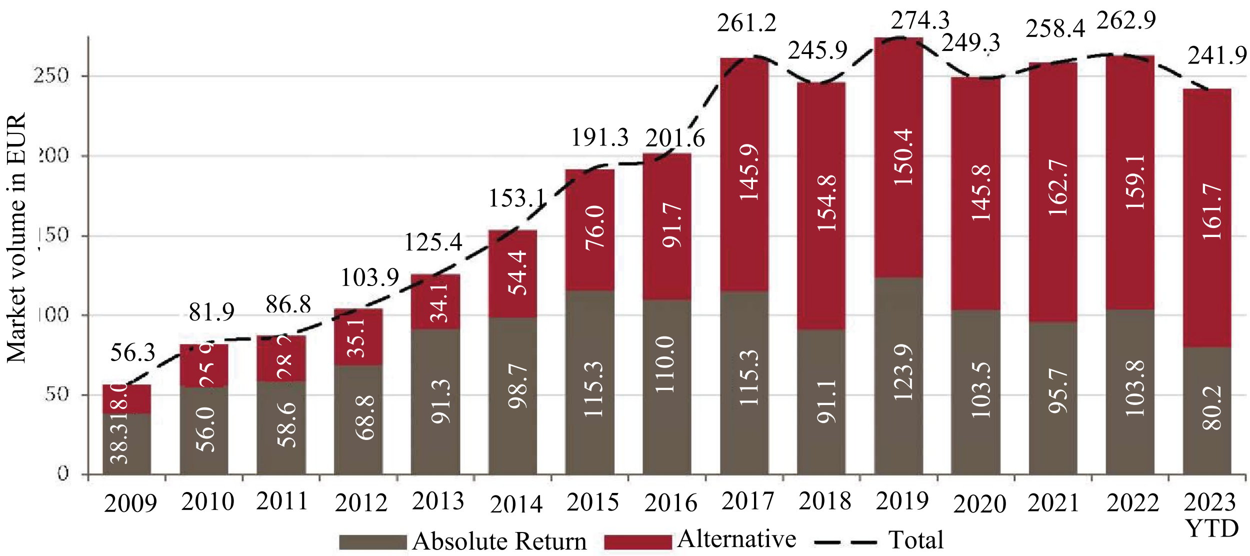
Number of funds stays constant



Market volume declines further

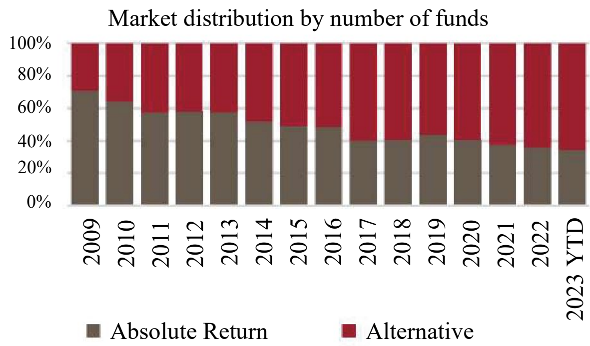
The liquid alternatives universe has recorded another sharp decline in volumes since the start of the year. The fundamentally positive average performance of 1.96% across all funds was not enough to compensate for considerable net outflows. The **volume of absolute return funds slumped by more than 20%** to just EUR 80.2 billion (previously EUR 103.8 billion). By contrast, the volume of alternative funds grew modestly to EUR 161.7 billion. Overall, the liquid alternatives strategy segment shrunk by 8% to just under EUR 242 billion.

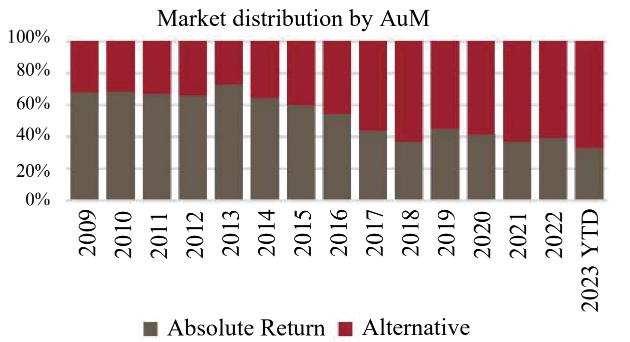
Market volume: absolute return funds record losses as alternatives strategies make gains



Both the number of funds and their market distribution by volume show that **liquid alternatives strategies have become increasingly dominant compared to absolute return concepts over time**.

Dominance of alternative strategies steadily increasing

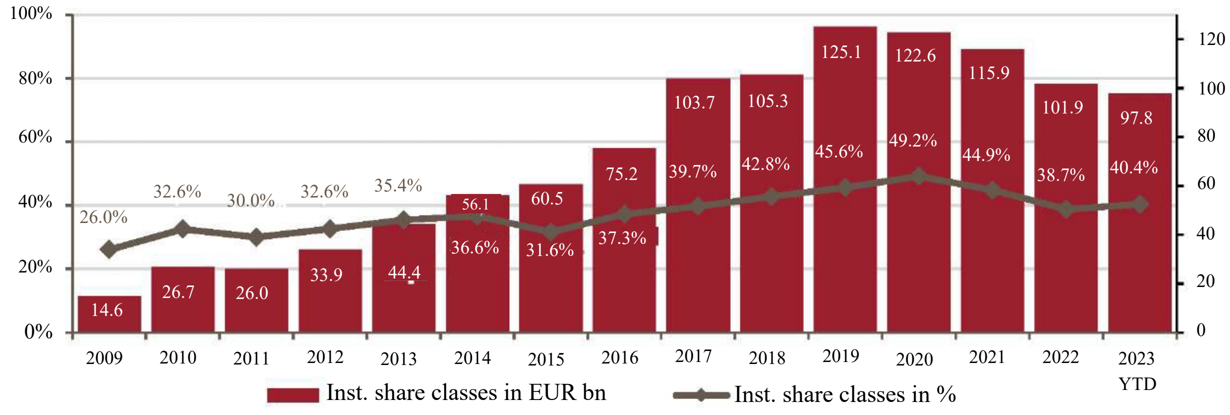




Institutional investors may have largely finished reallocating funds

Institutional volumes have only fallen half as much as in the segment as a whole so far this year (-4.3% vs. -8%) and are now just under EUR 98 billion. As a result, the **proportion of institutional share classes within the overall market rose from 38.7% to 40.4%**, even though volumes continued to fall in absolute terms. The slowdown in this trend during the first half of 2023 may indicate that institutional investors have largely finished reallocating funds away from regulated hedge fund strategies where possible. Within the institutional share classes, the absolute return segment declined by around 25%, with volumes falling by EUR 10.3 billion to just EUR 29.5 billion. By contrast, the alternatives segment grew by around 9.9% from EUR 62.1 billion to EUR 68.3 billion.

Market share of institutional share classes rises for the first time in years

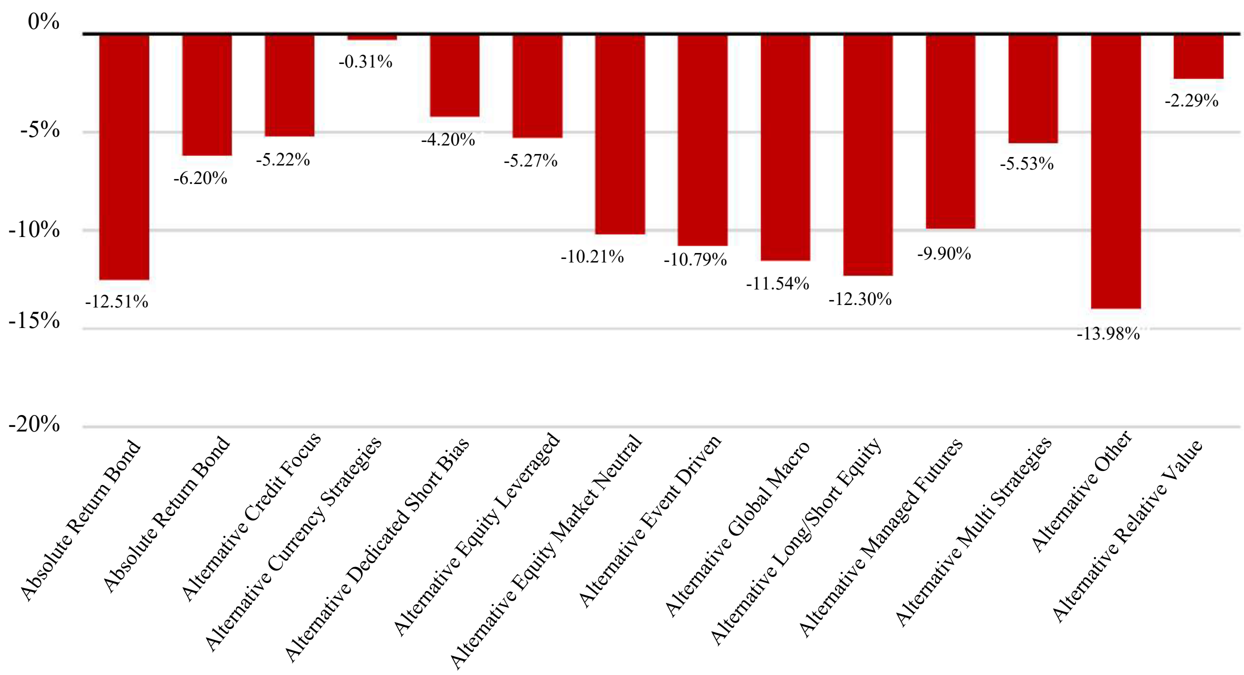


No strategies recorded net inflows in the first half of 2023

After EUR 17.56 billion flowed out of the liquid alternatives universe in 2022, outflows had already reached EUR 19.42 billion during the first half of 2023. No liquid alternatives strategies recorded net inflows on an aggregated level in the first six months of the year. Overall, outflows reached EUR 28.86 billion compared to inflows of around EUR 9.44 billion. As in previous analyses, outflows were higher in March and June than in the other months, which suggests investors were reallocating funds. Outflows were relatively balanced when comparing between institutional and retail investors.

All strategies record outflows

(Basis: assets under management by strategy)



The largest absolute outflows were recorded by Absolute Return, Alternative Long/Short Equity and Alternative Multi Strategies, while Alternative Currency Strategies, Alternative Equity Leveraged and Alternative Relative Value recorded relatively small losses in volume. At just under EUR 7 billion, more than a third of outflows came from the overall universe of Absolute Return strategies (Absolute Return and AR Bond).

Fund flows by strategy (in EUR bn)

Top 5

Alternative Currency Strategies	0.00
Alternative Equity Leveraged	-0.05
Alternative Relative Value	-0.06
Alternative Dedicated Short Bias	-0.10
Alternative Managed Futures	-0.67

Flop 5

Absolute Return	-4.92
Alternative Long/Short Equity	-2.53
Alternative Multi Strategies	-2.35
Absolute Return Bond	-2.07
Alternative Global Macro	-1.86

2023: One third of all funds record inflows despite overall net outflows

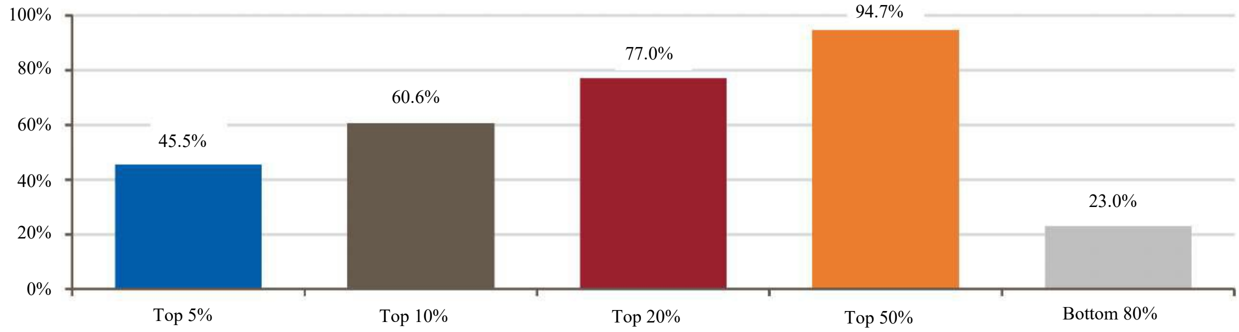
A more varied picture emerges at individual fund level, where a third of all funds recorded positive net inflows. Around half of funds suffered outflows despite generating positive returns over the past three years. There may be several reasons for this. Either profits are being realised, or returns have failed to meet the expectations of investors, who have found more profitable or suitable alternatives. This capital does not appear to have flowed into the broader equity markets. Market statistics show significant outflows in these markets in June, while bonds recorded considerable inflows. This supports the hypothesis that both the new interest rate environment and ongoing economic uncertainty are likely to influence current investor behaviour.

MARKET STRUCTURE

Top 50% of funds manage 94.5% of total volume

The basic market structure has barely changed compared to earlier analyses, **with large funds still dominating the market.** The top 5% of funds manage almost twice as much capital as the bottom 80%. As a result, the market continues to be dominated by a few large providers. This trend is even more pronounced when the market is divided into its upper and lower halves, with the top 50% of funds accounting for 94.5% of capital in this asset class while the lower half of funds manage barely 5% of all assets.

Top 5% of funds account for 45% of total market volume



Alternative Multi Strategies now the largest individual strategy

Just **five strategies make up over 70% of the overall market** between them. Alternative Multi Strategies grew by 3.1 percentage points to become the largest individual strategy in the segment. Absolute Return lost considerable market share, shrinking by 4.3 percentage points to be knocked off top spot. Absolute Return Bond also lost market share (-1.0%). Together with Alternative Credit Focus (+2.7%), these two **fixed-income strategies account for 25% market share** between them. It remains to be seen whether these strategies have created a stable core, as the trend has been moving downward for some time, with both bond strategies collectively making up around 40% of the liquid alternatives asset class as recently as 2020. It is conceivable that funds could start to flow back into these strategies as soon as investors believe there will be no more interest rate hikes.

Fixed-income strategies with just under 25 percent market share once again

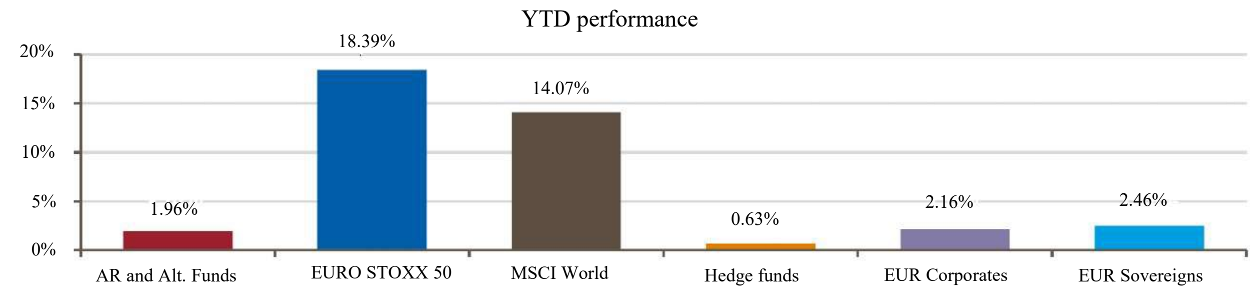
PERFORMANCE

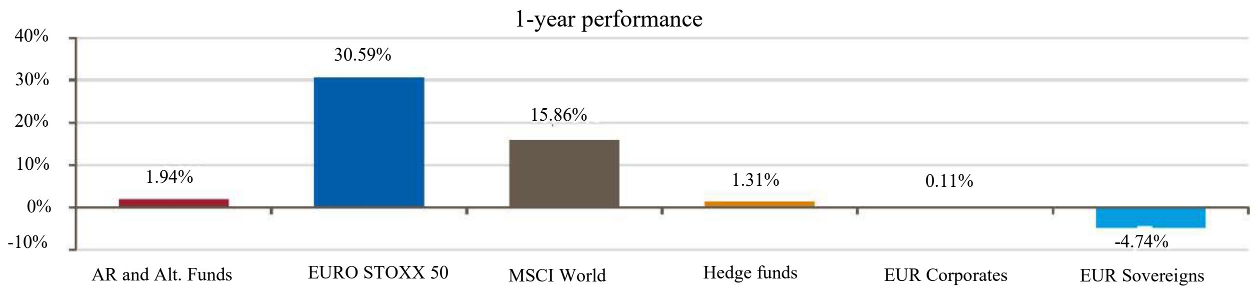
Liquid alternatives positioned between equities and bonds in the medium to long term

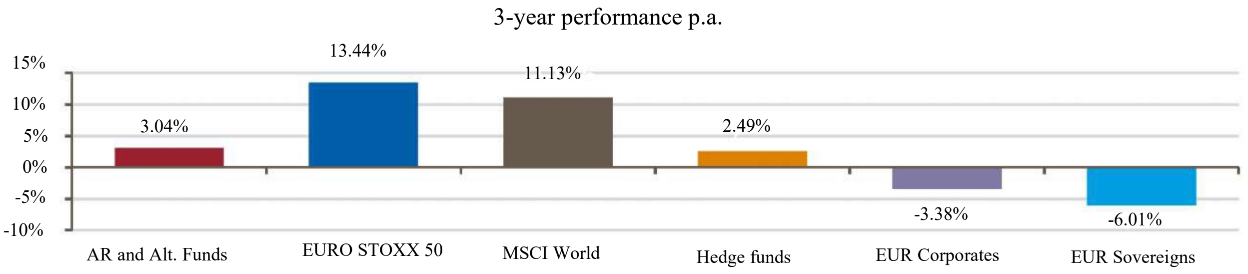
Liquid alternatives recorded performance of 1.96% in the first half of the year (see "YTD performance" chart) to significantly outperform the broader index for unregulated hedge funds. While these strategies succeeded in keeping pace with government and corporate bonds, they lagged well behind European and international equities. Liquid alternatives outperform the bond markets over one, three and five years. The sharp price decline in the bond markets after the turnaround in interest rates in 2022 is also a significant factor here. Although liquid alternatives had managed to narrow the performance gap to equities in the medium term, this gap has widened significantly once again due to above-average equity performance in the first half of 2023.

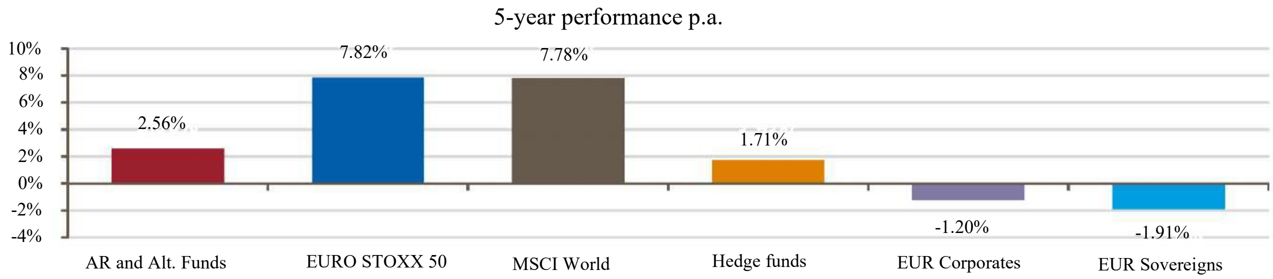
Given the current market environment, it is clear that equity exposure is particularly important for performance, while **liquid alternatives strategies primarily help to diversify and stabilise portfolios** (see also Volatility, page 9). There are many different reasons for the low participation of liquid alternatives in strong equity markets. Many strategies invest in other asset classes besides equities, while implementing hedging components can significantly impact performance in a robust long environment. In addition, many fund managers want to decouple their investments from the wider market to a certain degree to keep their product promise of uncorrelated returns. Overall, the performance of UCITS-compliant hedge funds places them between equities and bonds in the medium term.

Liquid alternatives positioned between equities and bonds in the medium term





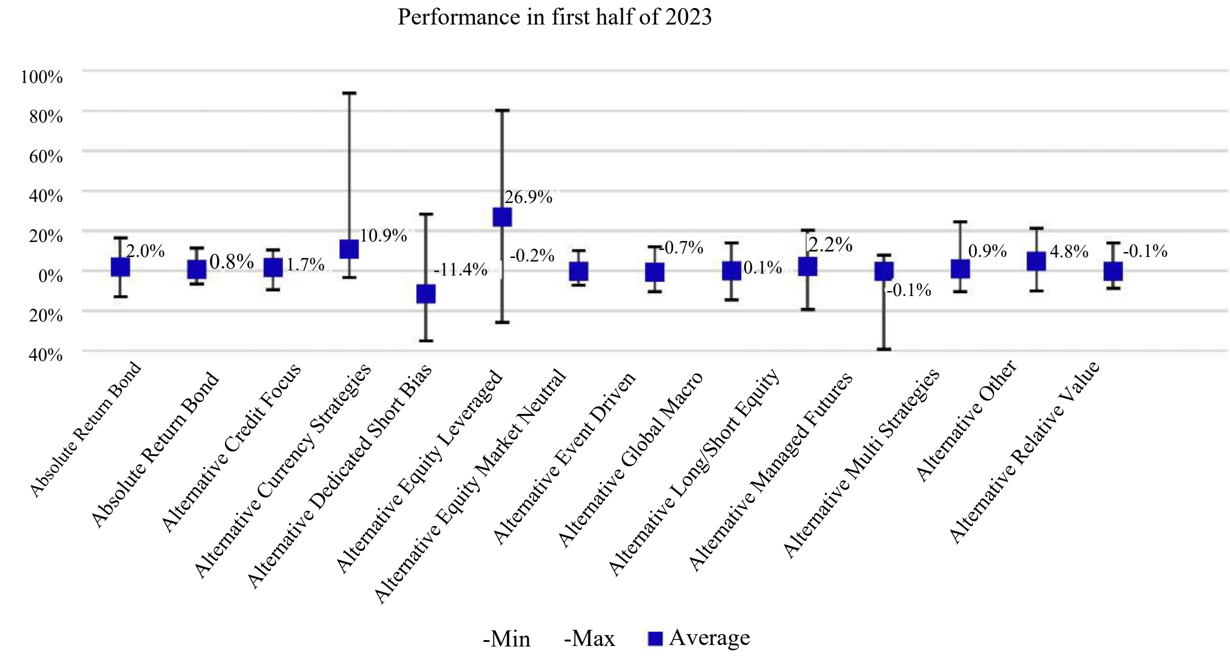




Strategy analysis: huge spread in performance

Equity exposure was also key to success for liquid alternatives in the first half of 2023, with the Equity Leveraged strategy recording the strongest performance. By contrast, Dedicated Short Bias – one of the best strategies in the previous year's negative market environment – fared worst of all, with an almost inverse performance to Equity Leveraged strategies. Neither strategy fits into the overall picture of a segment whose strategies generally seek to make the most uncorrelated possible contribution to portfolio returns. The average returns of the Alternative Long/Short Equity strategy look the most convincing in the medium to long term, demonstrating consistent returns of 4.21% p.a. over three years and 3.04% p.a. over five years. The extremely broad spread of returns within individual strategies once again demonstrates that selecting the right manager is ultimately the only way for investors to succeed.

Alternative Equity Leveraged records best average performance



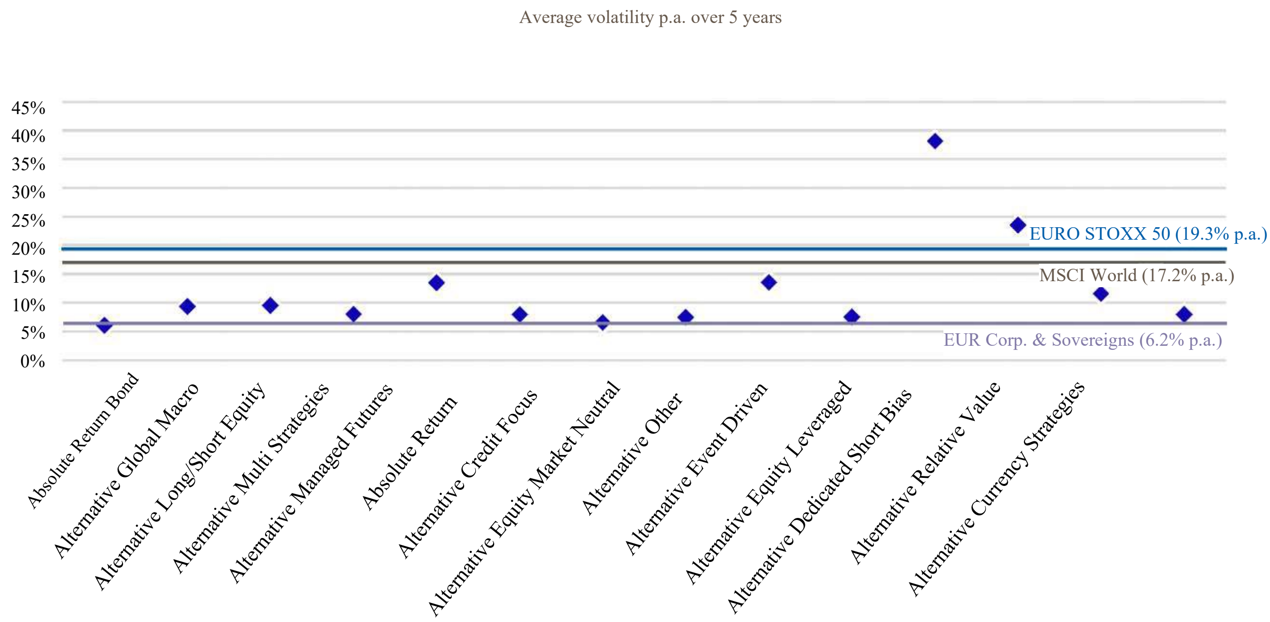
RISK ASSESSMENT

Liquid alternatives exhibit significantly lower fluctuations than equities

The strength of liquid alternatives lies in their ability to **reduce the intensity of fluctuations within a portfolio.** Over five years, most strategies in this segment succeed in keeping their volatility within a range of 5% to 15% (see chart). Average volatility across the entire segment is 9.62%, and as low as 8.4% excluding the leveraged and thus highly volatile Alternative Equity Leveraged and Alternative Short Bias strategies. Compared to traditional asset classes, volatility in the segment as a whole is close to that of European government and corporate bonds (approximately 6%) and well below the fluctuations recorded by European and international equities (EURO STOXX 19.3% p.a. and MSCI World 17.2% p.a.).

Naturally, leveraged equity strategies - the outliers from this range of moderate volatility - do not have this volatility-lowering effect on the overall portfolio. While **Alternative Equity Leveraged** suffered heavy losses during the coronavirus crash in particular, it generated above-average returns in the recent robust market environment, which means its volatility is high. The same logic applies to **Dedicated Short Bias** strategies, except for the fact that these strategies made gains during the coronavirus pandemic and relinquished some of these gains in the current environment of strong performance. There is also a significant spread of volatilities within these strategies, with some funds managing to keep volatility to only around 10% while others report fluctuations exceeding 40%. This reflects the funds' highly divergent risk profiles. The average volatility across all strategies is around 24%.

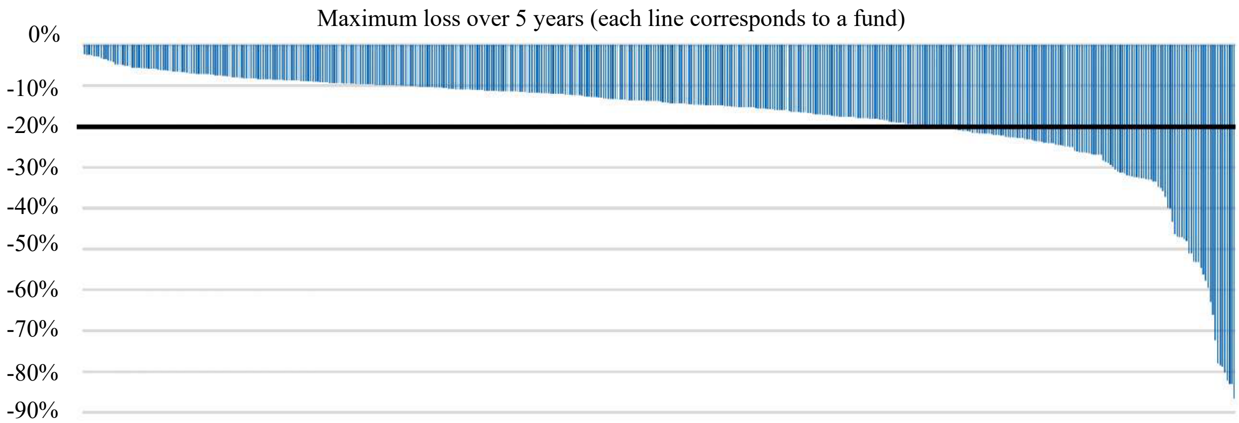
Strategies primarily fluctuate within a moderate range



Funds effectively limit maximum losses

Over five years – that is, including the slump triggered by the coronavirus pandemic – around **three quarters (73.97%) of funds managed to limit their maximum losses to 20%**. The average maximum drawdown was 17.4%. In this respect, liquid alternatives can play to their strengths not only by reducing volatility but also with regard to risk control. For comparison, here are the maximum drawdowns on established market indices: EURO STOXX 50: -25.34%; MSCI World (EUR hedged): -23.10%; Hedge Funds: -7.23%; EUR Corporates: -16.65%; EUR Sovereigns: -21.25%.

The average maximum drawdown over five years was 17.4%

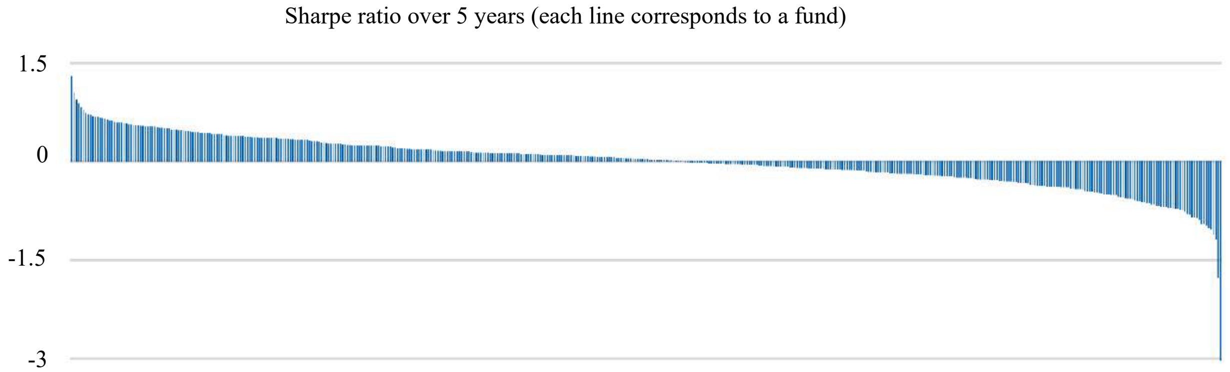


Half of funds have a positive Sharpe ratio

Almost half of all funds had a positive Sharpe ratio in the first half of 2023 (47.1%; 2022: 25%). This is all the more remarkable given that this key figure incorporates the rise in the risk-free interest rate. More than half of funds manage to generate a positive Sharpe ratio (53.3%) over a five-year period (see chart).

Over this period, 42 funds impressed with a Sharpe ratio of > 0.5, with two even boasting a Sharpe ratio of > 1. The Alternative Equity Leveraged and Alternative Equity Market Neutral segments in particular include many funds reporting good risk-adjusted long-term returns with a Sharpe ratio of > 0.5 (Equity Leveraged = 25% of funds and Market Neutral = 29% of funds). While Equity Leveraged strategies tend to generate healthy returns to offset their high volatility, market-neutral strategies primarily manage to generate risk-adjusted returns from a combination of robust returns and low volatility.

More than 53% of funds achieved a positive Sharpe ratio over five years



Costs largely unchanged

Costs have remained largely stable on average across all strategies since 2017, amounting to 1.50% in 2022 (2017: 1.62%). At 1.52%, they are currently in line with the long-term average.

Glossary

Absolute Return	Funds characterised by a highly regulated market environment and an absolute return target. They aim to add value in every market environment. They are usually measured against a risk-free or cash benchmark instead of a traditional long-only benchmark.
Absolute Return Bond	Funds that pursue positive return targets in all market situations and primarily invest in debt securities. Products with the words "Absolute Return" added to their name or investment objective may be included in this category. In this case, the benchmark is usually a risk-free or cash benchmark instead of a traditional long-only market index.
Alternative Credit Focus	Funds that invest in structured credit products and whose investment process is characterised by either fundamental credit analysis, quantitative approaches or (market) opportunities.
Alternative Currency Strategies	Funds that invest in global currencies to exploit arbitrage opportunities (carry, momentum, fundamental opportunities). They use short-dated money market instruments and derivatives to achieve their objectives. Funds that invest the majority of their assets in cryptocurrencies also fall into this category.
Alternative Dedicated Short Bias	Funds that maintain a net short profile on the market on an ongoing basis. This category also includes funds that exclusively take short positions.
Alternative Equity Market Neutral	Funds seeking to generate consistent returns regardless of market phases. The portfolio is also managed with a net market exposure of zero.
Alternative Event Driven	Funds that aim to exploit price inefficiencies caused by a business transaction (e.g. insolvency, acquisition, spinoff, etc.) in accordance with their sales prospectus. Event-driven funds can invest in a variety of instruments with different risk structures (e.g. equities, credit instruments, derivatives).
Alternative Global Macro	Funds that make global investment decisions based on economic theories. These strategies typically base their decisions on interest rate expectations, expectations concerning political developments, and other macroeconomic and systemic factors. Global macro funds typically use a wide range of instruments and investment universes to implement their investment ideas.
Alternative Long/Short Equity	This strategy uses both long and short positions in equities, equity options and equity index options. The portfolio manager can decide whether the net position of their fund is positive or negative depending on their market view.
Alternative Managed Futures	Funds that primarily invest in a portfolio of futures contracts and aim to generate positive returns that are independent from the market in any situation with limited volatility. Their investment approaches consist of proprietary trading strategies that can include both long and short positions.
Alternative Multi Strategies	Funds that aim to generate an overall return by managing several different hedging strategies. These funds typically follow a quantitative approach and seek to identify opportunities where there are changes to the long-term risk-adjusted relationship between two securities.
Alternative Relative Value	These funds use option and arbitrage strategies on highly correlated pairs of securities to exploit price differentials. In such cases, the funds sell the more expensive security (short position) while taking a long position in the relatively cheap security.
Alternative Equity Leveraged	Funds designed to generate more than 100% of the daily performance of a benchmark index. They use a customised combination of futures contracts, derivatives and leveraged products to achieve this.

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About Lupus alpha

As an independent, owner-operated asset management company, Lupus alpha has been synonymous with innovative, specialised investment solutions for over 20 years. As one of Germany's European small and mid-cap pioneers, Lupus alpha is one of the leading providers of volatility strategies as well as collateralised loan obligations (CLOs). Global convertible bond strategies complete its specialised product range. The Company manages a volume of approximately EUR 13.5 billion for institutional and wholesale investors.

For further information, visit www.lupusalpha.de.

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