Absolute Return and Liquid Alternatives in Germany

Investor confidence returning

Absolute return and liquid alternatives funds recorded significant inflows overall in the first half of 2021. Despite this, almost one in two funds shrank. Investors generally preferred lower-risk strategies. The largest funds continued to consolidate their dominant position in the market.

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.

Summary

Active, UCITS-compliant absolute return and liquid alternatives funds generated an average return of 4.24% in the first half of the year. At individual strategy level, Alternative Long/Short Equity US recorded the best performance at over 10% on average across all managers. AR EUR High funds showed the broadest spread with returns within a range of -15.57% and +25.36% as well as Alt. Multi Strategies between -3.78% and +37.47%.

While funds with a volume of more than EUR 1 billion only generated returns of 3.57% in the first half of the year, smaller funds lifted the average in the investment segment markedly with a performance of 4.27%. Over a five-year period it becomes clear that, with a few exceptions, the returns of the billion-euro funds move within a relatively narrow range of between zero and five per cent. On the other hand, while the results of smaller funds are more widely scattered, this means they also provide opportunities for bigger returns. In this case, investor success depends to a large extent on successful manager selection.

Assets under management across the entire segment have risen by EUR 54 billion since the start of the year, passing the EUR 300 billion mark for the first time to reach their highest level since this Study began. With a gain of 9.2%, the main beneficiaries of this were the top 5% of funds, all of which are larger than EUR 1 billion and are predominantly managed by large German and international managers with good brand recognition and a correspondingly strong sales offering.

It is interesting to note that, despite significant inflows in the segment as a whole, almost half of all funds (45%) recorded outflows. At individual strategy level, AR Bond strategies built on their existing dominance to expand their market share to almost 34%.

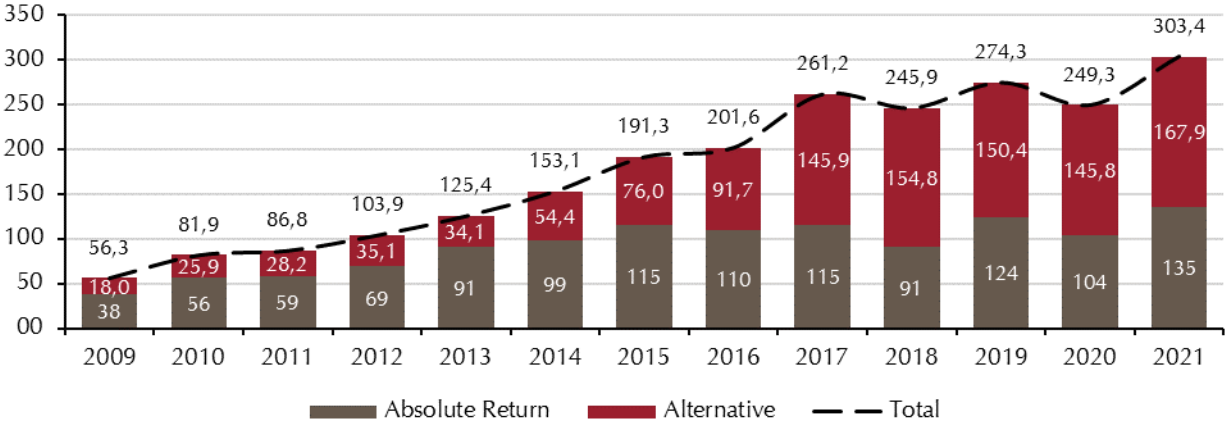
The results in detail

MARKET DEVELOPMENT

Market volume reaches record high

Assets under management within the segment rose by 21.7% overall in the first six months of the year. This positive development was driven by both a favourable market environment as well as the **return of investors** to this asset class. The total volume of EUR 303.4 billion represents a record high for investor funds under management in absolute return and liquid alternative funds.

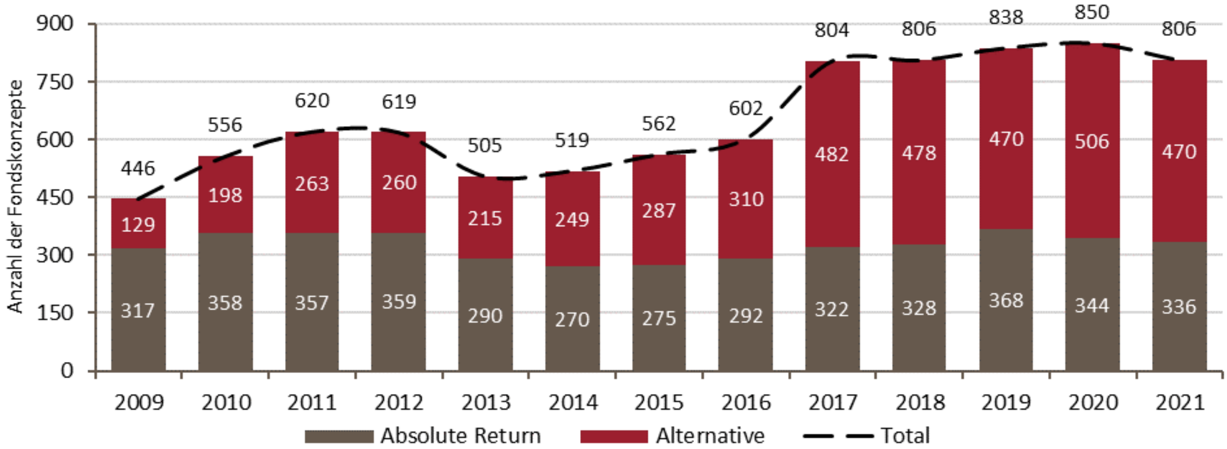
Development of market volume



Number of fund concepts plateaus

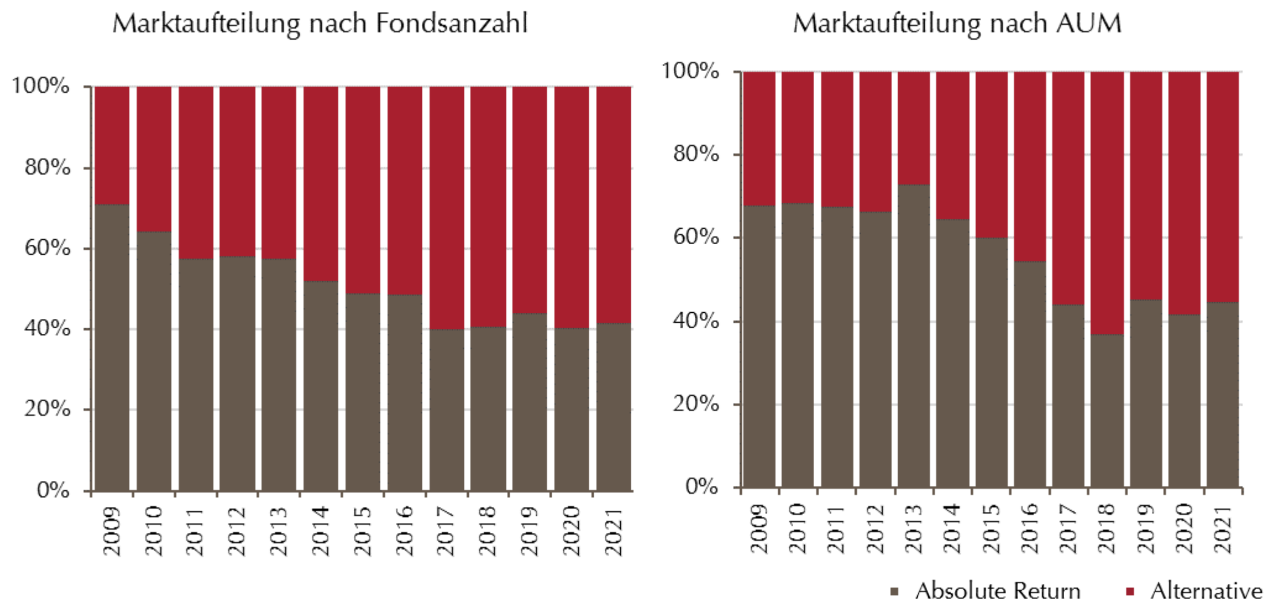
Although the number of fund concepts fell by 5.2% in the first half of the year, it continued to plateau as it has done since 2017. The fact that 412 of the 806 funds have been on the market for five years or more allows for a more in-depth analysis of fund size and returns that will be carried out later (from page 7).

Development of number of funds



Relationship between absolute and alternatives strategies strengthened

A certain degree of stabilisation is evident in the market distribution of absolute return and liquid alternatives strategies. There has been a clear shift towards alternatives in terms of market share since this Study began in 2008. The market distribution now appears to be settling down at a relatively stable ratio of **roughly 60% alternatives to 40% absolute return**. This would bring the trend observed since the early 2010s to an end for the time being. This observation applies to both the distribution of the fund concepts on offer (left) as well as the assets under management in each case (right).

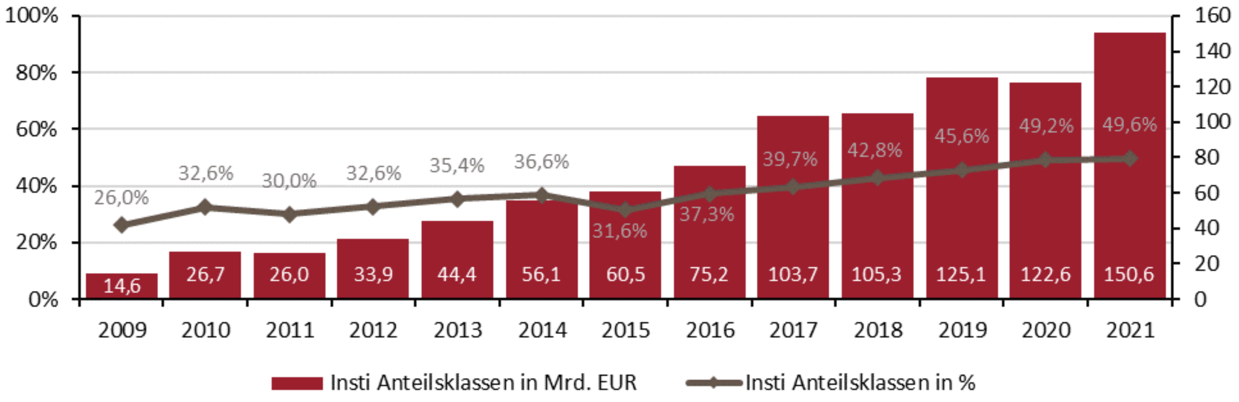


While liquid alternatives strategies can pursue very different goals, absolute return funds generally aim to generate a positive average return over a predefined period such as three or five years, for example. The reduction in safe interest rates to zero or even lower has made it difficult to maintain this standard, which could explain the sharp **decline in volumes for these concepts since around 2014**. The fact that the average fund – but by no means every fund (see page 10) – has nonetheless managed to fulfil its promise to its investors over the past five years could explain the stabilisation that is now emerging.

Share of institutional investors nearing 50%

The volume managed in institutional share classes reached a new high of EUR 150.6 billion, while the share of institutional investors rose by 0.4 percentage points in the first half of 2021. This 22.8% growth in institutional share classes is higher than the aforementioned 21.7% overall growth in the asset class. The recent slight flattening of the curve again after the increase in share leads us to expect that the share of funds invested in institutional share classes could stabilise at **around half of the overall volume**. It remains to be seen whether this expectation will be confirmed in the future.

Distribution of private/institutional investors

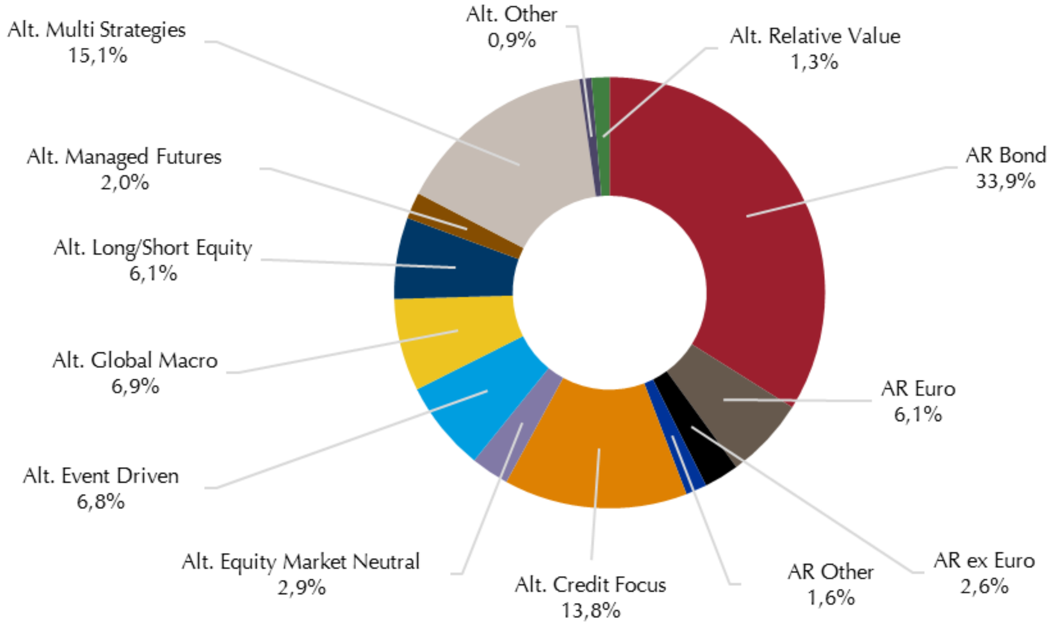


MARKET SHARE OF STRATEGIES

Absolute return bond strategies make up one-third of the segment

With 408 funds, more than half of all managers focus on six different strategies: AR Euro Medium; AR Euro Low; AR Bond USD; Alt. Long/Short Equity; Alt. Credit Focus and Alt. Multi Strategies. When breaking down strategies by volume, AR Bond strategies now have a market share of almost 34% after high inflows, which means they now make up more than a third of the entire segment. **Among the other strategies to make market share gains were** Alt. Multi Strategies with an increase of 2.2 percentage points and Alt. Event Driven, which rose by 1.2 percentage points. Although AR Other strategies increased their market share significantly to 1.6%, they did so from a previous level of just 0.1%. The market share of the other strategies stagnated or declined.

Market share of strategies within the analysed fund segment (by assets under management)



Some of the strategies analysed later in this Study (from page 10) are bundled together in the pie chart to provide a better overview (e.g. Absolute Return Euro High/Low/Medium with AR Euro).

FUND INFLOWS AND OUTFLOWS

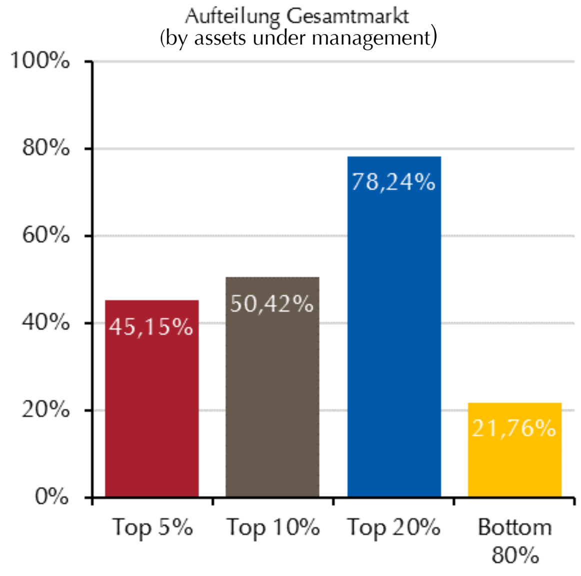
Only a few strategies recorded net outflows

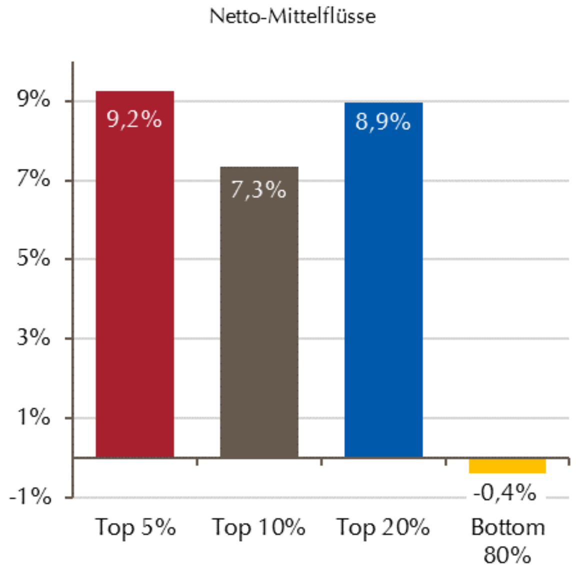
Fund flows do not give a clear picture, even though a certain shift towards lower-risk strategies can be identified. Only three strategies recorded outflows.

Top 5 inflows	Top 5 outflows
Alternative Event Driven	Absolute Return Euro
Absolute Return Bond	Alternative Equity Market Neutral
Alternative Multi Strategies	Alternative Other
Alternative Global Macro	--
Alternative Long/Short Equity	--

Large funds continue to increase their dominance despite below-average performance

As in previous years, a few very large funds dominate a large part of the overall market, with the largest 20% of funds managing 78.2% of total capital as of 30 June. These larger funds consolidated their advantage further in the first half of 2021, with the quintile containing the largest funds responsible for positive net inflows of 8.9%. **The largest 5% of funds recorded particularly high inflows** with above-average growth of 9.2%. The heavyweights at the very top of the tree exert a particularly strong pull on investors, even though their performance of 3.3% in the first half of the year was slightly down on the top 10% and 20% (3.9%) and well short of the segment as a whole (4.24%).





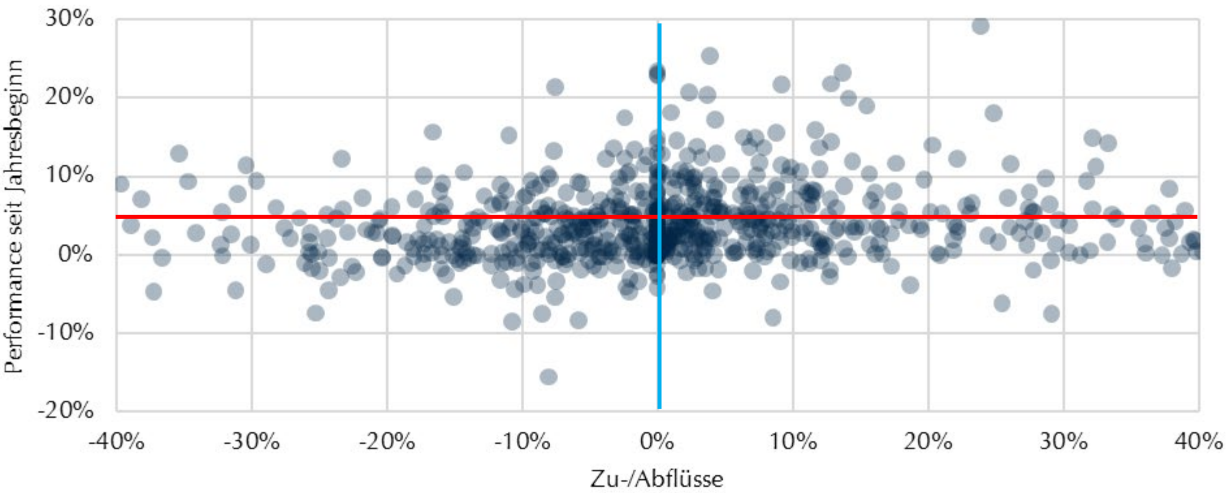
Investors prefer large funds from asset managers with well-known brand names

The managers overseeing funds in the top 5% are almost entirely made up of large German and international companies with well-known brand names. As a result, their growth is also attributable to the **sales capabilities of these providers**. In addition to brand and size, investors are also interested in a fund's track record: all 40 funds in the top 5% are larger than EUR 1 billion and at least five years old. Overall, there are 49 funds in the segment with a volume of more than EUR 1 billion, and every single one of them is more than five years old.

Extensive redistribution within the segment – 45% of all funds record outflows

The following dot chart illustrates the extent to which positive fund performance was accompanied by inflows or outflows. For this purpose, we are comparing net flows (x-axis) with performance since the start of the year (y-axis).

Fund flows in relation to performance (YTD)



- **Above the red line** are the funds that generated positive returns in the first six months of the current year. The majority of funds (83.4%) sit in this area.
- **Right of the blue line** are the funds that were rewarded with positive net flows; they make up a significantly lower proportion of the total at 55.0%.
- **In the top-right quadrant** are the funds that recorded both a positive performance and inflows. This category contains just under half of all funds (49.6%).
- **The top-left quadrant** shows the funds that experienced outflows despite recording a positive performance – 33.6% of all funds. This means that one in three funds was forced to cope with fund outflows despite performing positively.

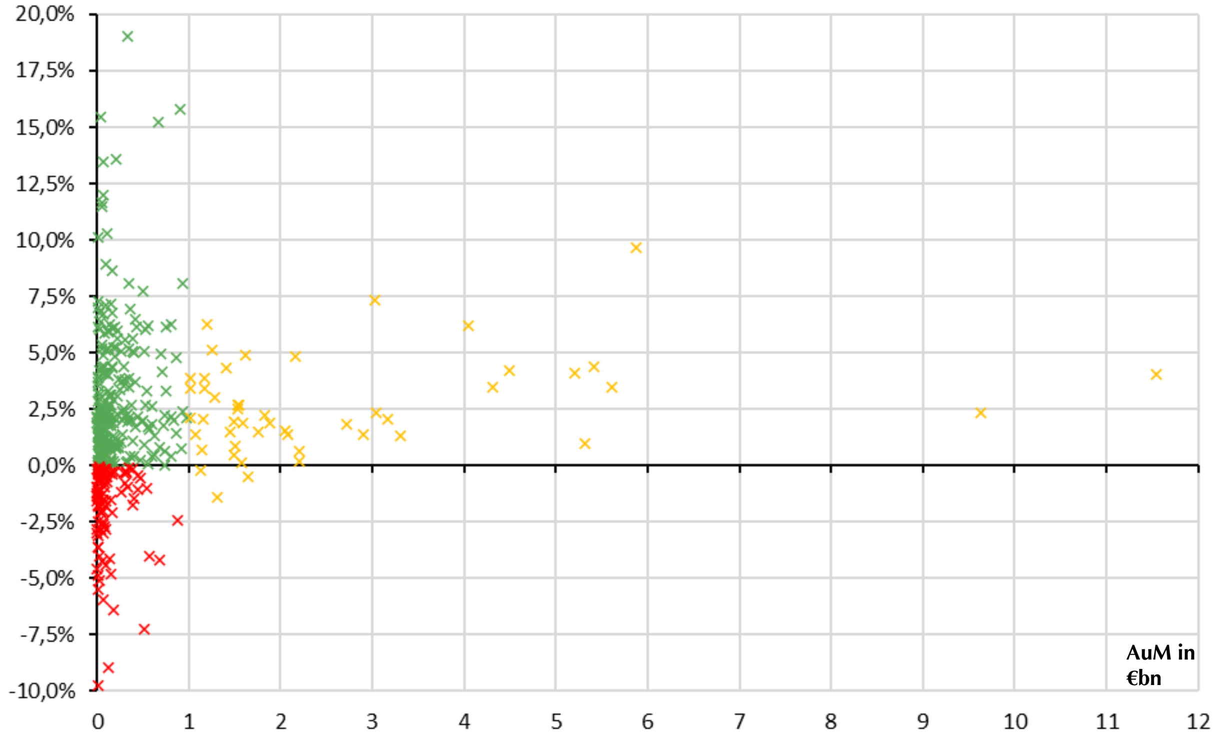
Overall, 45% of funds reported net outflows – in an asset class where overall volumes rose considerably. **This means that, in addition to fresh capital, there was also a noticeable amount of redistribution within the segment.** There may be several reasons for this. Firstly, it is possible that investors spread their interest across more strategies after failing to achieve the desired diversification effect during the coronavirus crisis. In addition, positive performance does not necessarily mean a fund is a good investment if other strategies or asset classes in the segment are performing better. Lastly, investors are likely to be focusing increasingly on tried-and-tested conservative approaches offered by large providers, as the analysis above has already shown.

PERFORMANCE

Narrow range of performance for large funds

The 412 funds spread across the chart below all have a track record of at least five years and are thus established on the market. Funds that can only demonstrate short-term high performance are thus excluded from the analysis.

Relationship between fund size and performance p.a.



The size of each fund in EUR billion is mapped on the horizontal axis, while the vertical axis shows their **annualised performance over a five-year period**. The largest funds with a volume of more than EUR 1 billion (49 funds) are displayed in **yellow**. These funds tend to line up in the middle of the pack in terms of returns; while the great majority of them **move within a range between 0% and 5%**, only a few funds exhibit a particularly poor performance. An investment in one of these flagship funds offers only limited potential for surprises on either the upside or downside. The subsegment consisting of small and medium-sized funds with a volume of up to EUR 1 billion contains a whole host of funds with extremely strong performance over a longer time horizon. These funds are shown in **green** in this chart. On the other hand, the small and medium-sized funds shown in **red** performed negatively over a five-year period.

Average fund performance over 5 years (p.a.)

Yellow:	2.65%	1.84%
Green:	3.06%	
Red:	-1.85%	

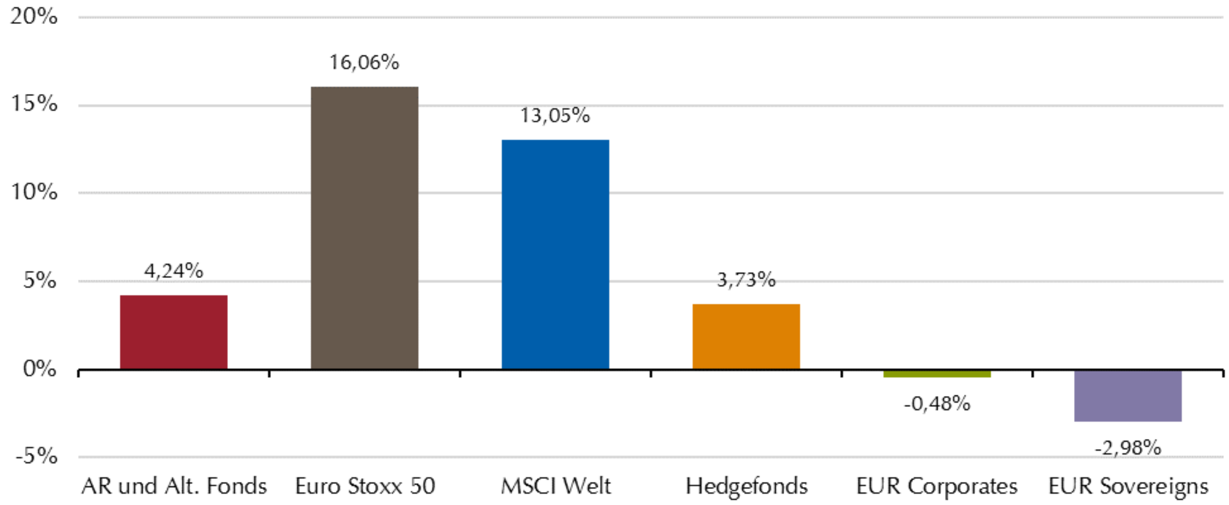
When investing in one of the large funds, the relative certainty of a positive performance costs investors an average of 41 basis points of return per year in absolute terms (**2.65%**./. **3.06%**) – a price that many investors are clearly willing to pay. The path to higher performance lies in successful **manager selection: buy green, avoid red.** Anyone reluctant to go to the effort of identifying a fund that could feature among the green funds in future is better off opting for one of the large (yellow) funds.

Large funds are characterised by their defensive risk-return profile. Bond and credit strategies alone account for around 49% of funds with more than EUR 1 billion in assets under management. By far the most funds follow the “Absolute Return Bond USD” strategy. It would apparently make little sense for the large players in this segment to use more aggressive or innovative strategies to improve their performance.

Performance in the first half of 2021: better returns than hedge funds and bonds

Absolute return and liquid alternatives funds performed extremely well in the first half of 2021 with a gain of 4.24%. While funds with a volume of more than EUR 1 billion only generated returns of 3.57% in the first half of the year, smaller funds lifted the average in the investment segment markedly with a performance of 4.27%. The segment as a whole outperformed traditional hedge funds (+3.73%) by around half a percentage point. Bonds were forced to deal with negative returns in the wake of growing inflation fears and due to only a slight easing of conditions on the bond market, with eurozone government bonds in particular reporting negative returns (-2.98%).

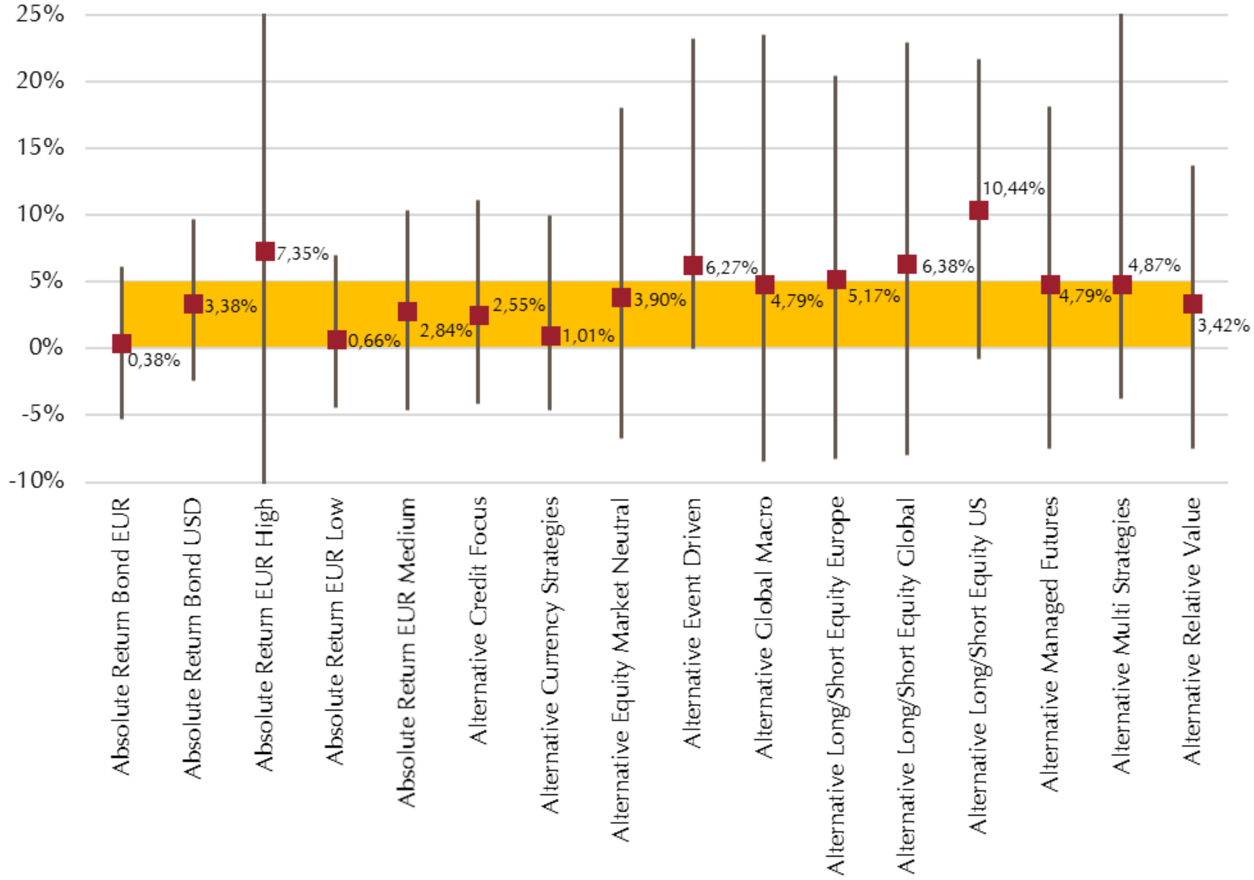
Performance by asset class (YTD)



Strategy returns closely grouped, fund returns broadly spread

Compared to our annual analysis in 2020, the performance of various strategies has differed more widely since the start of the year. Despite this, the funds for most strategies generated returns between 0 and 5% on average (yellow bar). The spread of returns for individual funds within each different strategy remains considerable. **AR EUR High funds showed the broadest spread** with returns within a range of -15.57% to +25.36%, as well as Alt. Multi Strategies between -3.78% and +37.47%.

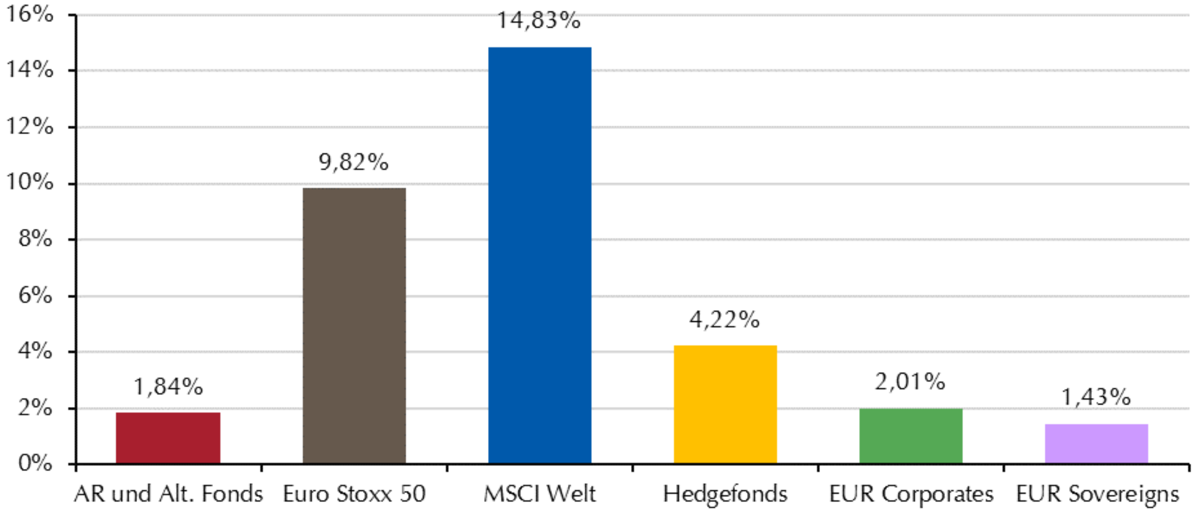
Performance by segment strategy (YTD)



Positive returns over a five-year period

The long-term performance comparison was dominated by the MSCI World (+14.83%) and Euro Stoxx 50 (+9.82%) share indices. AR und Alt. funds (+1.84%) sit between European corporate and government bonds. Hedge funds (+4.22%) managed to significantly improve their long-term profitability over the past half-year (previously: +3.29%).

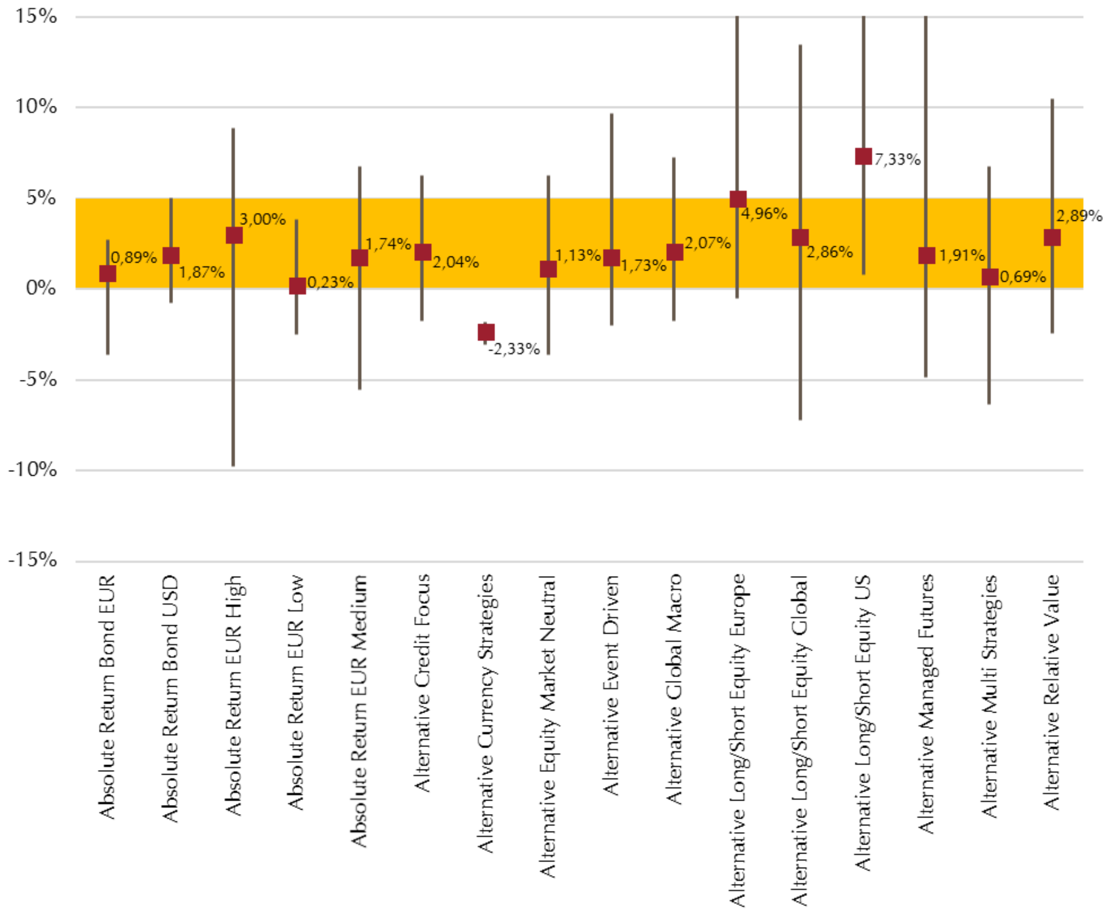
Performance over five years by asset class (p.a.)



Returns moving closer together over five years

Even over five years, most strategies remain at a similar level on average, even though they were largely able to return to profitability (performance > 0) compared to the 2020 annual report (with the sole exception of Alt. Currency Strategies).

Five-year performance by strategy

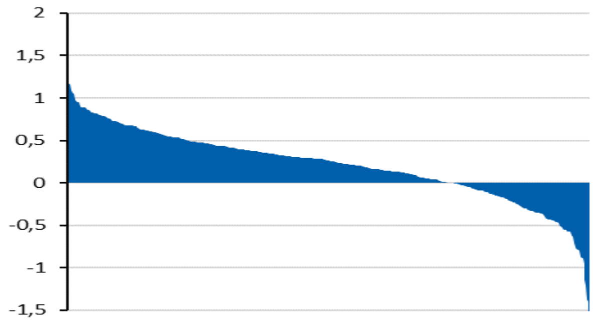


RISK-RETURN PROFILE

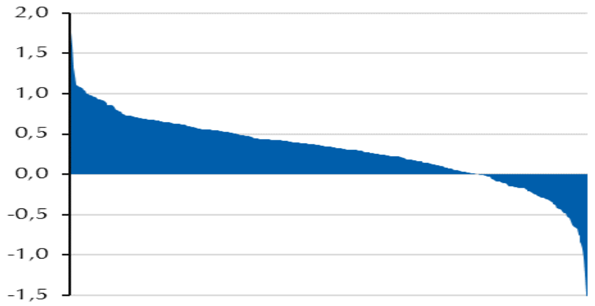
Majority of funds keep their product promise of a positive Sharpe ratio

Over the long term (five years), 78.6% of funds have achieved a positive Sharpe ratio (31 December 2020: 73.2%), thus delivering on their product promise. This further improvement suggests that the effects of coronavirus-related drawdowns will not have a lasting impact on the performance of most strategies. The average Sharpe ratio over five years, calculated based on the number of individual funds, is 0.29.

5Y Sharpe ratios as of 31/12/2020



5Y Sharpe ratios as of 30/06/2021

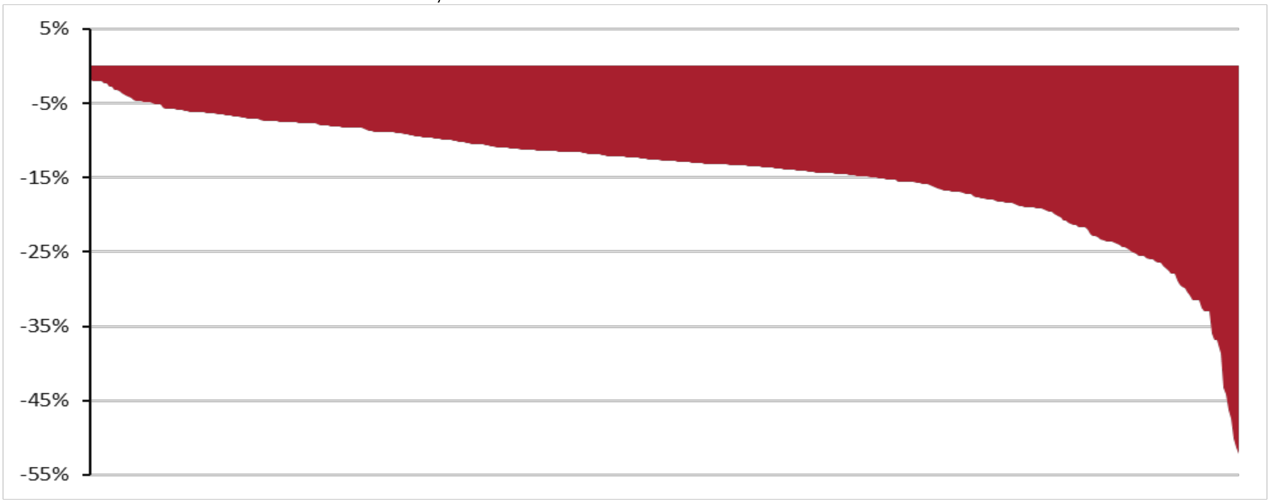


All funds offered are shown side by side in order of the value of their Sharpe ratio. Left: "73.2% of all funds had a positive Sharpe ratio."

Historic drawdowns burdened the segment

The average maximum drawdown during the current year is -1.9%, which corresponds more or less exactly with the Euro Stoxx 50. The average maximum drawdown for the first half of 2020 was significantly lower at -10.7%. The five-year average is -14.1%.

Maximum drawdowns H1 2021 (five-year view)



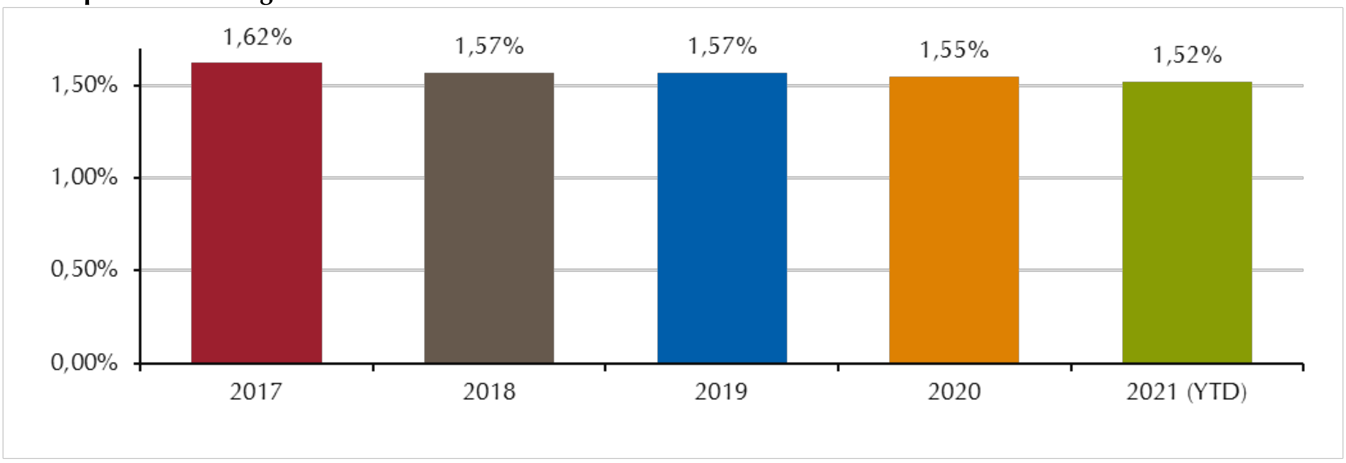
Each point on the horizontal axis of this chart represents a fund, while the y-axis shows this fund's maximum drawdown over the last five years. The funds on the x-axis are sorted according to the extent of their maximum drawdowns, thus producing the curve we see here. As only the maximum drawdown during the period under review is of significance here, the figure for almost every fund relates to March 2020, as this was the period of greatest market turbulence during the last few years. The market has largely calmed down since then.

COSTS

Lower cost pressure

The absolute return and liquid alternatives funds segment continues to face comparatively minimal cost pressure. Over the last five years, the total expense ratio (TER) has fallen by just 0.1 percentage points on average, while providers in other asset classes have found themselves in an outright price war over the same period.

Development of average TER



This does not come as a surprise in a special segment like this one, as UCITS-compliant hedge fund strategies, unlike ETFs for example, sell based on manager selection rather than price. In addition, these strategies should be at little risk of having to compete with inexpensive passive approaches. Anyone wanting to invest in hedge fund strategies is reliant on active managers.

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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 14.0 billion for institutional and wholesale investors.

For further information, visit www.lupusalpha.de.