Lupus alpha

Absolute Return and Liquid Alternatives in Germany

# Riding out the crisis with asymmetric strategies

With an average performance of -1.65%, liquid alternatives significantly outperformed equities and bonds in the first half of 2022. Short strategies are showing their strength in the current market environment, while pure long exposures are generating negative returns for their investors again for the first time in a long period. Asymmetric strategies that limit losses currently have the edge.

## About the Study

Since 2008, Lupus alpha has been evaluating the universe of absolute return and liquid alternatives funds on the basis of data from Refinitiv. The Study covers funds with an active management approach that are authorised for distribution in Germany and are also UCITS-compliant. 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 16 strategies. For example, the Long/Short Equity strategy includes 99 funds.

## Summary

**UCITS-compliant hedge fund strategies have proven successful in the current crisis and are demonstrating their diversification benefits compared to other asset classes. Although they recorded a slightly negative performance of -1.65% (as of 30 June) in the first half of 2022, they fared considerably better than the global equity markets, the bond segment and their unregulated counterparts, traditional hedge funds. The average performance of the evaluated strategies ranges from -20.0% (Equity Leveraged) to +19.1% (Dedicated Short). The results of individual funds within both of these market segments are widely scattered, while those of funds in most other segments are much more closely correlated. Strategies with a net short profile significantly outperform the others and have been able to benefit from a negative market environment in which almost all relevant asset classes have posted losses since the start of the year. Although liquid alternatives funds have been unable to avoid slipping into the red entirely on average, most are not far below zero. Generally speaking, asymmetric strategies that are less dependent on the direction of the market, such as Alt. Managed Futures or Alt. Relative Value, generated positive returns.**

**A net EUR 7.5 billion of capital flowed out of the investment universe, representing almost half of the strong inflows recorded in 2021 (EUR +15.5 billion). This development is surprising to say the least given the relatively strong performance within this universe. While many investors are clearly not prepared to monitor the impact of this asset class on the portfolio mix, these outflows could also be explained by the liquidity requirements of institutional investors, as it is simpler from a psychological perspective to dispose of the assets that will realise the smallest losses.**

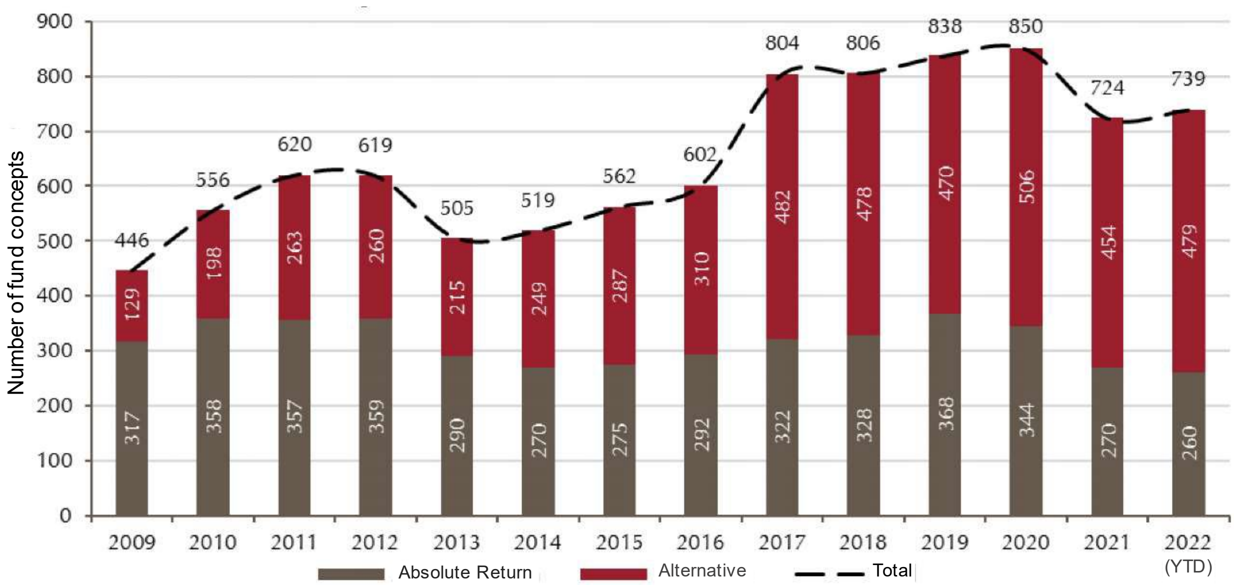
**The number of funds within the investment universe rose modestly to 739 (+15), including six newly-launched funds. This, together with an average performance that was only slightly negative, meant that the total volume in this asset class remained virtually unchanged at EUR 256.4 billion.**

## MARKET DEVELOPMENT

### Number of funds remains stable amid the crisis

The range of fund concepts on offer increased slightly (+2.1%) to 739. This figure is remarkably stable given how the current market situation is severely testing many approaches, and shows that this asset class can navigate critical market phases relatively well.

**Number of funds rises marginally in challenging market environment**




### Market volume declines only moderately

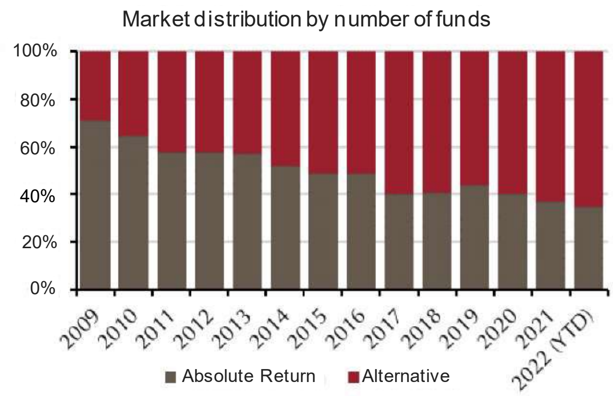
Despite a negative performance (-1.65%) and considerable net outflows (EUR -7.5 billion), volumes in this asset class decreased only slightly to EUR 256 billion (-0.8%) due to statistical changes in the fund universe. Of this total market volume, alternative funds account for EUR 166.4 billion (+2.3%) with EUR 90 billion (-6.0%) attributable to absolute return funds.

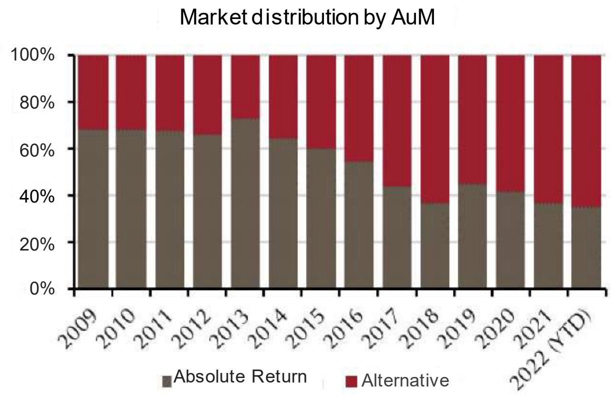
**Liquid alternatives strategies make gains as absolute return funds record losses**

## Alternative strategies consolidate their dominance

Liquid alternatives funds are rising further in investors' appreciation thanks to their broad spectrum of products and strategies. By contrast, the proportion of absolute return funds has fallen in both absolute and relative terms every year since 2019 and is now at its lowest level since 2012, with volumes of EUR 68.8 billion. As of the reporting date, the overall market of 739 funds comprised 479 alternatives and 260 absolute return funds.

**Absolute return funds steadily losing market share since 2019**

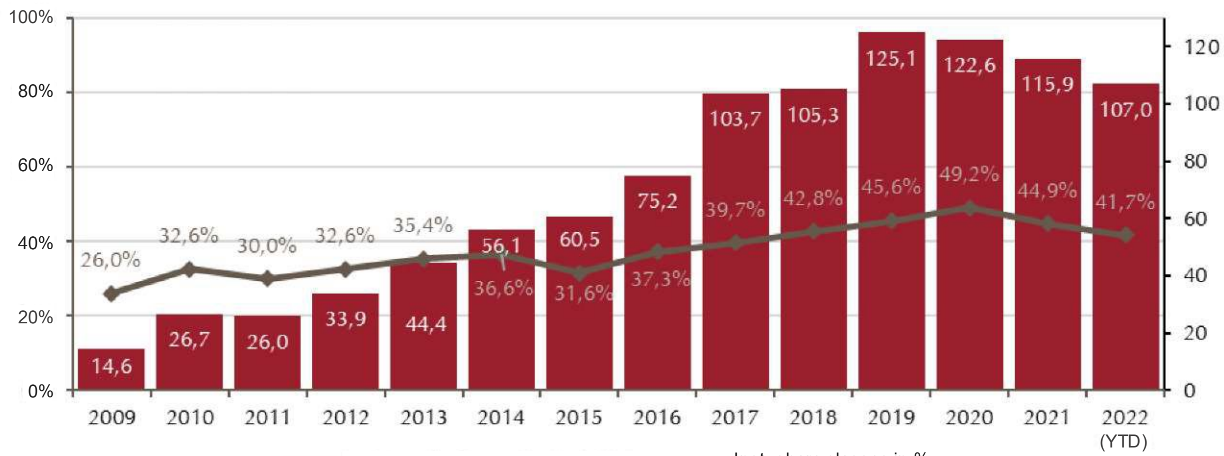



## Institutional investors becoming increasingly restrained

The market share of institutional share classes declined for the second time in a row to 41.7%. The volume of these share classes also fell by 7.7% to just under EUR 107 billion, dropping for the third successive year since reaching their peak in 2019. This decline is significantly more marked than in the asset class as a whole (-0.8%) and was the highest in absolute terms since the Study began in 2008. It is clear that, relatively speaking, institutional investors have considerably reduced the proportion of liquid alternatives investments they hold.

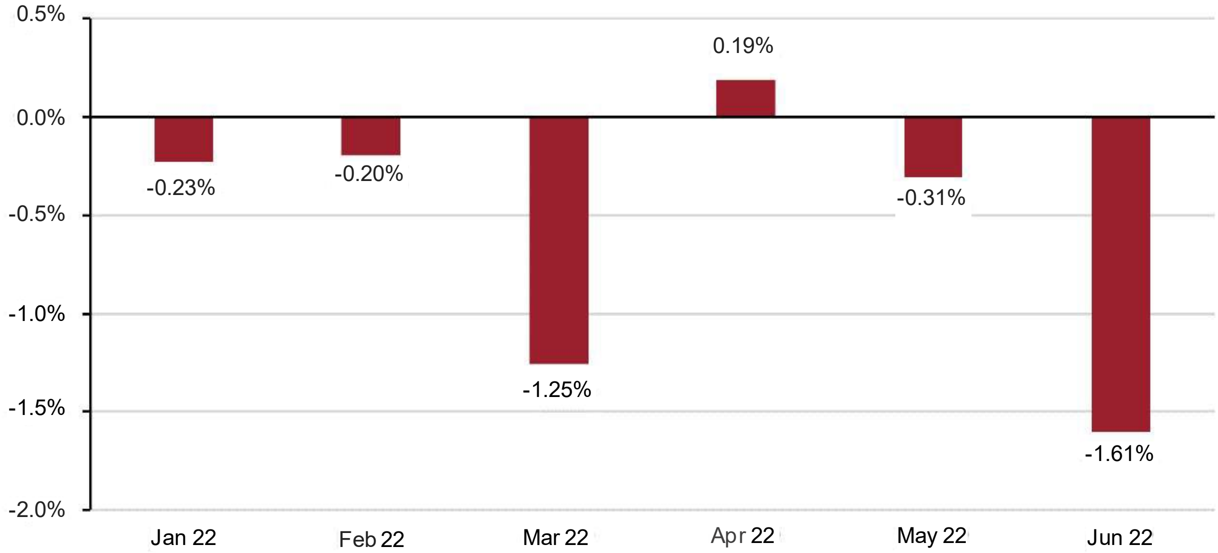
**Volume and share of institutional share classes falls for third successive year**



## Investors realigning their asset allocation at the end of each quarter

The net outflows of EUR -7.5 billion at asset class level were unevenly distributed across the first half of the year, with significant fluctuations at the end of the first and second quarters. This pattern suggests that investors are making divestments due to their rebalancing and reporting requirements.

**Significant net outflows recorded in most months**

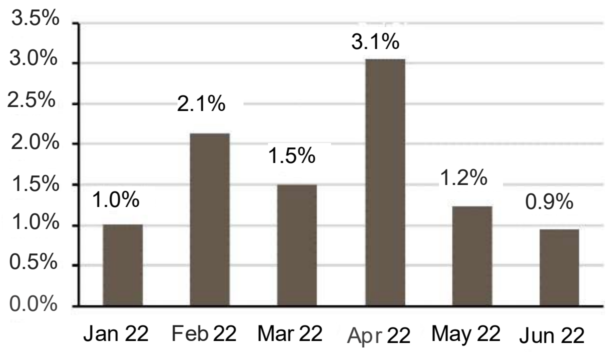



## Alt. Equity Market Neutral becomes investor favourite

We will now take a look at two strategies whose inflows and outflows are particularly striking in the current market environment: Equity Market Neutral and Alt. Credit Focus.

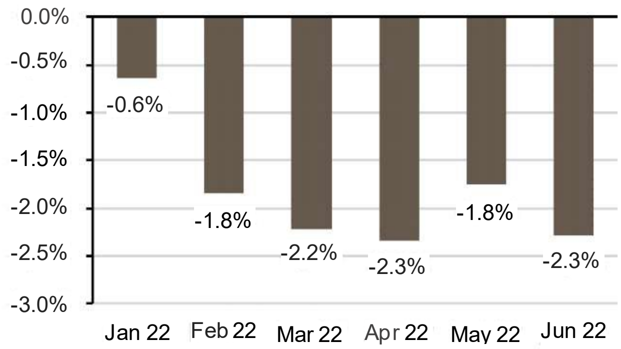
**TOP: Alt. Equity Market Neutral**

Market-neutral equity strategies are enjoying considerable popularity in an uncertain market environment, recording steady inflows in every month of the current calendar year and generating a positive return on average (+3.1%).




**FLOP: Alt. Credit Focus**

Meanwhile, investor focus is moving away from alternative credit strategies amid rising interest rates and high levels of inflation. Although these strategies were still able to record inflows in the first quarter of 2021, capital has been flowing out of them constantly since the start of this year.



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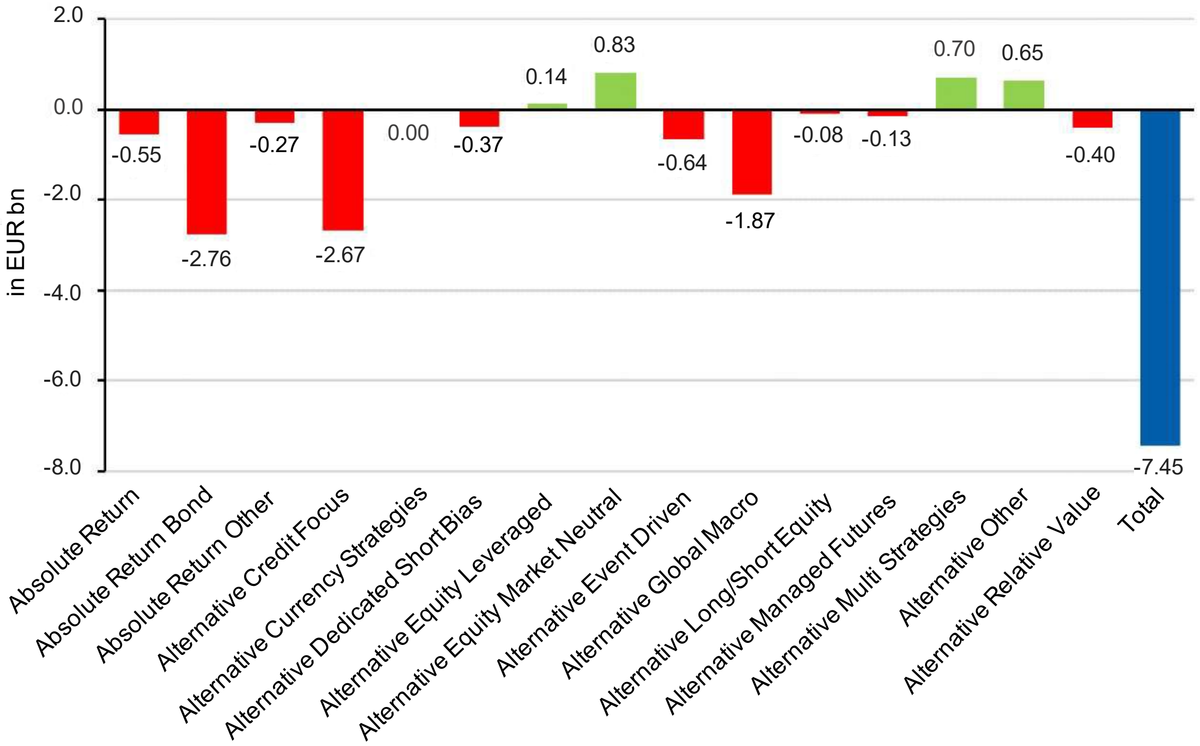
| As a result, the Alt. Equity Market Neutral (EMN) segment amassed +12.53% in new capital in the first half of the year, equivalent to an absolute increase of EUR 0.8 billion. | Amid growing fears of a recession, Alt. Credit Focus lost EUR 2.67 billion of its capital (-6.92%) and delivered a disappointing average return of -3.83% for its investors. |

## Net outflows primarily affect bond and credit strategies

The development of net funds provides a much more diverse picture compared to the previous year's analysis. Compared to inflows of EUR 15.5 billion across the whole of last year, the first half of 2022 looks extremely weak, with around half of 2021 inflows, or EUR 7.5 billion, already flowing out again. One of the biggest losers from this trend was the AR Bond strategy, which had already begun suffering considerable outflows in the fourth quarter of 2021. By contrast, Alt. Credit Focus was among the winners from the final quarter of last year, presumably because its variable interest rates and short terms were appealing in a world of rising interest rates. Although the benefits of such strategies remain unchanged, their variable interest rates provide no protection against inflation. However, this has had a much stronger impact than originally anticipated so far this year, significantly impacting the bond markets. It is also clear that strategies in the Alt. Credit Focus area could no longer escape this trend.

**Substantial differences in changes in net flows at strategy level**

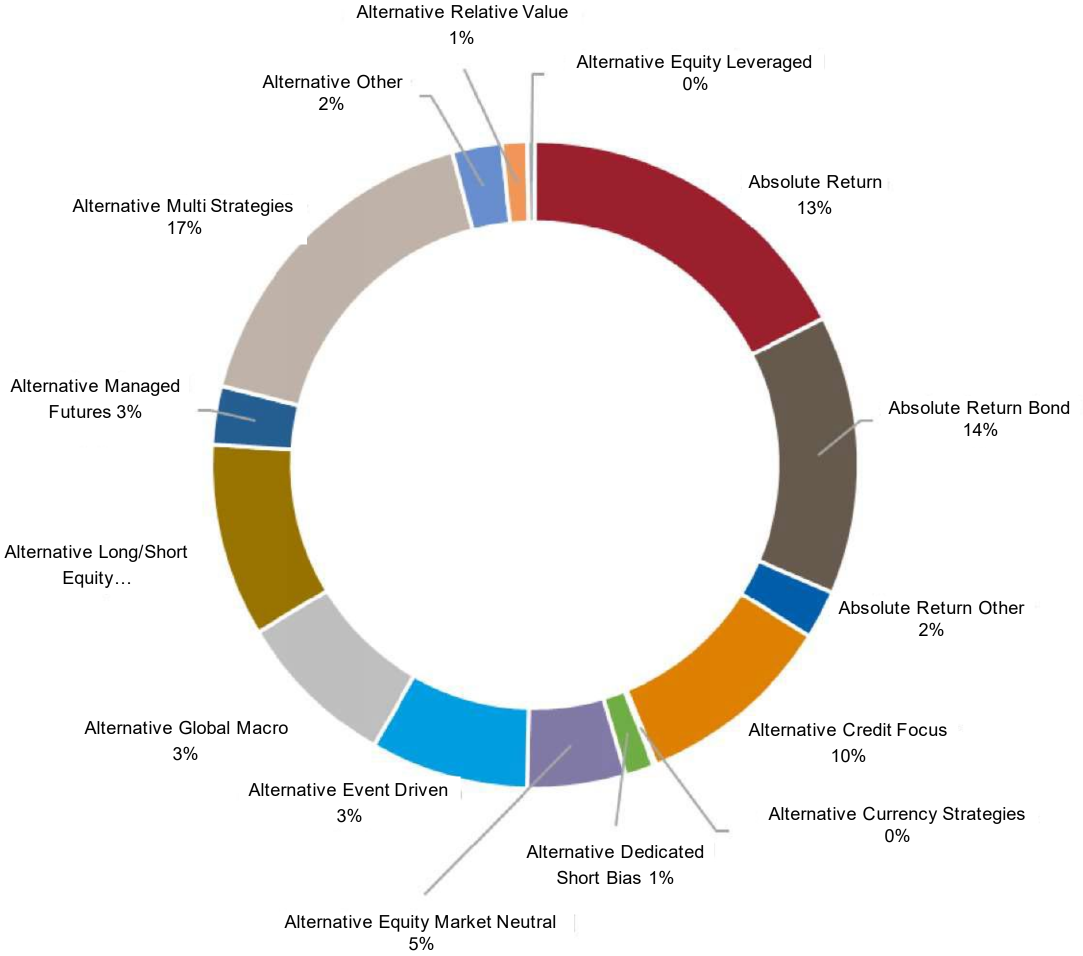



## Absolute Return is the largest individual strategy

Fixed-income strategies (AR Bond: 14% + Alt. Credit Focus: 10%) make up around 25% of the evaluated universe, while Absolute Return is the strategy with the largest share of assets under management at 18% (strategy definitions can be found in the glossary at the end of the Study). By contrast, the smallest seven strategies combined only make up one-tenth of the overall market. The distribution between individual strategies has hardly changed compared to the end of the previous year. The only striking development is the reduced share of Alt. Credit Focus, which has fallen from its previous level of 15% to just 10%. This development is consistent with the outflows from this strategy (see Top/Flop Strategies chart on previous page).

It is worth noting the steady growth in Alt. Multi Strategies, which managed 9.98% more capital as of 30 June than at the same time last year and is now just EUR 1.2 billion behind Absolute Return, the largest strategy in this segment.

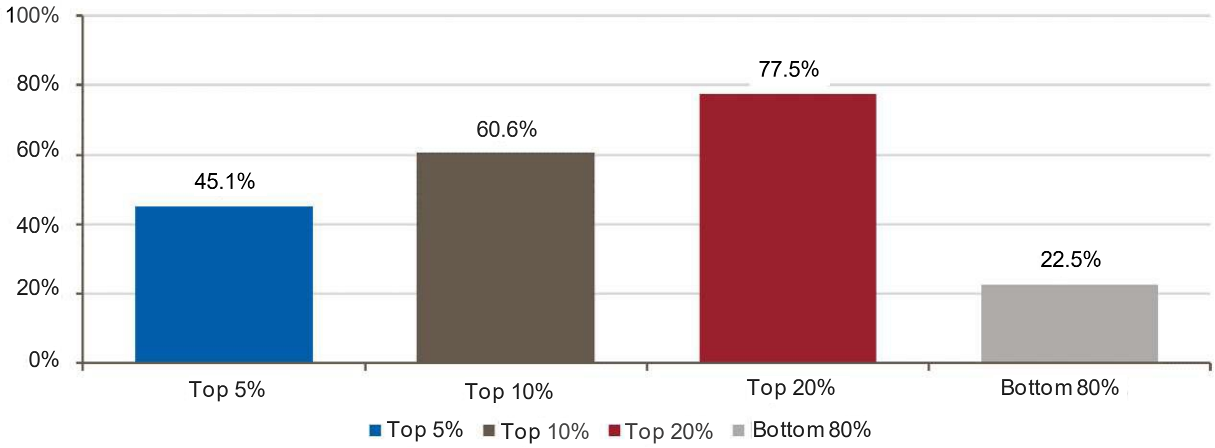
**Market share: fixed-income strategies make up one quarter of market**




## Large funds remain the dominant providers

The top 5% of funds manage more than 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 94.6% of capital in the segment while the lower half of funds manage barely 5% of all assets.

**More than 45% of fund volume still attributable to 5% of funds**




## Liquid alternative strategies leave other asset classes trailing in their wake

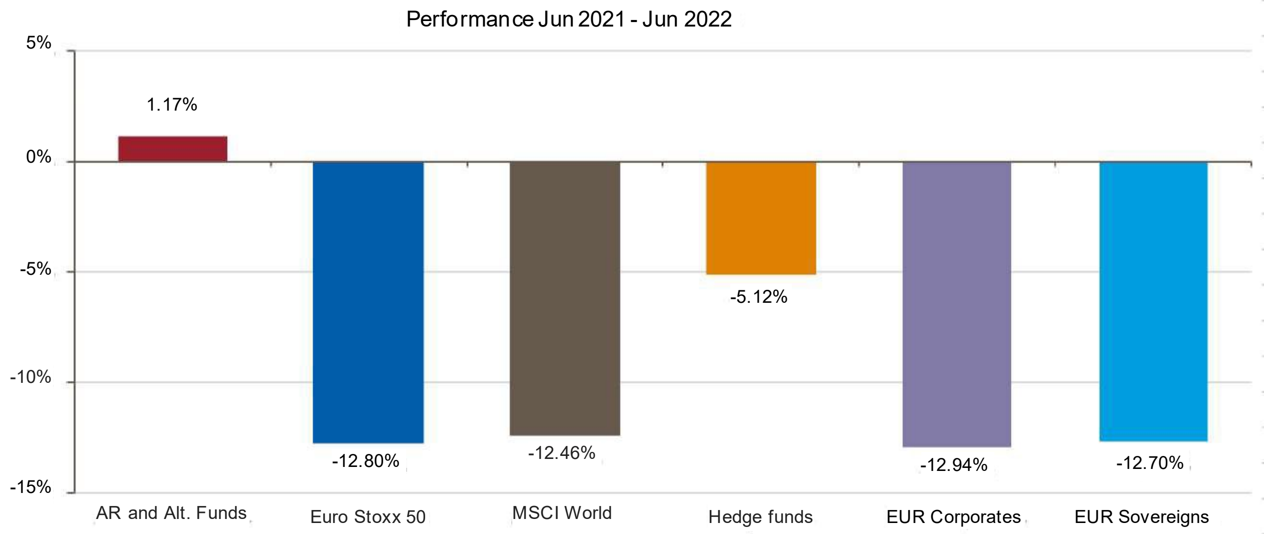
Portfolio diversification was at the top of the agenda for investors in the first half of 2022 thanks to Absolute Return and Liquid Alternatives strategies. Although these strategies ended the period under review with a modest loss of -1.65%, they significantly outperformed all other asset classes to keep losses at the overall portfolio level to a minimum.

**Liquid Alternatives faring better in the crisis**

## Major asset classes lose all of their gains from the previous year

Liquid alternatives were the only asset class from a comparable group of equities, bonds and unregulated hedge funds to record a gain over the past 12 months. However, this also means that the other asset classes have now completely eroded the gains they made in the strong second half of 2021.

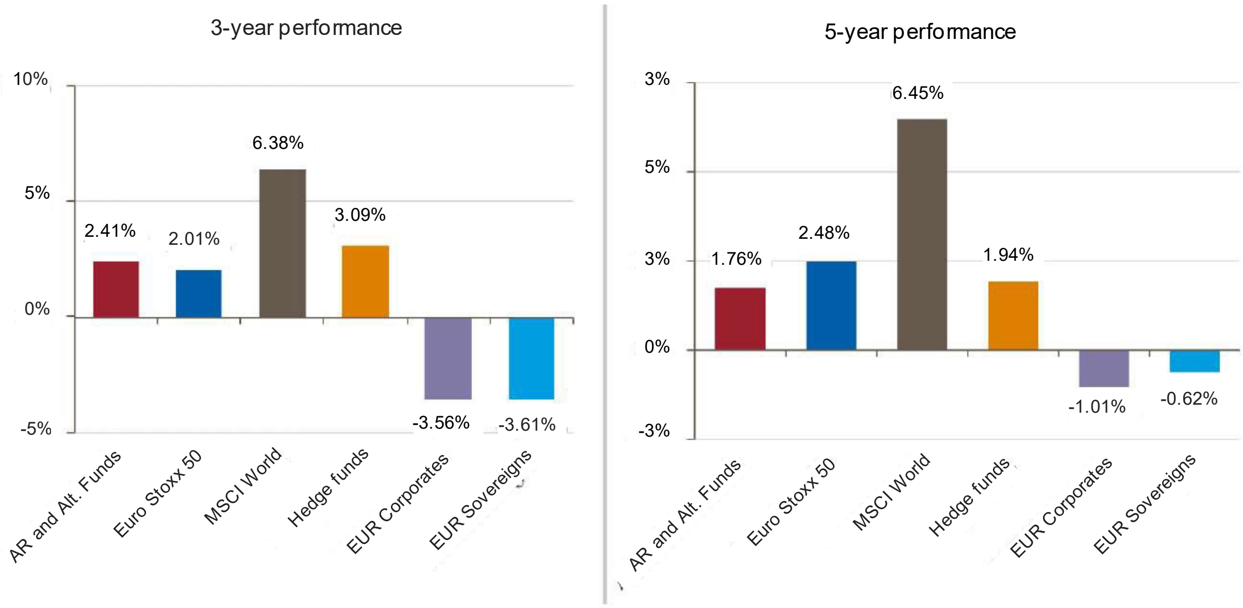
**Liquid alternatives also ahead – and making gains – over 12 months**




## Liquid alternatives also better than bonds in the long term

The picture for liquid alternatives has also improved considerably in relative terms over a three and five-year period, with significantly higher returns compared to bonds. If the current downturn has yet to reach its lowest point, resulting in further losses for the rest of the year, the long-term performance over three and five years could shift even further in favour of liquid alternatives.

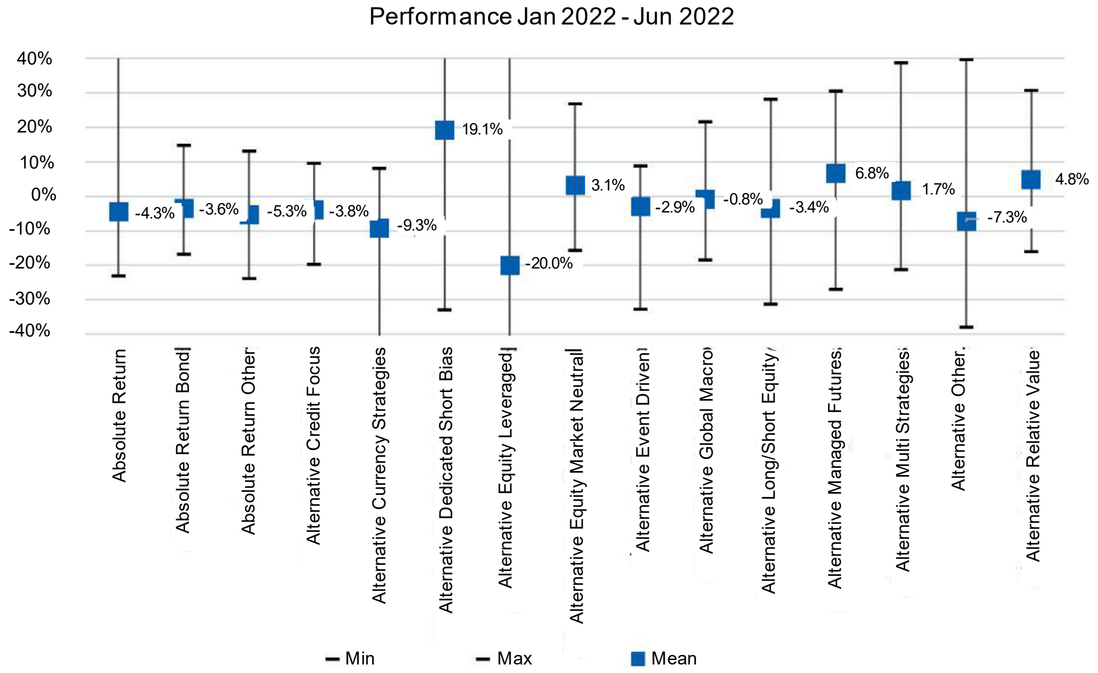
**Liquid alternatives also ahead – and making gains – over 12 months**



## Strategy analysis: asymmetric approaches have the edge

The following chart compares the half-year performance of the different strategies in the segment, with a blue square denoting the average for each strategy. The chart clearly shows that only a few strategies have been able to generate positive returns on average, namely Multi Strategies, Managed Futures, Dedicated Short, Equity Market Neutral and Relative Value. What all of these strategies have in common is that they are not purely directional strategies, which means they are less dependent on the direction of the market. The only exceptions to this rule are Dedicated Short strategies, which have benefited considerably from the current market environment and have generated a remarkable average return of 19.1%.

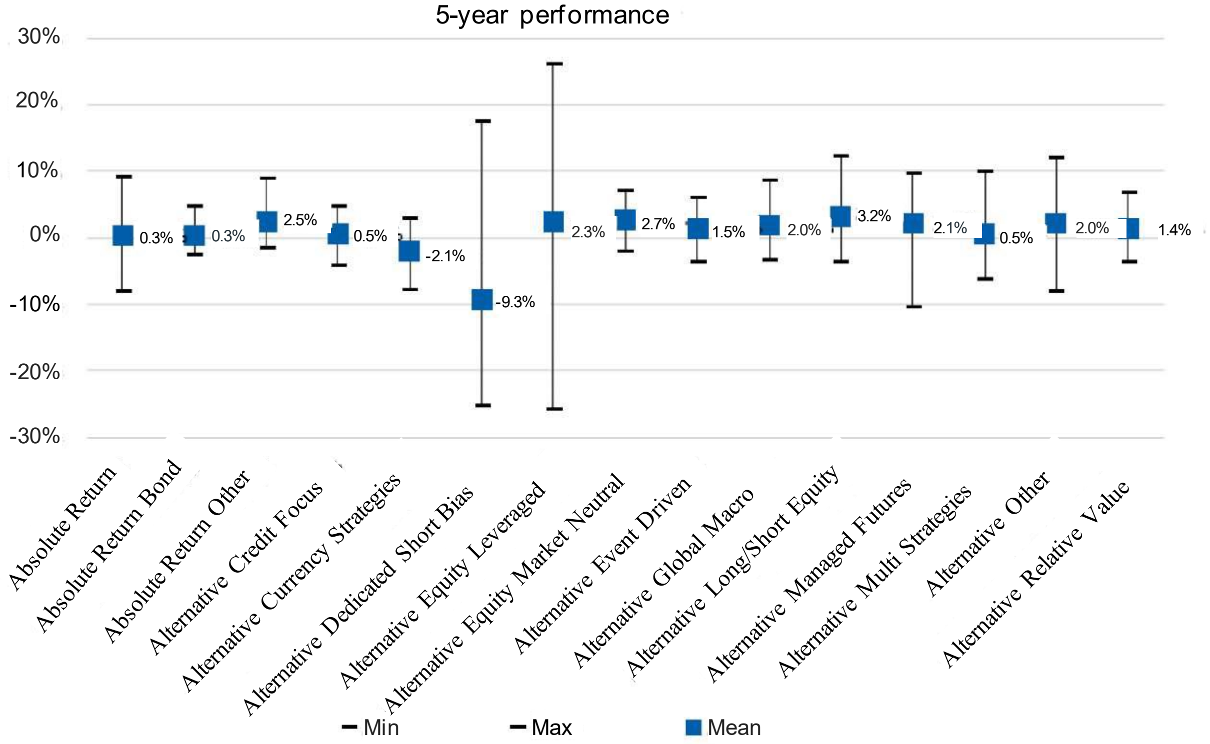
**Short strategies post strongest average performance in first half of 2022**




## Current winning strategy Alt. Dedicated Short Bias bringing up the rear over the long term

Despite their broad appeal to investors in the current calendar year, Alt. Dedicated Short strategies have not performed so well in the generally favourable market environment of the past few years, trailing well behind all other approaches on average over a five-year period. In addition, the variation in returns between these strategies is exceptionally large, not just over the long term but also during the period under review, while the spread of returns among funds in the Alt. Equity Leveraged segment is even broader. At the same time, it is apparent that the average annualised performance of the various strategies was much more closely correlated over a longer observation period.

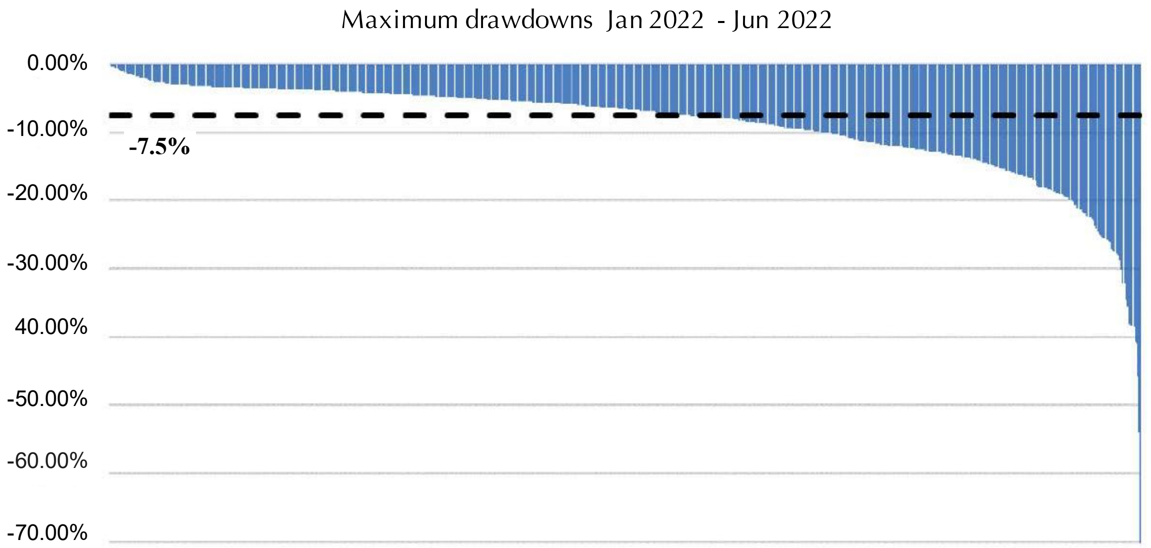
**5-year performance: the longer the observation period, the more closely correlated the strategies are.**




## Maximum drawdowns lower than during the coronavirus crisis

At -8.96% on average, the maximum drawdowns for liquid alternatives were well below those of the MSCI World (-19.14%) during the first half of 2022 and were also lower than over a five-year period (-17.21%). This suggests that most funds recorded a bigger maximum loss at least once over a five-year period. It goes without saying that this primarily happened in 2020 as a result of the dramatic slump caused by the coronavirus outbreak in March of that year. According to these figures, these funds are much better positioned in the current crisis than they were two years ago. Funds with a maximum loss of no more than -7.5% (dashed line) merit closer consideration, as it was easier for them to return to a positive return. The following section discusses this in more detail.

**Of 739 funds, 417 were able to limit their losses to a maximum of -7.5%**



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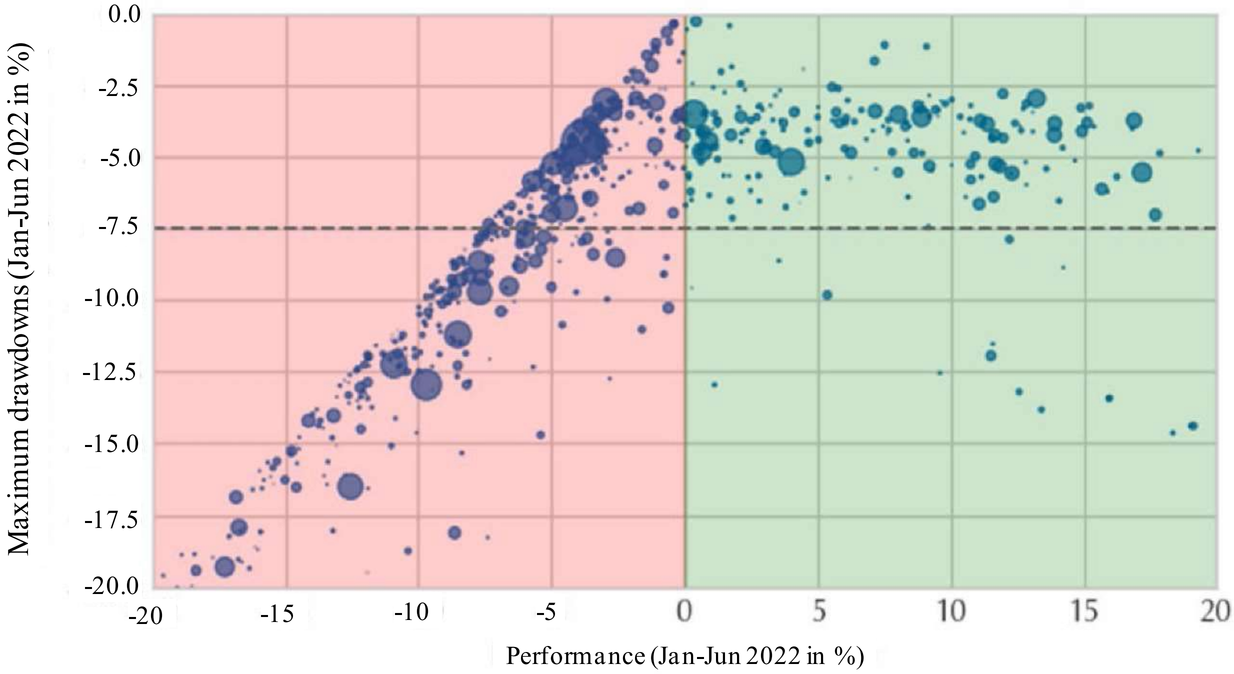
### Loss limitation and asymmetric risk profile encourages positive performance

The first priority for anyone seeking to generate positive returns in the first half of 2022 was to effectively limit their losses. Only a very small number of funds that were forced to absorb maximum losses in excess of -7.5% were able to return to profitability (see green area of chart below) by the 30 June reporting date. In the current market environment, this means it can be worthwhile to invest in fund products with an asymmetric return profile that prioritise some kind of capital preservation and do not lose sight of this objective even after several strong years for the equity market. However, it is vital to ensure that these funds do not trigger a cash lock – a situation in which the risk budget is fully used up and investors can no longer participate in a market recovery.

**Maximum drawdown and performance of individual funds (dot size denotes fund volume)**



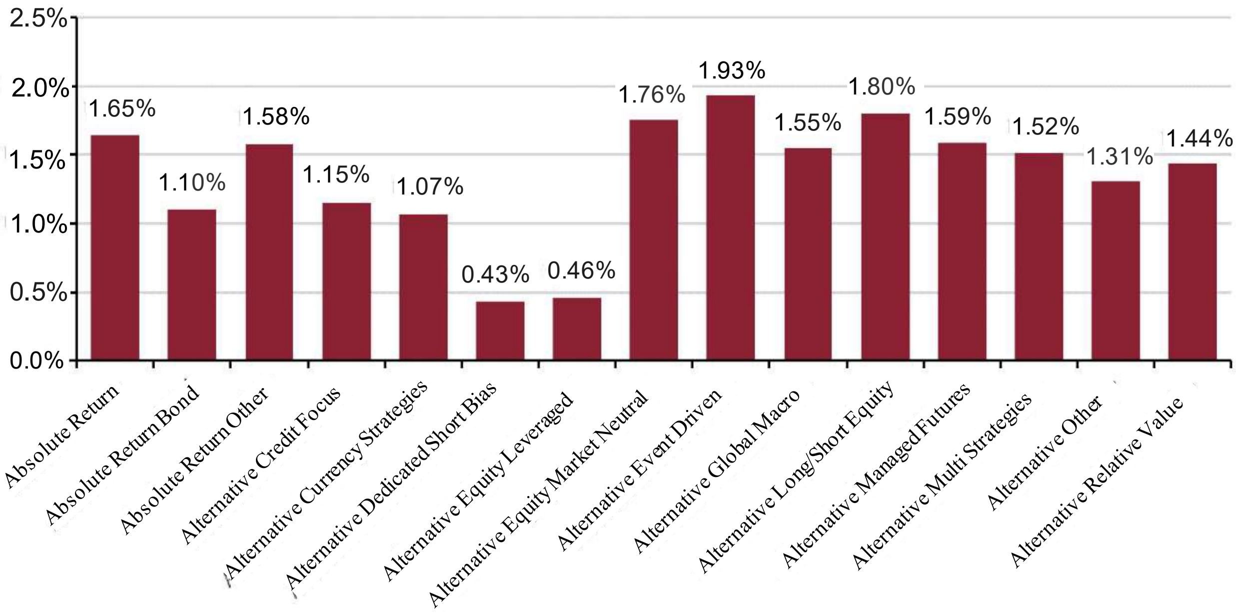

### Almost a quarter of funds with positive Sharpe ratio

Overall, 24% of funds achieved a positive Sharpe ratio to deliver on their product promise. Loss-limiting strategies with asymmetric risk profiles also excelled in this regard. Where funds did well, they often did very well indeed, with 14.4% achieving a Sharpe ratio of more than 1. More than half of funds delivered on their product promise to achieve a positive Sharpe ratio over a five-year period.

### Costs largely unchanged

Costs have remained largely stable on average across all strategies since 2018, amounting to 1.56% in 2021 (2017: 1.62%). While this figure is currently slightly lower at around 1.52%, it is still in line with the long-term average. There are more significant differences between strategies depending on the investment-related risks of each strategy.

**Average TER by strategy: higher risk, higher costs**




## Glossary

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| **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.<br>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 in line with their sales prospectus 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 classification 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. |

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| **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, according to their sales prospectus, 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** | They 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 15.0 billion for institutional and wholesale investors.

For further information, visit www.lupusalpha.de.



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