Morgan Stanley

INVESTMENT MANAGEMENT

2019 Market Outlook

Hedge Funds: Opportunities in Shifting and Volatile Markets

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As quantitative easing ends, investors should prepare themselves for higher volatility. The unwinding of central bank balance sheets removes a major source of market stability. We expect turning points in global economic growth trends and episodic shocks from geopolitical events will lead to higher volatility and less predictable asset class correlations, ushering in an investment environment very supportive of active management.

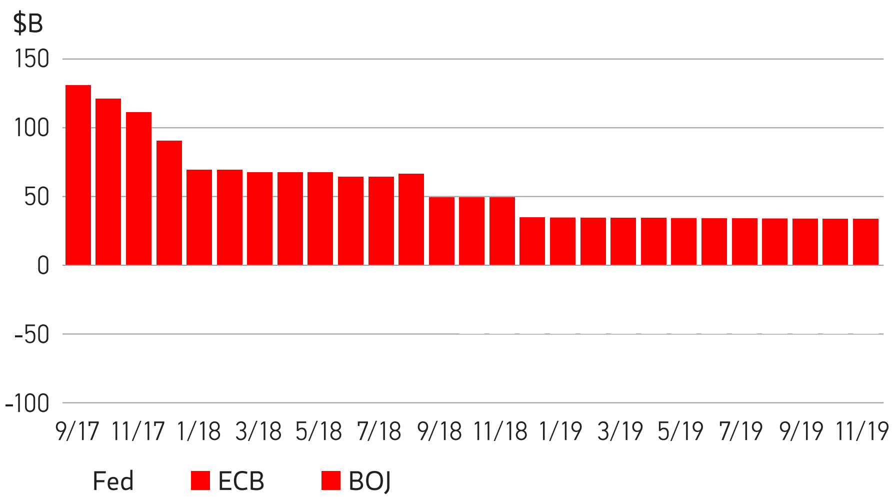
Representing the most innovative and unconstrained form of active management, we believe hedge funds are well positioned to exploit and magnify opportunities in a way that passive and long-only active managers simply can't.

Not all hedge funds have navigated the transition to a higher volatility regime well. Performance during recent selloffs revealed the strengths and vulnerabilities of different trading styles, separating winners from losers. The winners provided differentiated sources of return, diversification and downside protection and appear positioned to continue doing so. As we look toward 2019, we're very optimistic about what lies ahead for the most skillful managers. Here's why.

DISPLAY 1

Net Asset Purchase Trajectory

U.S. Federal Reserve, European Central Bank and Bank of Japan

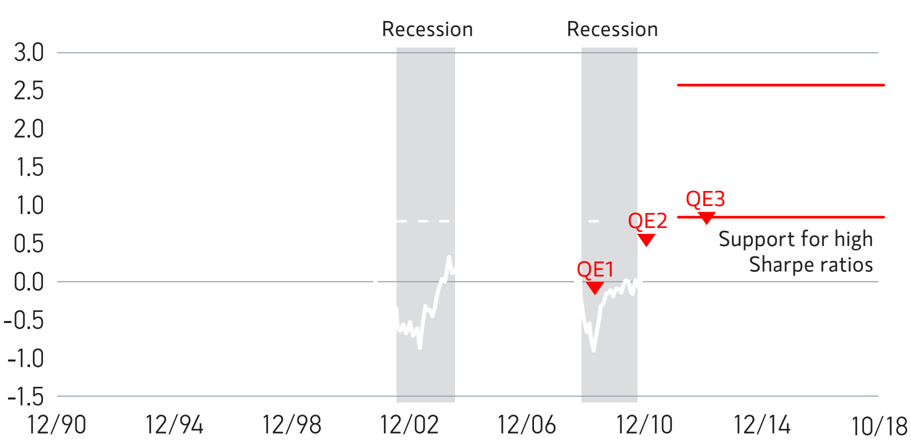


Source: Bloomberg Economics.
Note: Fed estimates based on caps from FOMC.
Runoff pace could be smaller, given limited amount of maturing securities.

DISPLAY 2

S&P 500 Index / Barclays US Aggregate Index Sharpe Ratio

From December 1990 to October 2018



1. **WE BELIEVE QUANTITATIVE EASING WILL SOON BE BEHIND US.** The data in *Display 1* suggests that aggregate quantitative tightening is not far off. Markets are moving beyond the synchronized, post-global financial crisis era regime to reflect widely differentiated growth potential and distinct country dynamics. Yet there remains uncertainty about how this will play out, which could be magnified by any of many potential sources of geopolitical instability.

2. **INCREASED VOLATILITY MAY MAKE THE RELATIONSHIP BETWEEN STOCKS AND BONDS LESS PREDICTABLE.** The negative correlation between stocks and bonds has served to dampen volatility and elevate Sharpe ratios of multi-asset portfolios over the last several years. We believe this relationship will hold during periods of market stress. However, with less liquidity in the market, behavior during non-stressed periods is less certain. We foresee increasingly unrelated moves, as bonds react to changing liquidity levels and inflation expectations while equities adjust to a slower growth environment. In other words, equities and bonds may not provide as much stability as they have in recent years. Hedge funds, on the other hand, tend to add value in volatile environments.

3. **HEDGE FUNDS CAN PROVIDE BALLAST WITH UPSIDE POTENTIAL.** With rising short-term U.S. interest rates and without intervention from global monetary authorities, we see new dynamics in the competition for capital. Higher cash rates raise the bar for risk-free hurdles, and environments of heightened uncertainty tend to test previous assumptions of risk tolerance.

Hedge funds with lower volatility profiles have the potential to offset risk at the portfolio level. Furthermore, hedge funds have the potential to provide a much needed performance boost during volatile periods.

Where do we see the most potential?

ASYMMETRICAL TRADING OPPORTUNITIES GEARED TO GLOBAL TRANSITION AND DISLOCATIONS. We see the greatest potential for this in the global macro space where geopolitical and event-specific risks abound: Brexit, US-China trade frictions and the evolving Italian economic crisis to name just a few. Global macro strategies are uniquely well-positioned to profit from making timely entry and exit points relating to abrupt and unexpected outcomes, and we believe managers with the ability to capitalize on the desynchronization of economic cycles across developed and emerging markets will have the chance to differentiate themselves. We are particularly focused on opportunities in medium-term global interest rates and currencies and emerging market sovereign debt and currencies. More specifically, we foresee continued strength from correctly positioned foreign exchange currency carry exposures and yield curve trades.

STRATEGIES WITH LESS SENSITIVITY TO BROAD MARKET VOLATILITY. We see a diverse set of strategies that should fare well in an environment of increased volatility. For instance, sovereign fixed income relative-value and equity market-neutral strategies have attractive risk/reward characteristics and comparatively consistent alpha generation. We believe securitized products also offer compelling return potential, with most of their return coming from different forms of carry, pricing inefficiencies and innovative hedging constructs. In the equities space, we are gravitating toward niche, sector-focused managers with low net exposures, especially those that have differentiated security selection views. Finally, investors may benefit from exposure to fintech alternative lending platforms, with the U.S. economic backdrop currently supportive of the consumer, in our view, and with direct lending offering the potential for stable returns.

EXPANDING THE DEFINITION OF HEDGE FUNDS. We've long said that to survive in the hedge fund space, managers have to evolve. Going forward, successful hedge fund managers will differentiate themselves by identifying idiosyncratic events, understanding complex situations and seeking more inefficient price discovery opportunities. We see great value in partnering with these types of managers in a more expansive way, outside the classic definition of "hedge fund." Negotiating bespoke structures allows access to specific risk/return profiles, niche ideas and targeted high-conviction trades without having most of the value lost through fees. For investors like us, the key lies in being able to invest across the liquidity spectrum, through an array of implementation options and with a strict value-per-unit-of-fee discipline.

CO-INVESTMENTS. Further outside of the realm of "traditional" hedge fund investing, we continue to see a strong flow of interesting co-investment opportunities. The benefits of co-investments include reduced fees, full transparency, strong alignment and a tailored risk profile. However, barriers to entry are high, with execution experience required.

Conclusion

As we've said before, we think the future of hedge fund investing lies in an expanded view on what hedge funds can do. We have every confidence that hedge funds will continue to evolve, unearthing specialized forms of investing that require resources and niche expertise. We believe that higher volatility levels will be sustained because of the simultaneous late-stage economic transition and withdrawal of post-crisis government support. This should provide hedge fund managers the opportunity to add value in what we expect to be a very fertile investing environment.

GLOSSARY

Correlation: Statistical measure of the degree to which the movements of two variables are related.

Dispersion: A term used in statistics that refers to the location of a set of values relative to a mean or average level. In finance, dispersion is used to measure the volatility of different types of investment strategies. Returns that have wide dispersions are generally seen as more risky because they have a higher probability of closing dramatically lower than the mean. In practice, standard deviation is the tool that is generally used to measure the dispersion of returns.

Foreign Exchange: The exchange of one currency for another, or the conversion of one currency into another currency. Foreign exchange also refers to the global market where currencies are traded virtually around-the-clock. The term foreign exchange is usually abbreviated as "forex" and occasionally as "FX."

Volatility: A statistical measure of the tendency of a market or security to rise or fall sharply within a period of time – usually measured by standard deviation.

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Barclays Global Aggregate Index (Hedged USD): The Barclays Global Aggregate Index provides a broad-based measure of the global investment grade fixed-rate debt markets. Total Returns shown in hedged USD.

S&P 500 Total Return Index: The S&P 500 Total Return Index is an index that consists of 500 stocks chosen for market size, liquidity and industry group representation. The S&P Index is a market value weighted index with each stock's weight proportionate to its market value. The S&P Index is one of the most widely used benchmarks of U.S. equity performance. The performance of the S&P Index does not account for any management

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9435121_KC_1218 CRC 2333731 Exp. 11/30/2019