Lupus alpha

**Absolute Return and Alternative Funds in Germany**

# Interest rate reversal dampens regulated hedge funds – highest outflows since 2008 despite strong performance

In 2023, investors withdrew €35.1 billion net from hedge fund strategies available in Germany in the UCITS format. Although fixed income strategies lost volumes in the first year after the interest rate reversal, they increased their market share by 4.5 percentage points to 28%. The asset class delivered a performance of 5.28% on average across all strategies.

## About the Study

Since 2008, Lupus alpha has been evaluating the universe of absolute return and alternative funds on the basis of data from LSEG Lipper (formerly 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, includes 102 funds.

**SUMMARY**

**Hedge fund strategies in the UCITS format were severely affected by the market distortions after the interest rate reversal in 2023. Net outflows from this asset class reached €17.65 billion in 2022 and €35.1 billion in 2023. To put this into perspective: In July 2022, after more than six years, the ECB raised interest rates from 0% to 0.5%. Since September 2023, the ECB key interest rate has remained at 4.5% after nine further steps. Initially, the prices of safe Euro government bonds fell by almost 20% as a result of the massive rise in interest rates. However, with the return of interest rates, investors quickly and decisively turned to the interest rate market. This led to a massive reallocation, which also left its mark on the investment strategies analysed. In the first quarter of 2023, the Deutsche Bundesbank reported "historically high shifts" to fixed-interest investments, a trend that accelerated later in the year.**

**In keeping with this new interest rate environment, nearly 40% of gross inflows into liquid alternatives were attributable to the only two fixed-income strategies in the segment: Alternative Credit Focus and Absolute Return Bond. However, the key to a high return in 2023 was in the equity market, with Liquid Alternatives clearly lagging behind with an average performance of 5.28%. Focusing purely on performance, however, does not take into account their stabilising contribution to the overall portfolio. This is evidenced by the medium and long-term perspective. In the disastrous investment year of 2022, when equities and bonds fell simultaneously, Liquid Alternatives stabilised their investors' portfolio returns, while bonds viewed over three and five years are still chasing their losses today. The same applies to volatility and maximum drawdowns. Here too, Liquid Alternatives**

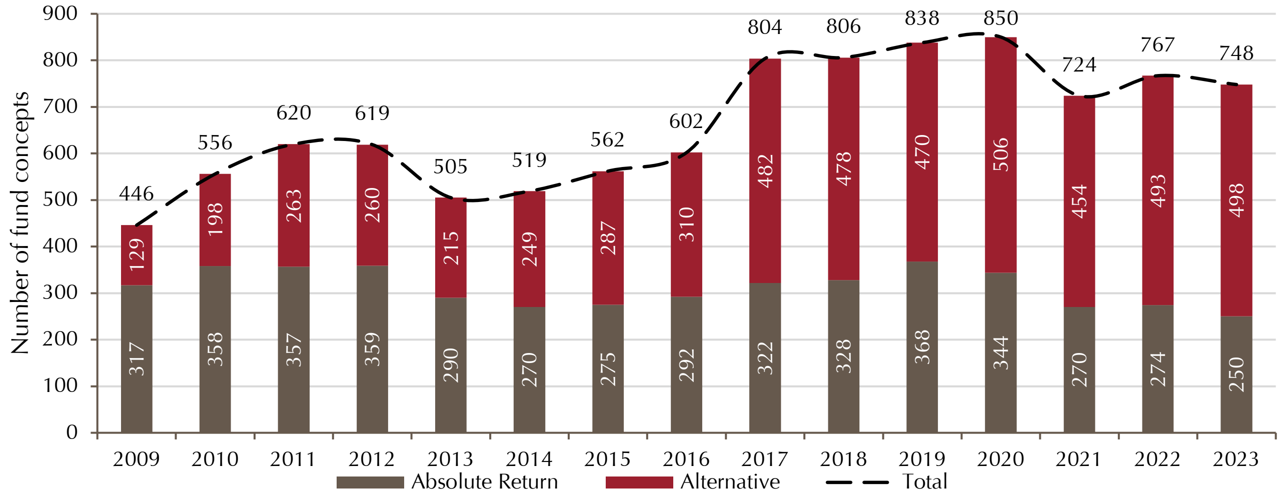
**show their strengths: Over five years, their average maximum drawdown was 17.9%, compared with 25.3% for the Euro Stoxx 50 (on a monthly basis).**

## MARKET DEVELOPMENT

### Alternative funds extend their lead

The number of funds within the Liquid Alternative Strategies segment has fallen by just 19 (2.4%), and has thus levelled off at a new plateau since the adjustment following the coronavirus year 2020. However, the **trend away from absolute return concepts** (24 fewer funds) and towards alternatives (5 more funds), which has been observed for a long time, is clear. This means that alternative concepts dominate the market with a two-thirds share.

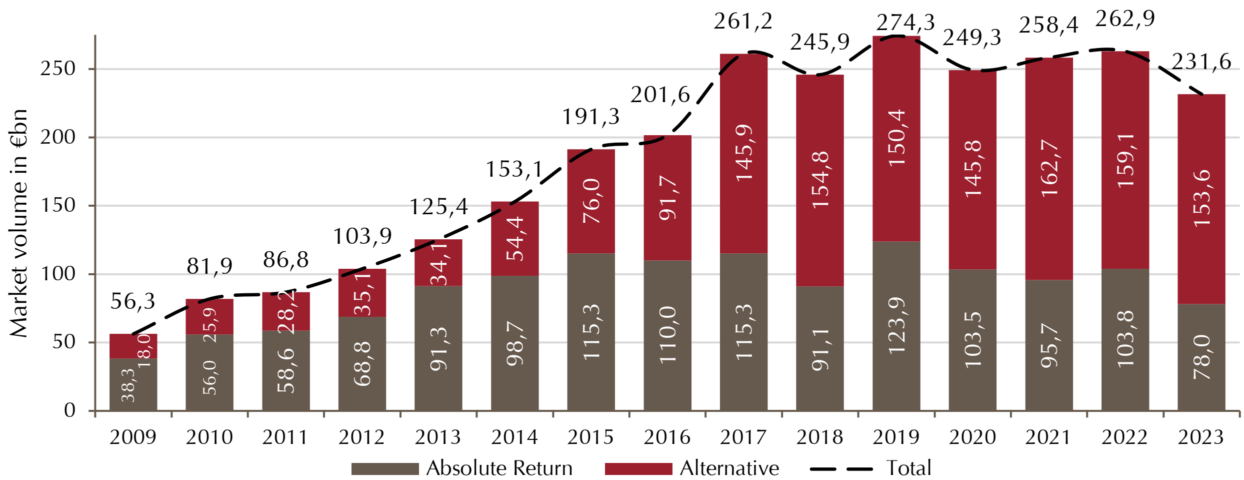
**Number of funds at a stable level**




### Interest rate reversal leads to significant decline in market volume

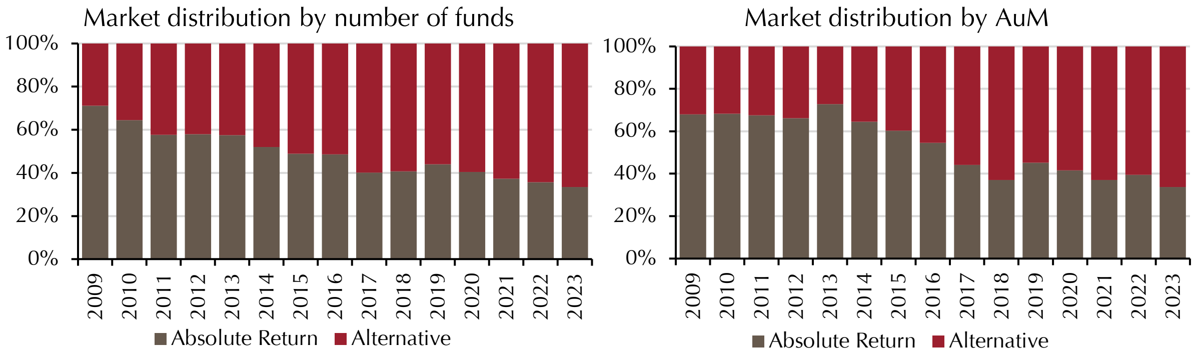
While the number of funds in the analysed sector remained largely constant, these funds had to cope with significant outflows. The main reason for this is the **reallocation of investor funds towards interest-bearing investments, which has been implemented since the interest rate reversal in July 2022.** Including a positive market effect, the market volume fell by almost 12% to €231.6 billion.

**Significant decline in market volume**



Net outflows amounted to €35.1 billion, the highest level in the past 15 years. Here too, investors' are turning to **alternative concepts, which lost only around € 5.5 billion (-3.5%),** while absolute return funds experienced a notable decline of €25.8 billion (-24.8%). Both the number of funds and the market allocation by volume indicate that the Liquid Alternatives Strategies group has become increasingly dominant over Absolute Return over time, as illustrated by the following graphs:

**Dominance of alternative strategies is growing steadily**

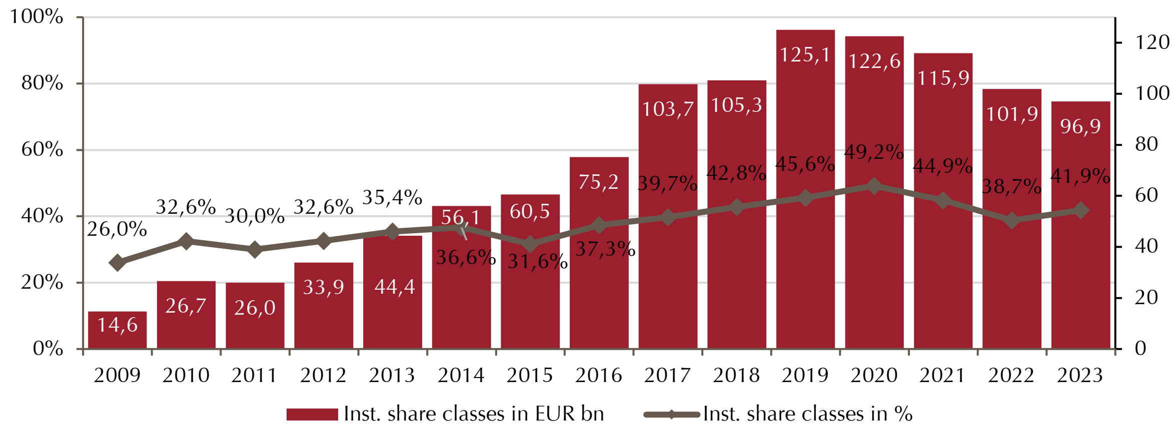



It seems that investors in Alternatives appreciate the opportunity to select strategies that are better tailored to their own preferences and thus optimise the return-risk profile of their overall portfolio in a more targeted manner. In addition, the diversity of strategies allows them to adapt flexibly to market scenarios, from defensive to offensive-leveraged concepts. If loss limitation is desired, this can also be reflected in such strategies with corresponding instruments.

**Share of institutional investors on the rise again**

Institutional investors are far more loyal to the asset class than private investors. Its volume in this market has also fallen by €4.9 billion, or 4.8%. However, this decline is significantly lower than for the non-institutional share classes, which have shrunk by €26.4 billion, or 16.4%. **Accordingly, the percentage share of institutional share classes has increased to 41.9%**. A comparison between Absolute Return and Alternatives paints a familiar picture: The institutional volume in Absolute Return funds decreased by around 22.6% from €39.8 billion (2022) to €30.8 billion. On the other hand, institutional volume in Alternatives grew from €62.1 billion (2022) to €66.2 billion, up by around 6.6%.

**Higher institutional share after comparatively low outflows**



### No strategy with net inflows in the wake of the interest rate reversal

Almost no strategy was able to raise net funds, with the exception of Alternative Relative Value with a minimal increase of €0.09 billion. The move away from the Absolute Return approach is also confirmed at strategy level: At around €13.42 billion, significantly more than one third of net cash outflows are attributable to the two strategies Absolute Return and Absolute Return Bond. However, both strategies are still among the largest in the segment (see market share).

**Fund flows by strategy (€bn)**

**Top 5**

| | |
|---|---|
| Alternative Relative Value | 0.09 |
| Alternative Currency Strategies | -0.02 |
| Alternative Equity Leveraged | -0.09 |
| Alternative Managed Futures | -0.11 |
| Alternative Dedicated Short Bias | -0.52 |

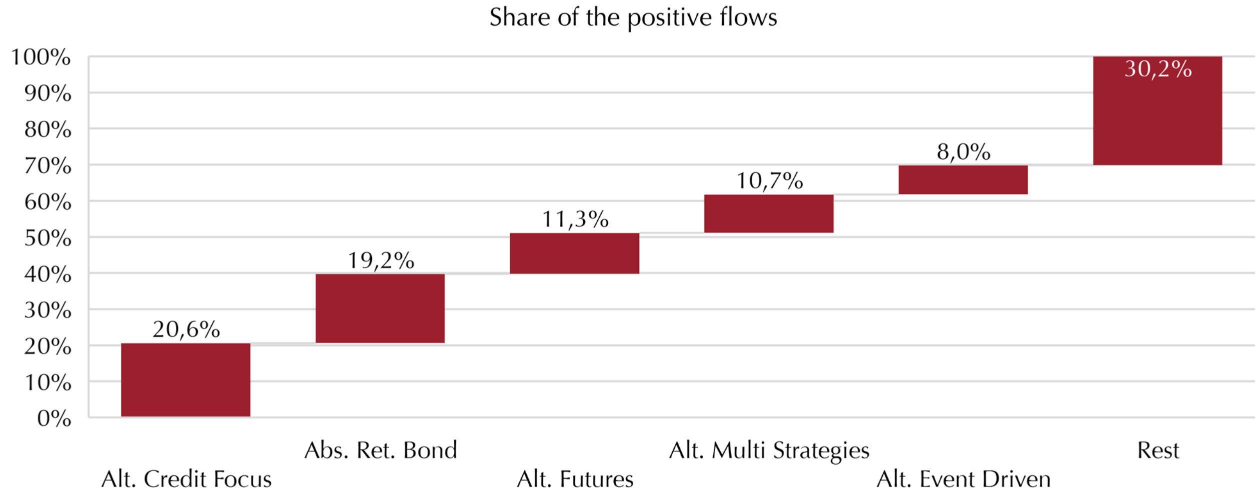
**Flop 5**

| | |
|---|---|
| Absolute Return | -8.72 |
| Alternative Multi Strategies | -6.76 |
| Absolute Return Bond | -4.78 |
| Alternative Long/Short Equity | -4.70 |
| Alternative Global Macro | -3.53 |

### Positive fund flows mainly in fixed income strategies

Overall, more than a quarter (28.4%) of the funds have seen net positive fund flows despite the generally negative market environment for this asset class. **The positive fund flows totalled €16.6 billion.** It is striking that almost **40% of these inflows were attributable to the only two fixed income strategies in the segment**: Alt. Credit focus (20.6%) and Absolute Return Bond (19.2%). A significant proportion of investors therefore also prefer fixed income strategies in this context. On balance, inflows were barely able to offset outflows (gross of €51.7 billion), resulting in net outflows of €35.1 billion.

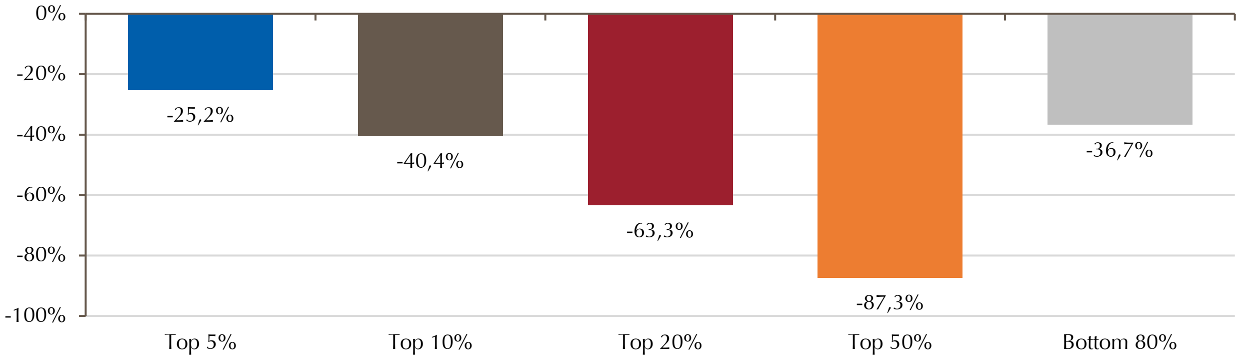
**Fixed income strategies attract investor funds**




### Large suppliers dominate the market

Only around a quarter of the total net outflows of €35.1 billion are attributable to the largest five per cent of funds, although they manage almost half of all funds. It seems that investors place more trust in large funds and therefore withdraw funds less frequently, and large funds are more likely than small funds to compensate for their outflows with inflows.

**The top 5% of funds account for around a quarter of outflows**

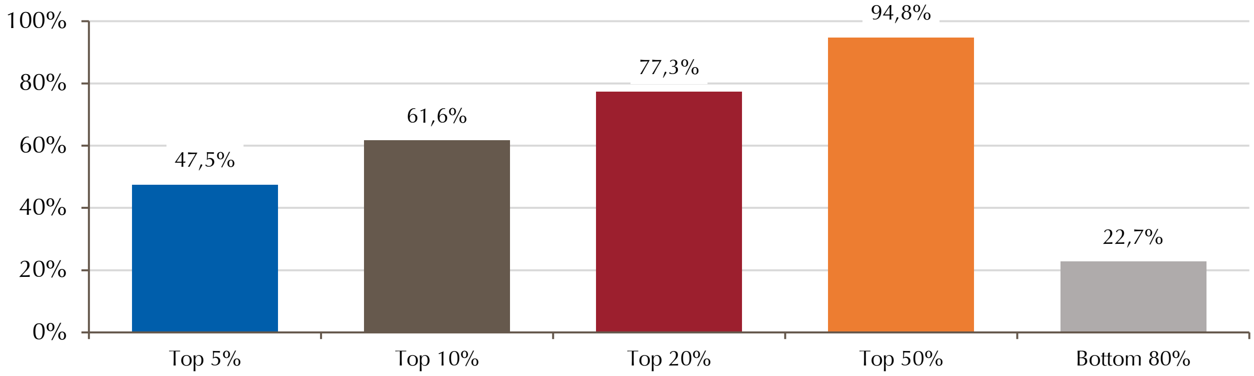



## MARKET STRUCTURE

### Top 20% of funds manage three quarters of total volume

Compared to previous analyses, the market structure has barely changed, with large funds continuing to dominate the market and gaining around 3.5 percentage points compared to 2022 (44.0% to 47.5%). 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 tendency becomes even more pronounced when the market is divided in the upper quintile: **The top 20% of funds account for more than three quarters of funds in this asset class,** while the vast majority of funds manage less than a quarter of total assets.

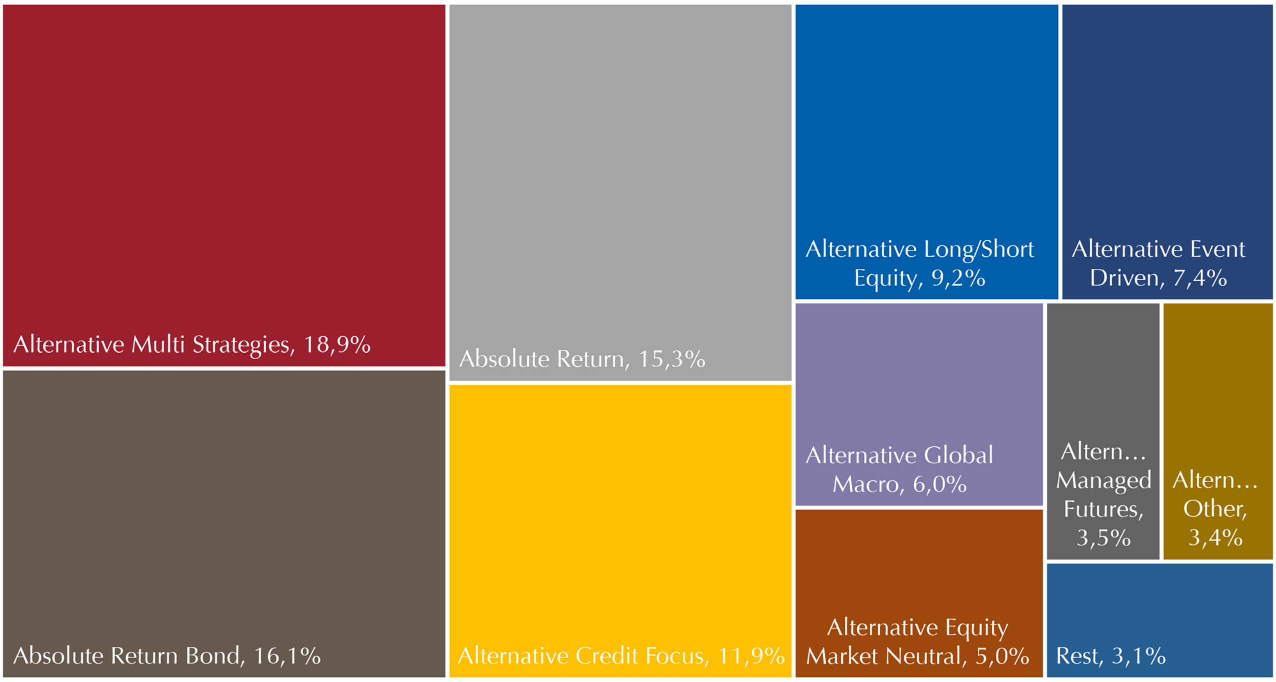
**Top 5% of funds account for 47.5% of total market volume**




### Fixed income strategies significantly increase market share

There is also a concentration in the allocation by strategy, with the three largest accounting for half of the market volume. **The strongest change is shown by the previously leading Absolute Return strategy with a very significant drop of 6.6 percentage points.** Alt. Multi Strategies came out on top with plus two percentage points. These multi-asset vehicles have been gaining in importance for years. Market shares also confirm the **trend towards fixed income strategies:** Together, Absolute Return Bond and Alt. Credit Focus account for more than a quarter of market volume after increases.

**Absolute Return falls from first to third place**

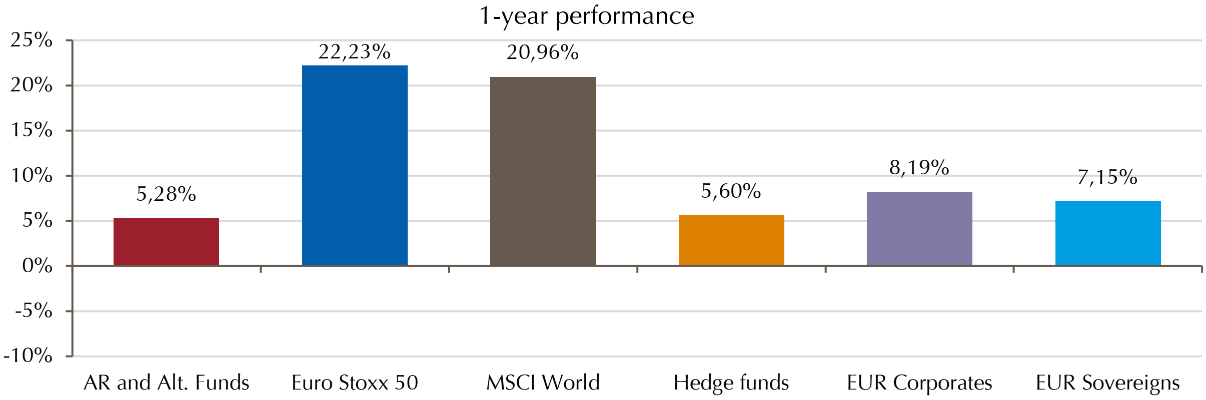



## 2023 PERFORMANCE

### Liquid Alternatives underperform major asset classes in 2023

Liquid Alternatives delivered solid performance to their investors at an average of 5.28%, but lagged behind the large asset class. 2023 was a good year for equities, but government and corporate bonds also partially recovered their major losses after interest rate hikes. Unregulated hedge funds, by contrast, were almost on par with their regulated counterparts. **Overall, around 80 per cent of UCITS hedge funds have a positive return.** Only 24 of the funds recorded better returns than the Euro Stoxx 50 (3.8%). European corporate bonds outperformed 156 funds (22%).

**Equities key to performance in 2023. Pensions are catching up.**



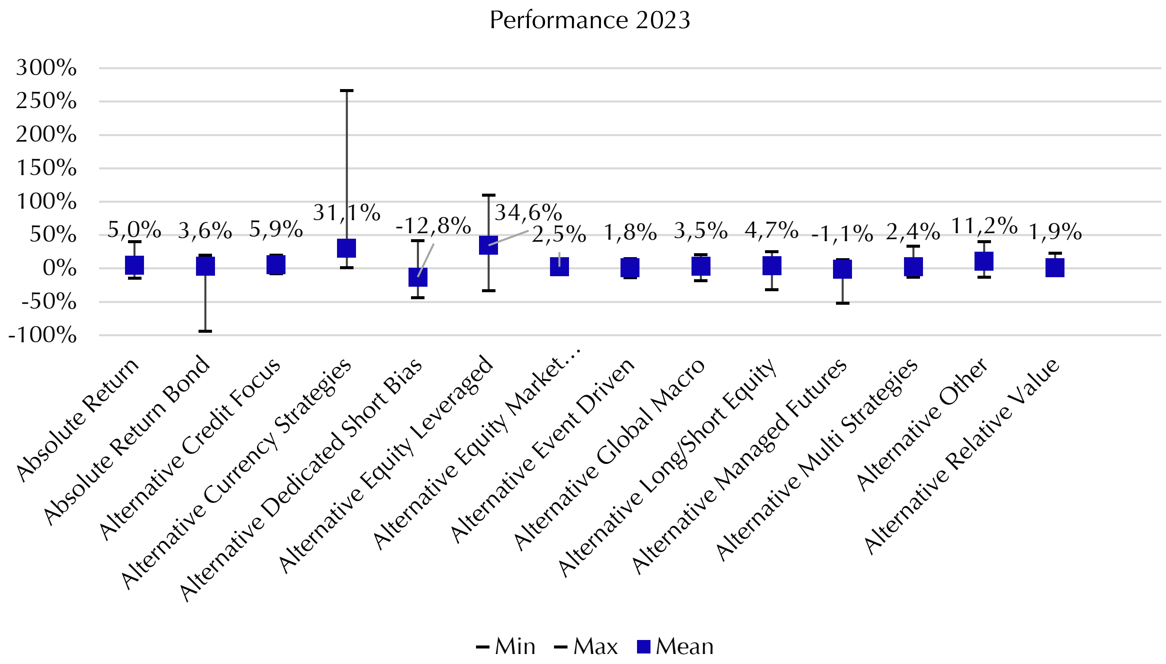

### Performance dispersion: Due diligence is key to investment success

**Alt. Credit Focus,** the strategy with the largest share of cash inflows in the segment (see page 4) was among the best with an average performance of 5.9%. The dispersion of returns between the funds in this strategy was also relatively narrow. **In general, fund performance was more broadly diversified across strategies.** Some funds managed to achieve returns well above 30%, but a few moved at the other end of the scale to near-total loss.

**A significant dispersion in performance is generally attributable to individual funds or a small number of funds.** The maximum for the Alt. Currency strategy is a single crypto fund. By contrast, the minimum for Absolute Return Bond is a fund that was probably struggling due to the banking crisis in March and the Credit Suisse crisis. While dispersion is within manageable limits in the vast majority of strategies, the outliers in these two strategies severely distort average performance – upwards in the case of Alt. Currency strategies and downwards for Absolute Return Bond.

Fund performance within the Alt. Equity Leveraged strategy also shows a relatively strong spread. The fact that this shows the strongest average is not surprising; **in 2023, equity exposure was the key to success and a leveraged equity strategy was unbeatable.** Nevertheless, even in this group, the worst fund was down 33%. In-depth due diligence remains the decisive success criterion in the Liquid Alternative strategies segment.

**Extreme spread in Alt. Currency strategies skews performance average**

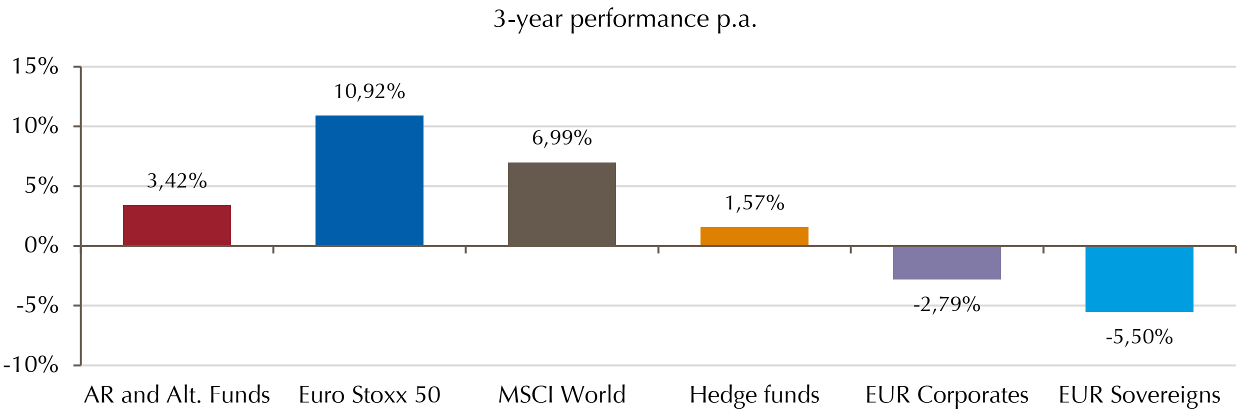



## LONG-TERM PERFORMANCE

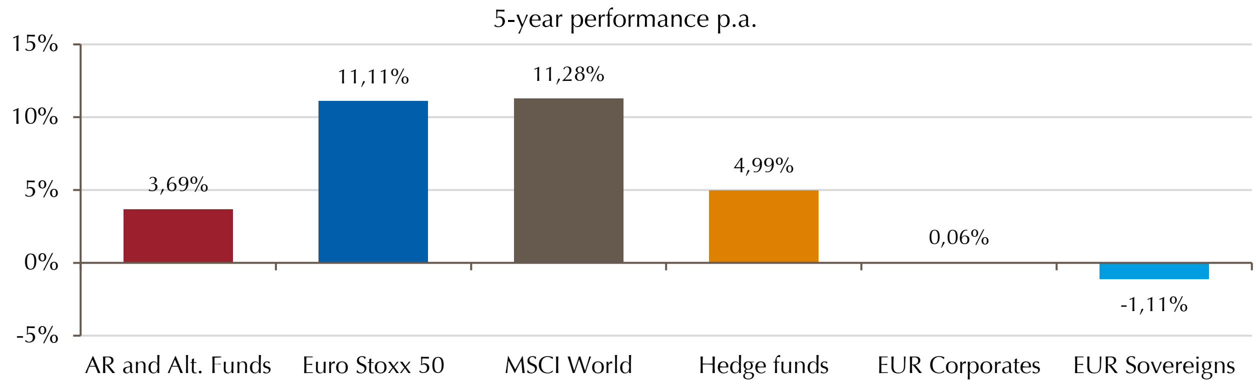
### Liquid Alternative strategies position themselves in the long term between equities and bonds

Despite the strong bond performance in 2023, Liquid Alternatives significantly outperform the bond markets over three and five years, **bonds are still processing the price losses after the 2022 interest rate reversal.** Equities, on the other hand, have recovered their losses from 2022 at index level. Regulated hedge funds, with their diversifying properties, thus position themselves in the context of an overall portfolio between equities and bonds.

**3 years: Liquid Alternatives with a solid return. Bonds still recording losses.**



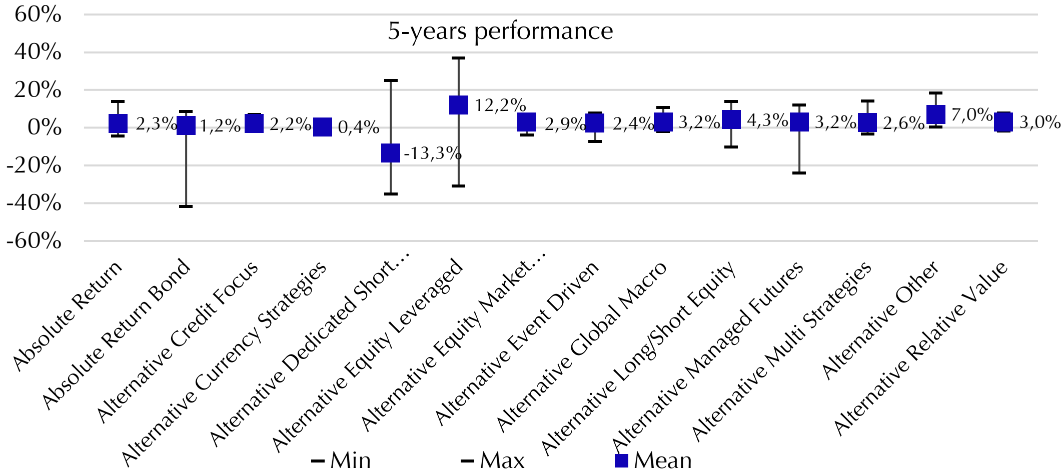

**5 years: Liquid Alternatives reveal their role in the portfolio. Stabilization during poor market phases.**




### Average performance positive over 5 years

With the exception of Alternative Dedicated Short Bias, all strategies show a positive average fund performance over five years. What is striking is the greater spread of fund returns compared to 2023. The years 2020 and 2022 clearly stand out in this respect.

**Return differentials are significantly higher in the long term.**

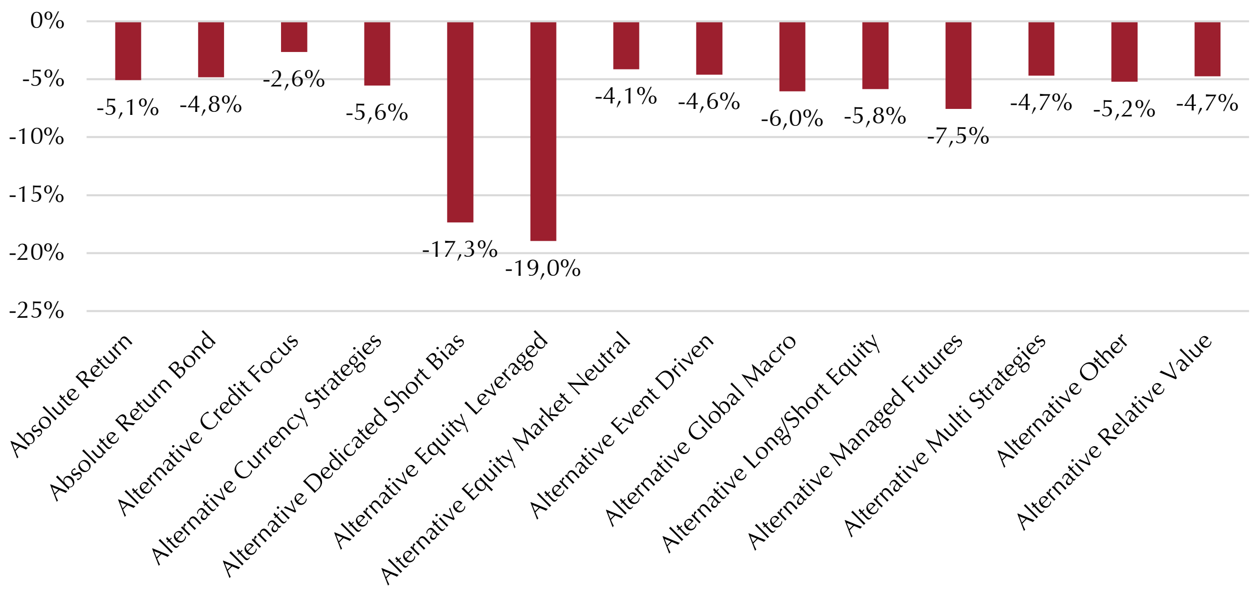



### RISK ASSESSMENT

### Majority of funds effectively limit losses

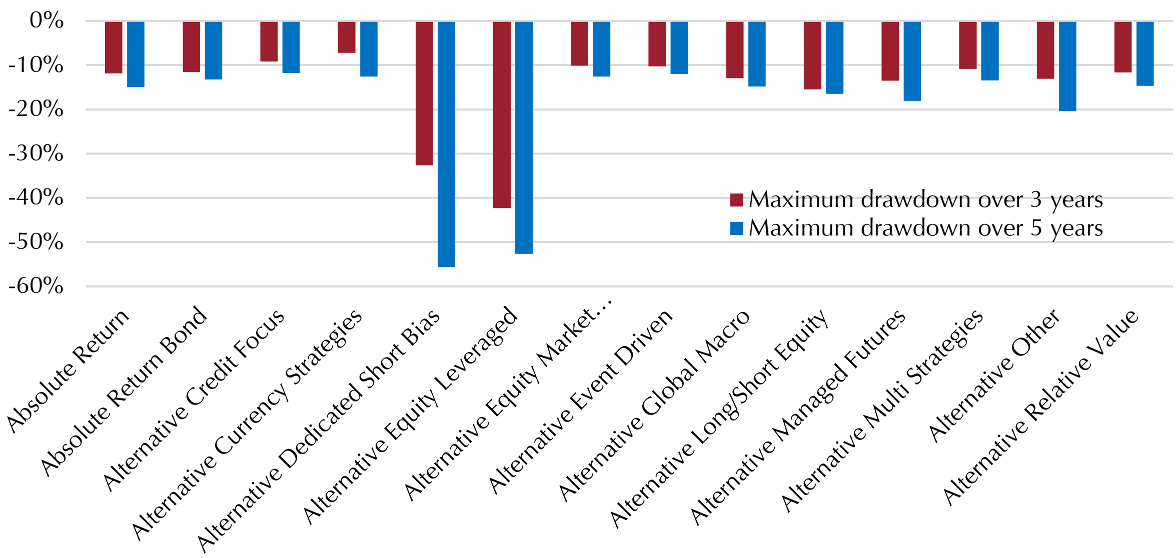
The majority of funds managed to limit losses effectively in 2023. **Maximum losses averaged only 5.71% across all strategies** (on a monthly basis). The Alt. Credit Focus fixed-income strategy was the most stable with a maximum loss of only 2.6%. It stood at 9% in the Euro Stoxx 50 and over 8% in the MSCI World.

**2023: Average maximum drawdown per strategy**




**3 and 5 years: Stability anchor in the portfolio**

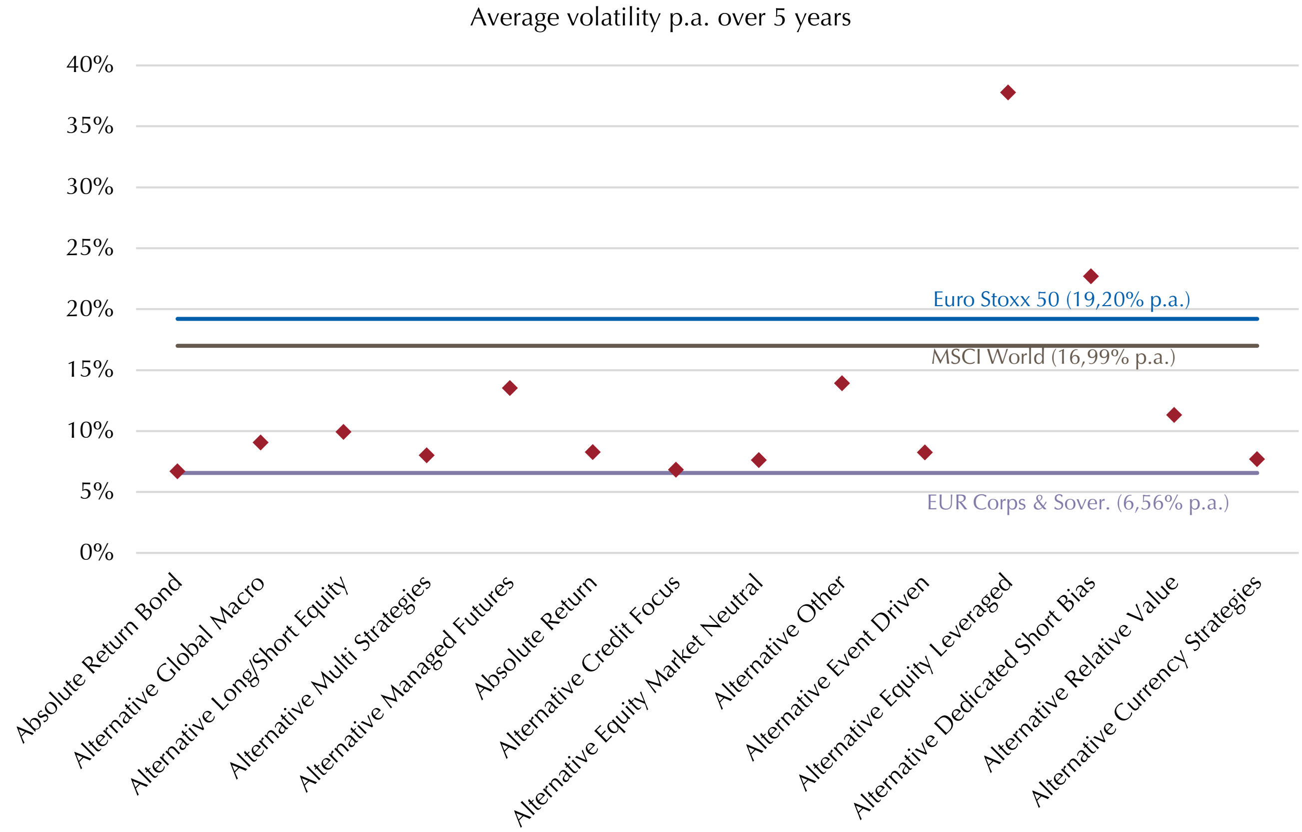
In the medium and long term, the stabilising role of Liquid Alternative strategies is even clearer: Over five years, their average **maximum drawdown was 17.9%** (monthly basis). The Euro Stoxx 50 reached 25.3% and even Euro government bonds had to face regulated hedge fund strategies with a maximum loss of 21.3%.



### Volatility much lower than equities

Liquid Alternatives can reduce the volatility as well as the maximum loss of a portfolio. Compared to traditional asset classes, the overall segment's **volatility over five years is close to European sovereign and corporate bonds** (around 6.5% p.a.) and **well below the volatility of European and global equities** (Euro Stoxx 50: 19.2 p. a.). Most strategies manage to maintain their volatility between 5% and 15%. The average volatility across the segment is 9.9%.

**Strategies mostly move within a moderate fluctuation band**




## RISK-RETURN PROFILE

### Sharpe ratio significantly improved after 2022

The interest rate reversal must also be taken into account when classifying the Sharpe ratio, because if the risk-free interest rate rises to 3.5%, the yield must also be 3.5% in order to achieve a Sharpe ratio of zero at all. **Despite a significant rise in risk-free interest rates, more than half of the funds (56.2%) managed a positive Sharpe ratio in 2023**, averaging 0.34. The good stock market year in 2021 shows how low interest rates affect this indicator: At that time, 79% of funds were in positive territory. By contrast, in the **extremely negative year of 2022**, rising interest rates and falling markets coincided: Only a quarter of the funds achieved positive scores.

### 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 around 1.50%, they are currently at the 2022 level and also 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 Strategy** | 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** | 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). The specialist product range is rounded off by global convertible strategies and risk overlay solutions for institutional portfolios. The Company manages a volume of more than €14.0 billion for institutional and wholesale investors. For further information, visit www.lupusalpha.de.

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