Implications for Hedge Funds After the Fed Lift-Off

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Dear reader, this is our last weekly of 2015, we'll be back the first week of January. Happy Holidays to all!

For the first time in almost a decade, the Fed has finally hiked rates as the FOMC decided that the US growth/ inflation mix was robust enough to absorb monetary tightening. Over the next twelve months, three to four additional rate hikes of 25 bps are on the cards (p. 2).

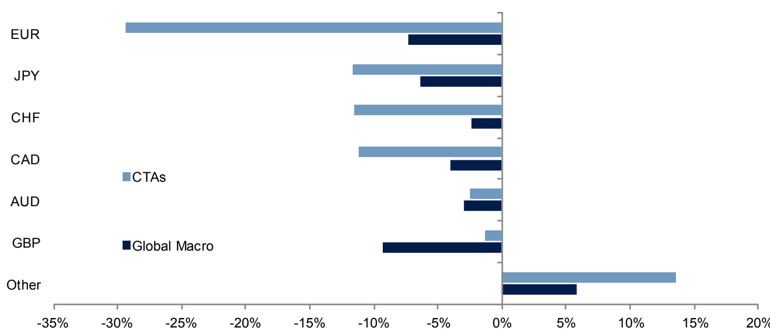
As we head into 2016, investors are left wondering what will be the wider market implications of these moves. While the new monetary stance is backed by strong US economic data, investors will need to keep in mind that liquidity tightening is a headwind for risk assets such as US equities and High Yield credit. We believe that the market sentiment in 2016 is likely to rotate between exuberance and depression swiftly. Over the last six months the investment horizon has shortened considerably and this is likely to continue. In a nutshell: be tactical.

Long term investors are likely to struggle in such an environment and the value proposal of hedge funds makes greater sense in this context. In a recent publication (A New Era for Hedge Funds) we highlighted that monetary policy tightening in the US should translate into an outperformance of hedge funds versus traditional assets. With little market beta to capture from now on across the asset classes, alpha generation will be key. Selecting the right strategy and the best manager within each strategy is likely to ensure attractive risk adjusted returns amidst volatile conditions.

In terms of hedge fund strategies following the Fed lift-off we favor Global Macro, and to a lesser extent CTAs, for their diversification properties. Both tend to outperform when the volatility regime is higher. In the L/S Equity space, we suggest managers who have limited directionality. We err on the side of caution with Event-Driven managers who are active in the distressed and high yield space (i.e. preference is with Merger Arbitrage over Special Situations). It is likely that the sharp widening in HY spreads over recent weeks is an indication of how market conditions will prevail in this segment during 2016. Finally, we prefer Fixed Income Arb. to L/S Credit. We are however more concerned about US L/S Credit than European L/S Credit.

CTAs and Macro managers' long exposure to US dollar should benefit from the Fed rate hike

Net Exposure to currencies vs US dollar, % NAV



As of December 8th. Equally weighted. Source: Lyxor AM

RESEARCH BY LYXOR
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THE WEEK IN 3 CHARTS

Hedge Fund Snapshot: Hedge funds down 0.5% amidst risk off conditions

	WTD*	MTD	YTD
Lyxor Hedge Fund Index	**-0.5%**	**-0.7%**	**-0.2%**
CTA Broad Index	-0.7%	-0.7%	-1.6%
Event Driven Broad Index	0.2%	0.1%	-4.2%
Fixed Income Broad Index	-0.3%	-1.2%	-3.3%
L/S Equity Broad Index	-0.3%	-0.4%	3.4%
Global Macro Index	-1.4%	-2.0%	2.4%
S&P 500	*-1.0%*	*-2.2%*	*-1.8%*
10 Y US Treasury (Change in bps)	*5*	*3*	*8*

*From 08 December to December 15, 2015

Hedge funds were somewhat resilient in a risk off environment last week (up to December 15th). The Lyxor Hedge Fund Index was down 0.5%.

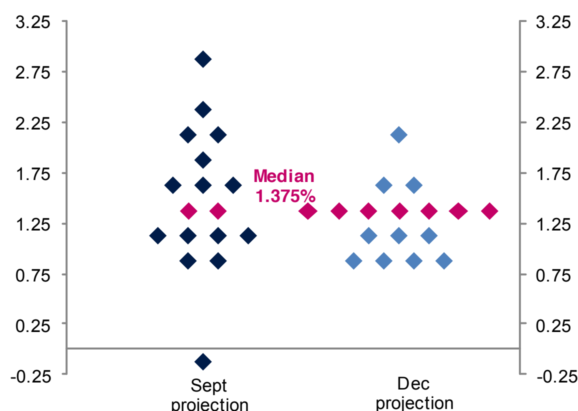
Event Driven managers outperformed, with both Merger Arbitrage and Special Situations funds ending flat or slightly positive.

L/S equity funds navigated the turmoil relatively well; strategies with limited directionality generated better results than long biased funds.

On the negative side, Macro managers suffered from their long positions on the USD against other currencies, whilst CTAs proved resilient, thanks to their sizeable exposure to the energy sector.

Fed dot plot suggests three to four 25 bps rate hikes in 2016. Markets are more complacent: a recipe for volatility?

Fed Fund rate expectations at end-2016 by FOMC participants
Median values are highlighted



30-day Fed fund futures, December 2016

Source: Bloomberg, Lyxor AM

For the first time in nearly a decade, the Fed funds rate was raised by a quarter points. In order to effectively implement its monetary policy and drain excess liquidity, the Fed has used a broad set of tools such as an overnight reverse repurchase programme.

Yet, the stance of the Fed remains somewhat accommodative as further increases would be "gradual" and this has supported risk assets initially.

But while the Fed dot plot suggests three rate hikes next year, with a median Fed fund rate at 1.38% in December 2016, the market seems more complacent. Fed Fund futures suggest Fed fund rates will stand at 0.8% at the end of 2016, i.e. one or two rate hikes.

On the data front, global equities initially responded positively to the Fed announcement, however these moves were short-lived. The US dollar resumed its upward trajectory, while major uncertainties lie on US High Yield credit on the back of the Fed tightening and the collapse in oil prices.

CTAs and Macro managers will benefit from the appreciation of the greenback, as they both have sizable long exposures to the currency.

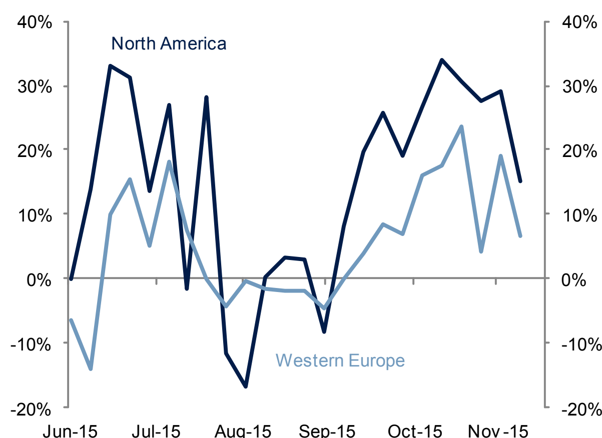
CTAs

	WTD*	MTD	YTD
CTA Broad Index	**-0.7%**	**-0.7%**	**-1.6%**
CTA Long Term	-0.8%	-0.7%	-1.4%
CTA Short Term	0.2%	-0.1%	-3.7%

*From 08 December to December 15, 2015

CTAs reduced their appetite for equities

Net Exposure to Equities, % NAV



As of December 8th. Equally weighted. Source: Bloomberg, Lyxor AM

Long Term CTAs underperform

CTAs posted a negative performance. Short-term systems proved more reactive to the strong market movements and as expected outperformed long-term ones.

Global equity markets fell for a second week in a row. Gains generated on short exposures to Asian indices did not offset losses on long positions on European and US equities.

In the fixed income space, most systems were penalized by their long exposure to DM bonds as interest rates went up. Long positions on both US and European bonds dragged down the performance.

Meanwhile, FX added to the losses as long exposures to the US dollar suffered from the depreciation of the greenback against most G10 currencies. Short Euro and Japanese Yen contracts proved to be detrimental.

However, systems successfully extracted alpha from their commodity portfolio. Short exposure to oil, gold and silver turned profitable as prices continued to fall. Yet, this couldn't offset the losses generated on other asset classes.

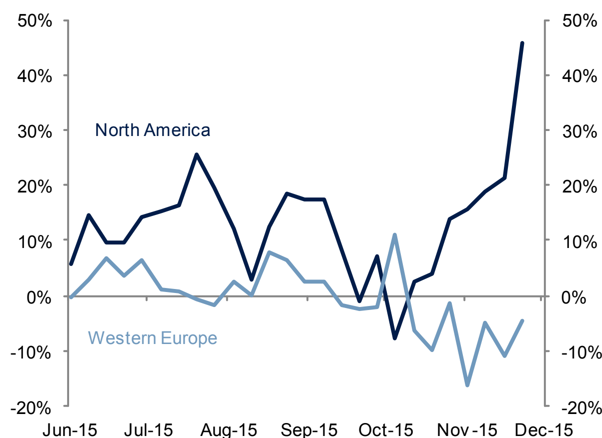
GLOBAL MACRO

	WTD*	MTD	YTD
Global Macro Index	**-1.4%**	**-2.0%**	**2.4%**

*From 08 December to December 15, 2015

Macro managers increased their long positions on US bonds

Net Exposure to Fixed Income, % NAV



As of December 8th. Equally weighted. Source: Bloomberg, Lyxor AM

Long USD positions detract

Macro managers suffered from negative headlines in various asset classes, but have managed to slightly recover since then.

Fixed Income markets were the most active as the Fed rate hike loomed. Interest rates increased on both sides of Atlantic, which turned to the advantage of short exposed funds. Short UK rates were the most rewarding positions.

Within FX, the depreciation of the US dollar against most DM currencies hit long exposures to the USD. Short Euro and JPY positions and long bets on some emerging currencies proved detrimental.

Long exposure to Global Equity markets detracted across all DM, especially in Japan.

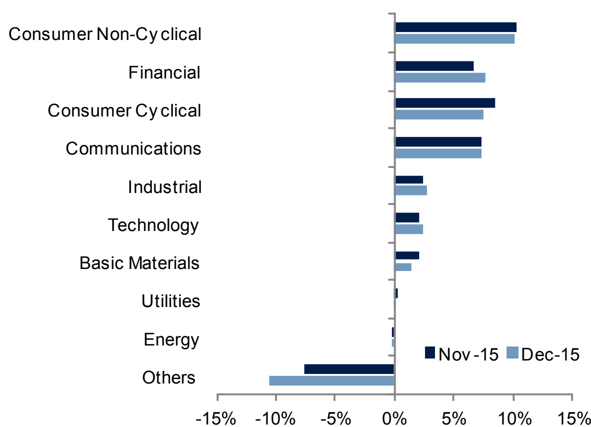
In commodities, oversupply and a weak demand continued to drive oil prices down: the WTI ended the week under $38 a barrel. As a result, short exposure to energy paid off.

L/S EQUITY

	WTD*	MTD	YTD
L/S Equity Broad Index	**-0.3%**	**-0.4%**	**3.4%**
Long Bias	-0.9%	-1.6%	5.2%
Market Neutral	0.4%	-0.4%	-3.1%
Variable Bias	-0.3%	0.5%	6.7%

*From 08 December to December 15, 2015

L/S equity managers remained largely exposed to Healthcare
Net Exposure to sectors, % NAV



As of December 8th. Equally weighted. Source: Lyxor AM

Market Neutral meets expectations

L/S Equity hedge funds were somewhat resilient in the risk off environment. Market neutral managers outperformed while variable bias managers managed to limit losses.

Long biased funds suffered the most from the adverse market environment. In contrast, some of the variable biased funds fared better and managed to generate alpha on the short book. Our healthcare specialist performed well, benefitting from mispricing in the sector.

In Europe, most managers posted losses. However dispersion in returns remains significant. Outcomes were mainly driven by idiosyncratic risk rather than market beta; the most defensive managers posted losses while trading oriented funds were flat.

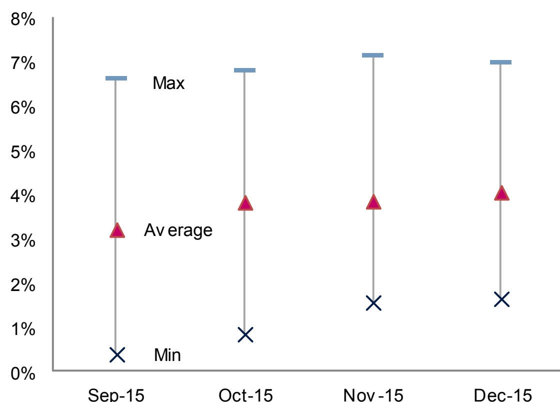
Finally, our Asia, China and emerging market focused funds ended the week flattish to slightly positive. Stock selection made the primary difference.

EVENT DRIVEN

	WTD*	MTD	YTD
Event Driven Broad Index	**0.2%**	**0.1%**	**-4.2%**
Merger Arbitrage	0.2%	1.1%	-1.3%
Special Situations	0.0%	-1.5%	-8.6%

*From 08 December to December 15, 2015

Event-driven managers were exposed to Dow Chemical before the merger announcement with DuPont
Net Exposure to Dow Chemical, % NAV, average over the period



As of December 8th. Equally weighted. Includes merger arb. and Special Situations.

Merger Arb. Outperforms

The Event-Driven Platform was slightly up last week but this was due to a few outliers recording strong returns. The bulk of the managers were in the red and Special Situations funds drove the losses.

The top detracting sectors were communications, basic materials, consumer cyclicals and energy. On the contrary, gains came from specific long positions on companies such as Valeant Pharmaceuticals or some Greek banks.

A new M&A mega deal was announced on 11th December: the amicable all-stock merger of equals between Dow Chemical and EI du Pont de Nemours (DuPont). The combined entity, DowDuPont, would form a $120 billion chemical giant divided into three businesses that would each be traded as separate entities. One of our activist manager who held a stake in Dow Chemical long before the announcement publicly backed up the deal.

Source: Lyxor AM

L/S CREDIT ARBITRAGE

	WTD*	MTD	YTD
Fixed Income Broad Index	**-0.3%**	**-1.2%**	**-3.3%**
L/S Credit Arbitrage	-0.3%	-1.4%	-4.7%

*From 08 December to December 15, 2015

US distressed spreads moved beyond 2011 levels
US HY Cash Pay CCC & Lower constrained index

Source: Bloomberg, Bofa Merrill Lynch, Lyxor AM

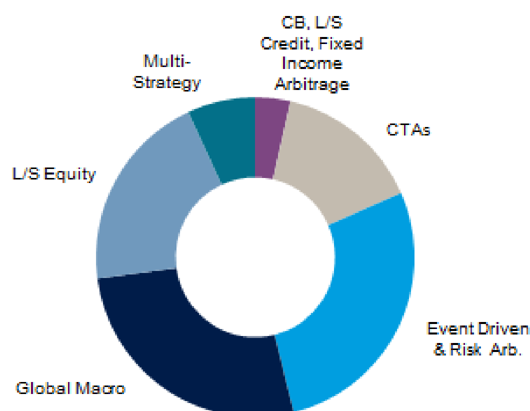
High Yield Sells Off

Credit Arbitragers ended the week in negative territory as credit markets experienced a strong sell-off especially in the low-grade segment. HY corporate bonds underperformed IG and saw their spread widen, by respectively 36 bps and 44 bps in Europe and the U.S. The lack of liquidity and the critical situation of some sectors (energy in particular) dragged returns down. As a consequence, outflows in HY funds spiked which turned out to be highly challenging for some managers. Regardless of fundamentals, news of funds facing redemptions added stress.

Within the Lyxor platform, the Asian fund was the worst performer as investors turned to a risk-off mode in this rough environment. One European fund was hurt by credit indices positions in its convexity book as spreads widened; the other suffered as well from the global sell-off in credit markets across various sectors.

METHODOLOGY

Breakdown of AUM by strategy



- **70 funds** in the platform
- **USD 8.4 billion** of assets under management (as of November 30, 2015)
- Replicating approximately **USD 250 billion** of AUM

Lyxor Hedge Fund Indices

Based on the complete range of funds available on the Lyxor Managed Account Platform, a universe of funds eligible for inclusion in the indices is defined on a monthly basis taking into account the following elements:

- Investability Threshold

  To be included in any index, the managed account must have at least $3 million of AuM.

- Capacity Constraints

  All index components must possess adequate capacity to allow for smooth index replication in the context of a regular increase in investments.

- Index Construction

  For each index, the relative weightings of the component funds are computed on an asset-weighted basis as adjusted by the relevant capacity factors.

- Each Lyxor Hedge Fund Index is reviewed and rebalanced on a monthly basis.

- The Index construction methodology has been designed to mitigate well-known measurement biases. Inclusions and exclusions of new Hedge Funds do not impact the historical index track record.

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