Lupus alpha

Absolute Return and Liquid Alternatives in Germany

Best performance since 2008: liquid alternatives significantly outperform hedge funds

Opportunistic equity strategies with high inflows. Expectation of rising interest rates drives investors away from bond strategies in fourth quarter.

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 14 strategies. For example, the long-short equity strategy includes 100 funds.

Summary

UCITS-compliant hedge fund strategies performed extremely well in 2021 to record their strongest performance since this study was first published in 2008. With an average return of 6.71%, they significantly outperformed unregulated hedge funds (3.65%) and positioned themselves as an alternative to the bond market's negative returns in particular. The average performance of the different strategies ranges from -0.90% to 10.86%, while the return differential between funds within the strategies is even greater. Bond and credit strategies are exhibiting a much narrower range than equity-focused strategies.

Although fund returns are spread along their ranges, extreme upward or downward deviations are often attributable to individual outliers. Overall, this picture underscores the importance of carrying out intensive manager due diligence before selecting funds. This becomes very clear in the case of strategies that are by definition market-neutral in the Alt. Equity Market Neutral segment, where manager risks clearly dominate. Individual strategies correlate strongly with the wider equity market. This aspect must be incorporated into fund selection, provided that investors are primarily interested in developing alternative sources of return.

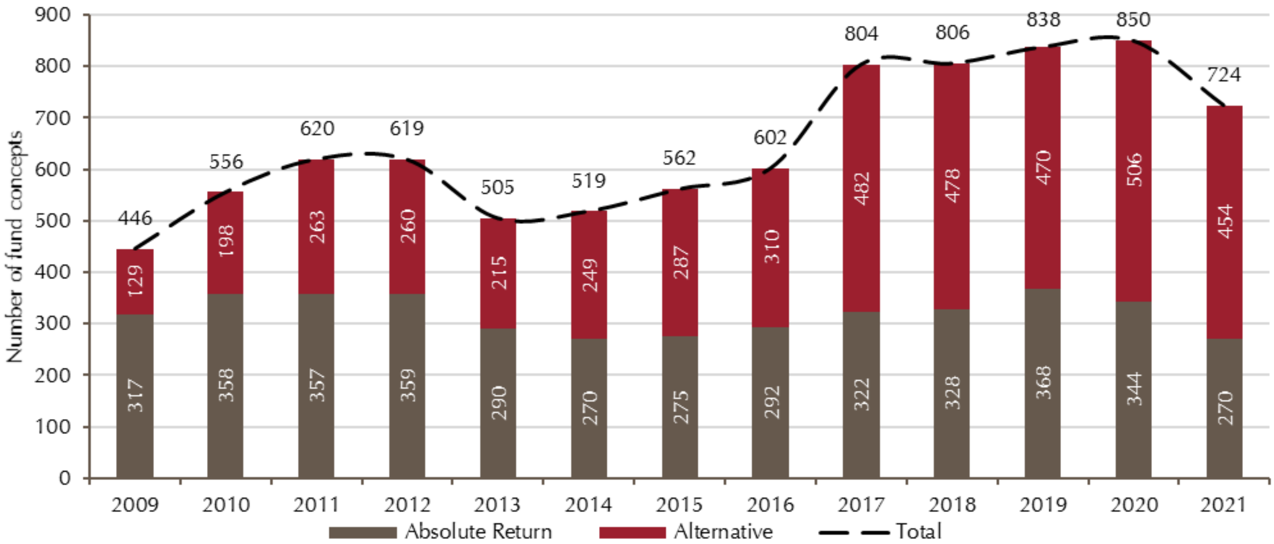
The evaluated investment universe had a net inflow of EUR 15.5 billion. Although the number of funds fell by 15%, with significant volumes withdrawn from the segment, the net inflows and strong performance ensured that the asset class developed positively, growing by EUR 9.1 billion compared to the end of 2020 to reach almost EUR 260 billion. At strategy level, it is interesting to note that Absolute Return Bond recorded significant outflows compared to other strategies in the last quarter. It seems reasonable to conclude that this is connected to the US Federal Reserve's clarification of its plans to move towards a tighter monetary policy. Investors increasingly turned their attention to opportunistic strategies such as Long Short Equity and Event Driven where they clearly saw particularly strong return potential.

MARKET DEVELOPMENT

Number of funds declines

The number of funds in the market fell by 126 to 724. In addition to fund closures, mergers or withdrawal from the German market, this decline especially reflects the reclassification of funds by data provider Refinitiv. This particularly affected funds in the Absolute Return Bond category, which accounted for 48 of the 71 reclassifications, while 40 new products were launched. Taking all of the reasons for inflows and outflows into account, the number of products in the Absolute Return funds group declined from 344 to 270 funds, while the number of Alternatives funds fell from 506 to 454.

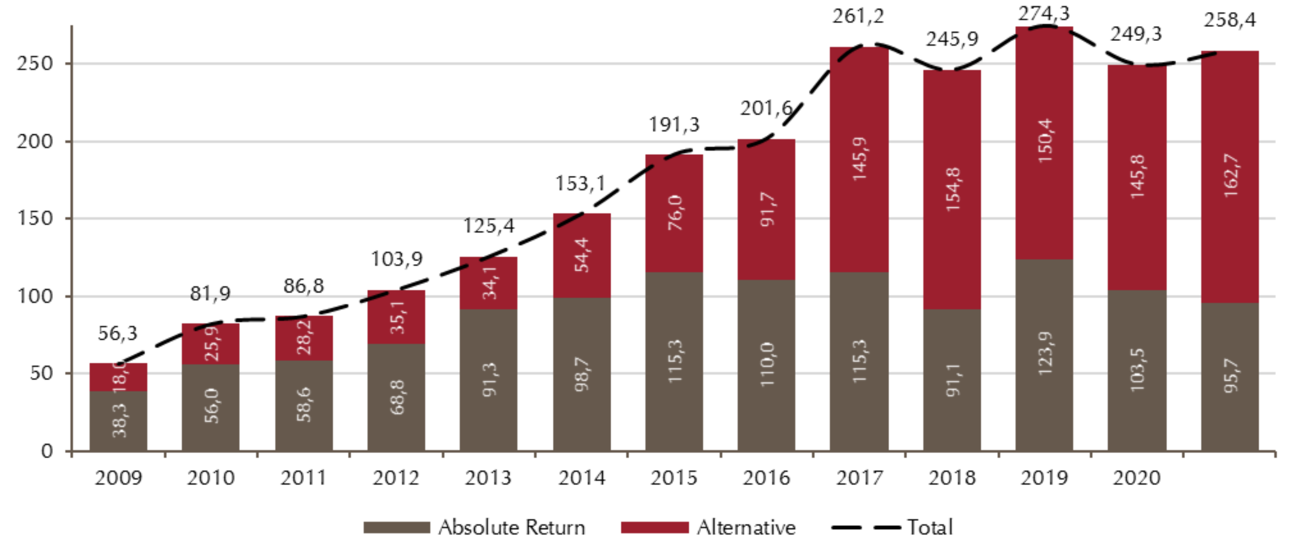
Number of funds: shifts in fund classification shrink universe



Market volume rises to almost EUR 260 billion – despite decreasing number of funds

The evaluated market volume grew by EUR 9.1 billion despite the lower number of funds (see chart on next page). This was due to both net inflows, which added up to EUR 15.5 billion during the course of the year, as well as exceptionally strong performance. As a result, the inflows and performance more than offset the negative impact of reclassification on market volume.

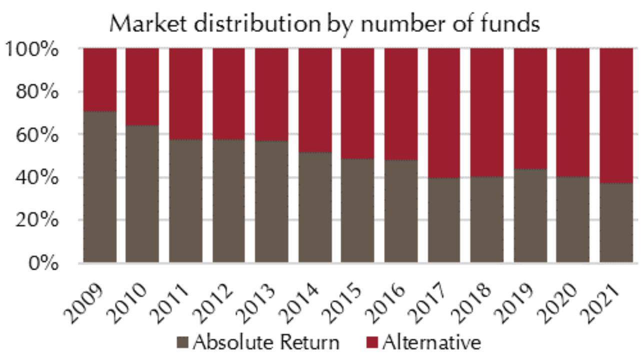
Market volume: high inflows and performance compensate for lower fund numbers

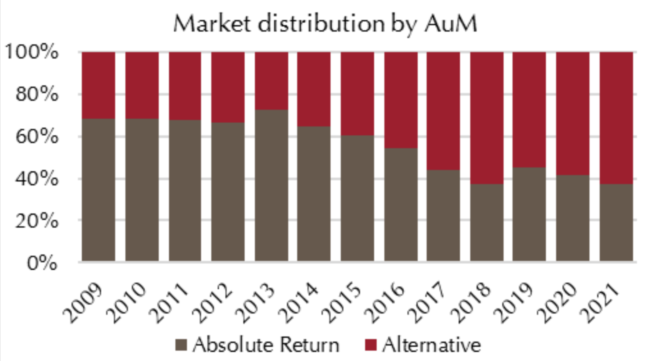


Alternative strategies increasingly dominant

The reclassification shifted the weighting even further towards Alternative strategies, which now make up 63% of market volume (see right-hand chart), while the share of Absolute Return strategies dropped to around 37%. This trend was already apparent in previous years regardless of statistical effects.

Alternative strategies take on further significance

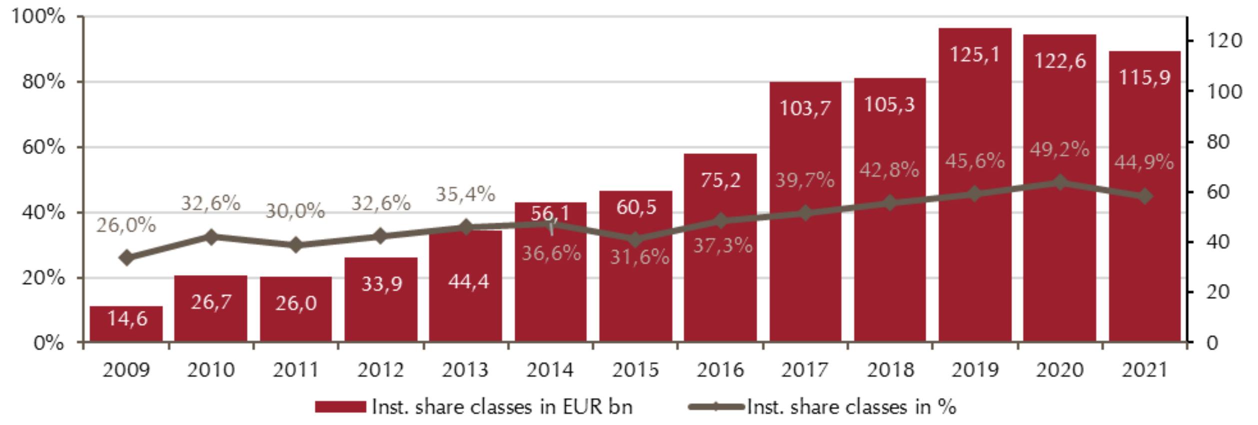




Decline in share of institutional investors primarily a statistical effect

The proportion of institutional share classes fell for the first time since 2015 and is now just under 45%. However, this decline is primarily due to reclassification. The proportion of institutional investors is now especially large in Absolute Return Bond strategies, where a statistically extremely high number of funds dropped out of the evaluated universe. This does not mean that institutional investors are withdrawing from the strategies in question, but that they are simply no longer included in the statistics.

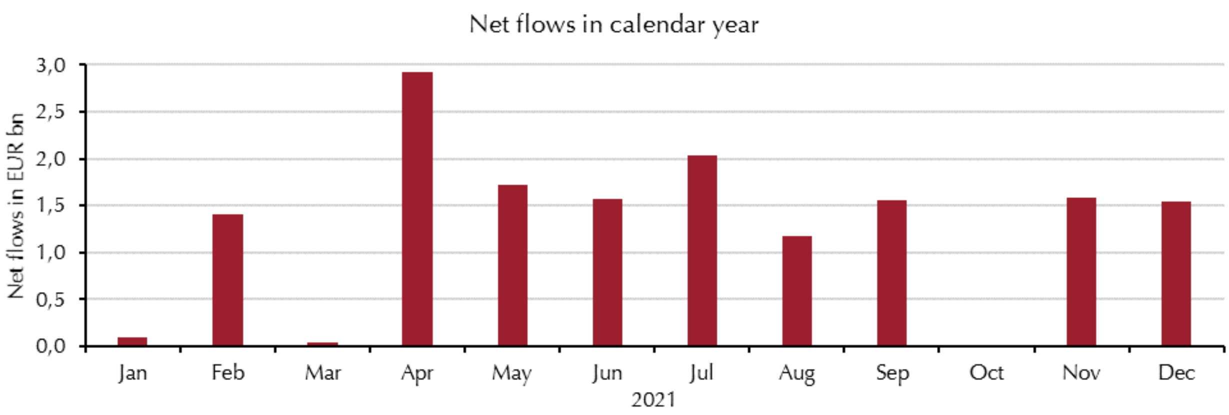
Volume and share of institutional share classes falls



Inflows: investors steadily redirecting capital into liquid alternatives in 2021

The positive net inflows at asset class level (EUR 15.5 billion) continued almost constantly through the year. The only net outflows were in October and primarily affected Absolute Return Bond strategies.

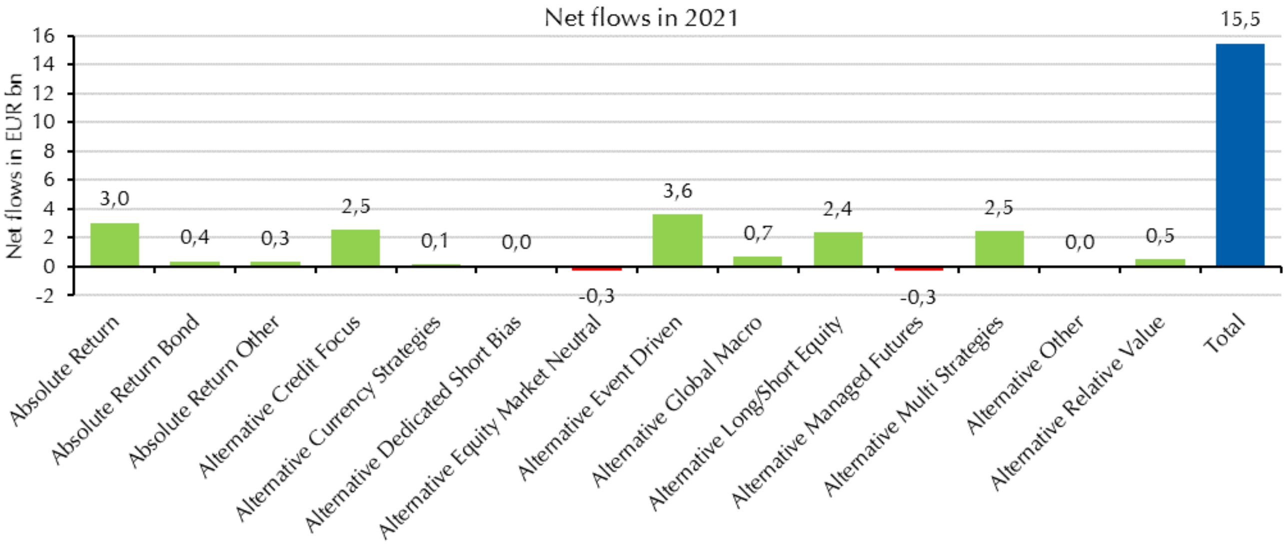
Significant net inflows recorded in most months



Alternative Event Driven favourite among investors; Mounting inflation fears: high outflows for Absolute Return Bond in Q4

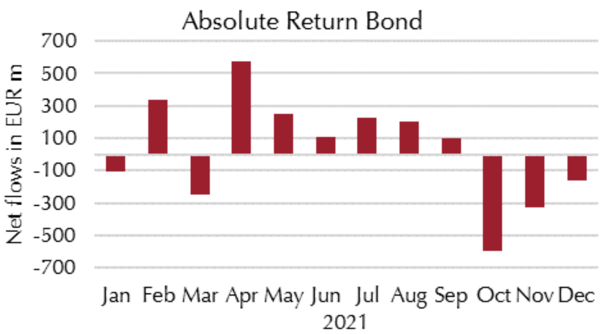
Event Driven strategies recorded the biggest inflows, both in absolute terms at EUR 3.6 billion and in relative terms at +25.6%. Absolute Return strategies ranked second in terms of inflows at EUR 3 billion. Absolute Return Bond ultimately recorded positive flows despite significant outflows in the fourth quarter. Only the Alternative Managed Futures and Alternative Equity Market Neutral strategies suffered outflows. Investors clearly turned their backs on market-neutral strategies with low beta, as these strategies were unable to profit from the strong upturn in the equity markets. Amid significant equity market gains, investors instead increasingly turned their attention to opportunistic strategies such as Long Short Equity and Event Driven where they clearly saw particularly strong return potential. Although it seems as the market is concerned about a correction, investors want to remain invested and are not prepared to watch the next upward surge from the sidelines.

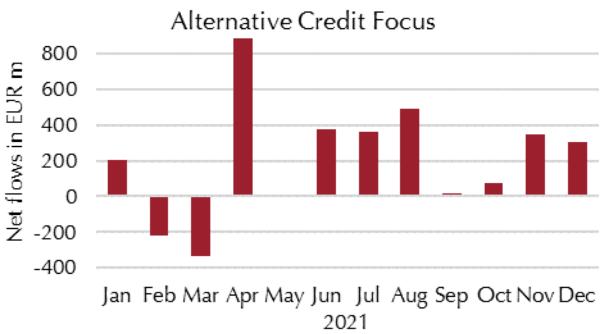
Most strategies generated net inflows



The following provides a closer look at flows in and out of Absolute Return Bond strategies as the second-largest individual strategy in the segment. When inflation fears and the looming spectre of interest rate hikes reached the market, there were significant outflows totalling just under EUR -1.1 billion. These movements occurred irrespective of the reclassification. By contrast, investors continued to favour credit strategies during the fourth quarter, enabling them to record inflows. One potential explanation for this is that, unlike bonds, credit structures often have variable interest rates and are therefore far less sensitive to rising interest rates. Despite this, Absolute Return Bond strategies also recorded net inflows of EUR 354 million over the course of the year.

Absolute Return Bond loses investors in fourth quarter, Credit makes gains

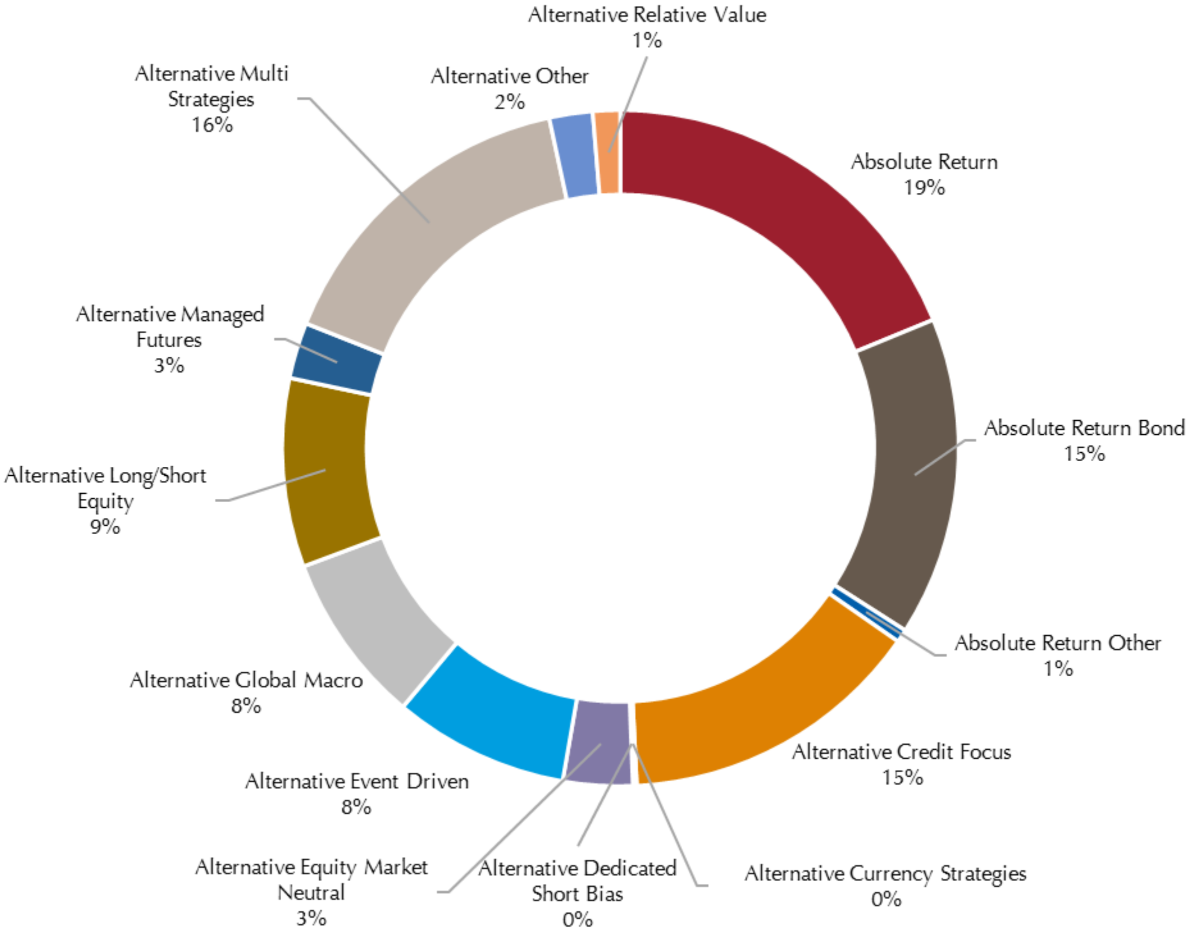




Absolute Return is the largest individual strategy

Fixed-income strategies (AR Bond: 15% + Alt Credit Focus: 15%) make up around 30% of the evaluated market, while Absolute Return is the strategy with the largest share of assets under management at 19%. The smallest seven of the 14 strategies combined only represent one tenth of the market.

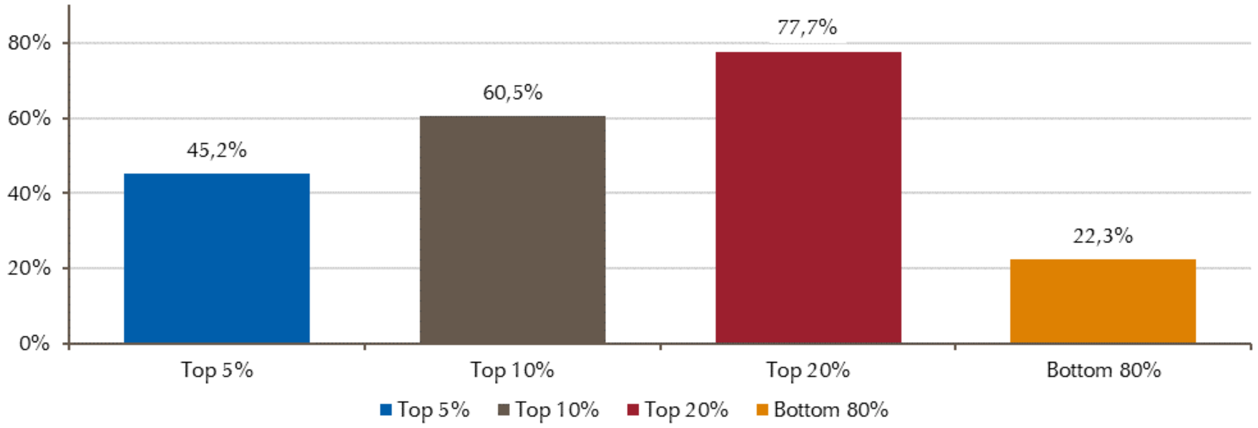
Market share: fixed-income strategies make up one third of market



Almost half of fund volume attributable to only five per cent of funds

The top 5% of funds manage more than twice as much capital as the bottom 80%. However, the dominance of large funds has shifted slightly in favour of the smaller funds compared to 2020 (12/2020: top 5% = 51.4% and bottom 80% = 17.0%).

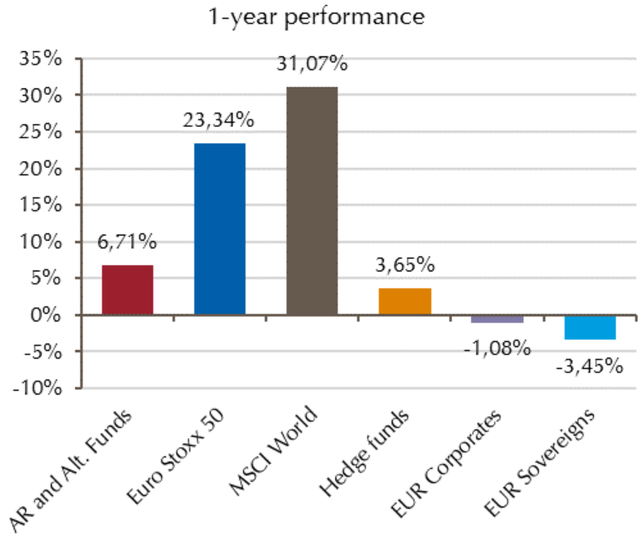
Almost half of fund volume attributable to 5% of the largest funds

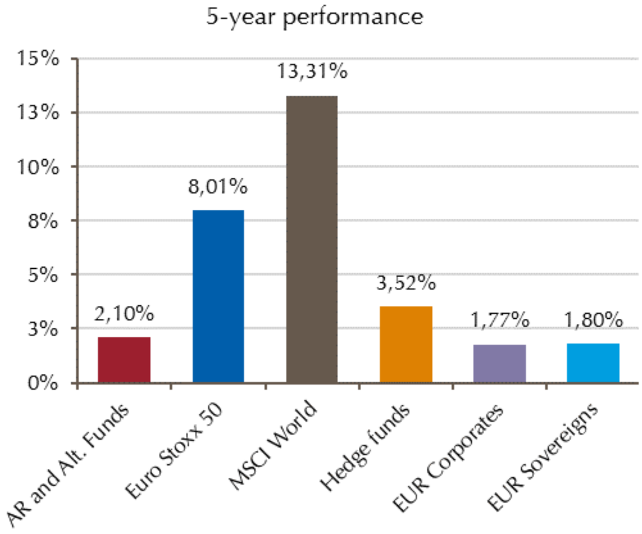


2021: liquid UCITS funds leave unregulated hedge fund strategies trailing in their wake

2021 was a strong year for absolute return and liquid alternatives funds, with the investment segment recording its best result since the study was first published. With a return of 6.71%, they ended the year in much better shape than traditional hedge funds (3.65%) and positioned themselves as an alternative to the bond market's negative returns in particular. Liquid alternative strategies also outperformed the bond markets over five years.

Liquid alternatives better than bond markets in short and medium term

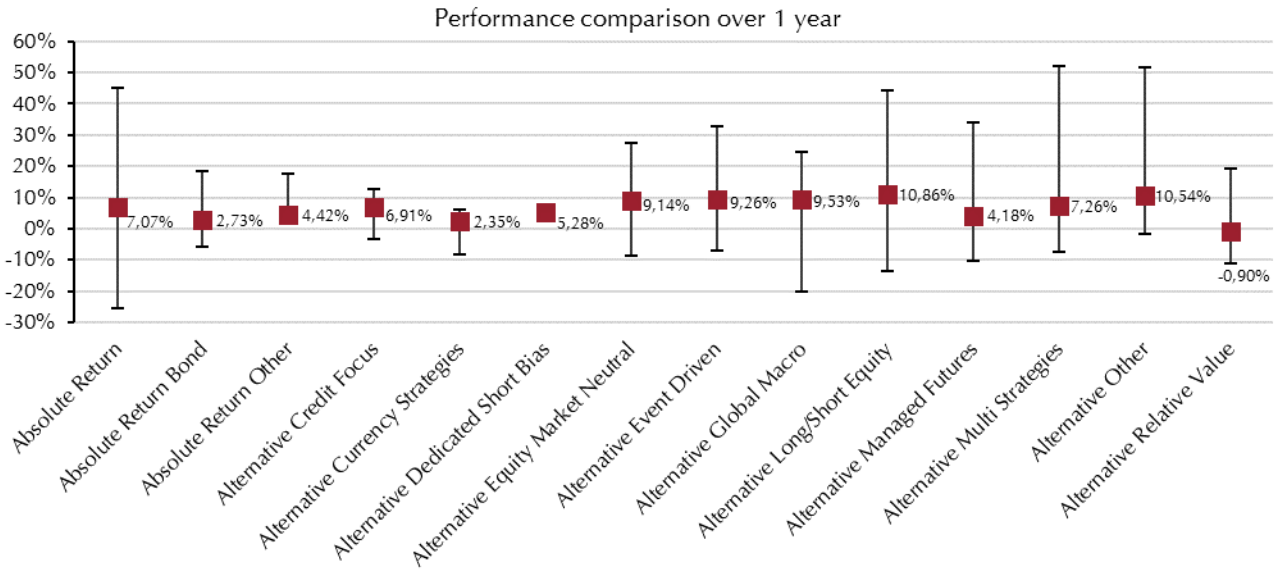




2021: Significant differences in performance between strategies, even greater differences between managers

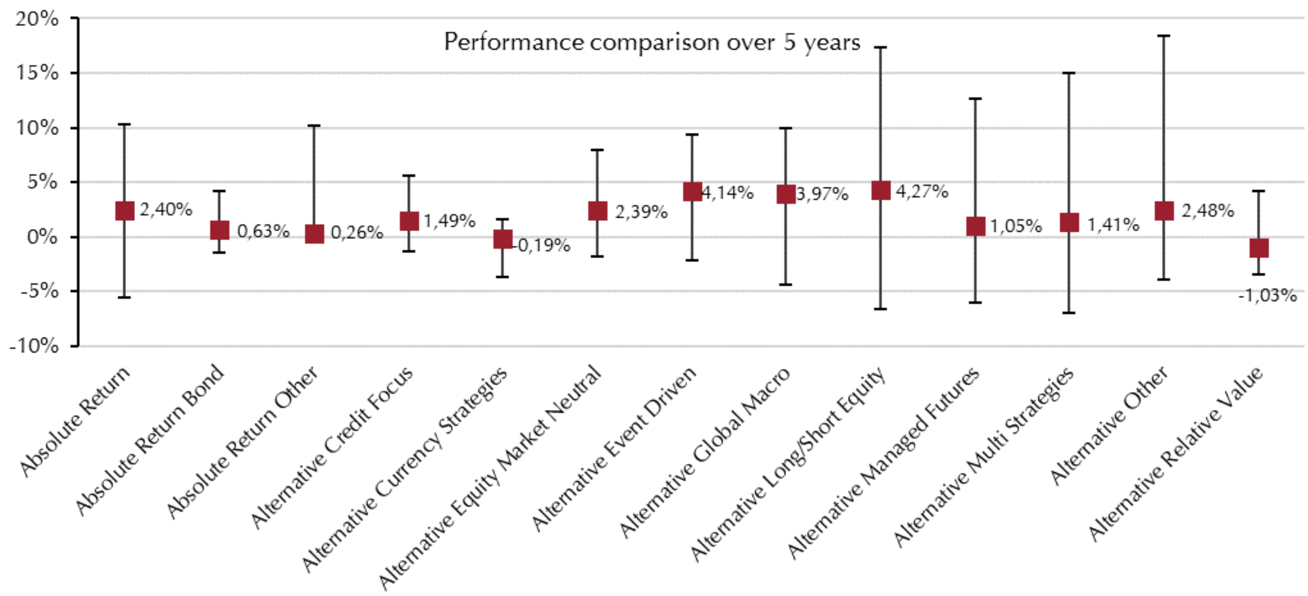
Most funds recorded a positive performance in 2021. Within strategies, the spread of returns for fixed-income strategies as well as Alternative Credit and Absolute Return Bond tended to be narrower compared to higher-risk strategies such as Long Short Equity, Managed Futures or Global Macro. The significant spread in Equity Market Neutral strategies suggests that although beta-neutral strategies eliminate market risk, they can involve a high level of manager risk.

One thing all strategies have in common is that the greater the dispersion between the funds within a given segment, the more important it becomes to select an exceptional manager. This even applies to fixed-income strategies such as Absolute Return Bond, whose funds ended the year with returns between -5.75% and 18.44%. This means that dedicated manager selection is particularly crucial if investors are planning to enter a complex strategy with the potential for more significant operational or investment-related risks.



In-depth manager selection also appears to be advisable when looking at funds over a five-year period. Although most funds are profitable over this time, a few manage to consistently generate more than 5% per annum.

Average performance over 5 years at lower end of return spectrum



Correlations: Equity markets provide tailwind for individual strategies

Looking at correlations between HFRX indices, there are significant differences between strategies over a five-year period. Some strategies correlate strongly with the global equity market, giving them a significant boost over the past year. Investors aiming to open up alternative sources of returns by committing to the liquid alternatives segment should include the correlation of these strategies with the equity market in their due diligence.

Some strong correlation with the MSCI World equity index (5-year HFRX indices)

	Absolute Return	Macro/ CTA	Equity Hedge	Global Hedge Fund EUR	Equity Market Neutral	ED Merger Arbitrage	Event Driven	Fixed Income Credit	Relative Value Arbitrage	MSCI World Net TR USD
Absolute Return	1									
Macro/CTA	0.240	1								
Equity Hedge	0.616	0.495	1							
Global Hedge Fund EUR	0.497	0.222	0.889	1						
Equity Market Neutral	0.613	0.488	0.988	0.874	1					
ED Merger Arbitrage	0.490	0.083	0.273	0.267	0.284	1				
Event Driven	0.702	0.001	0.443	0.383	0.431	0.220	1			
Fixed Income Credit	0.470	0.120	0.434	0.342	0.441	0.152	0.283	1		
Relative Value Arbitrage	0.560	0.131	0.785	0.615	0.778	0.210	0.531	0.323	1	
MSCI World Net TR USD	0.654	0.212	0.693	0.557	0.705	0.234	0.436	0.786	0.545	1

Sharpe ratio: Almost 80% of funds deliver on their product promise

Overall, 79% of funds achieved a positive Sharpe ratio and delivered on their product promise over the past year, although only 3.6% generated a Sharpe ratio above 1. Over a five-year period, equity strategies in particular stand out: of the 15 funds with a Sharpe ratio above 1, six follow an Alternative Long/Short Equity strategy and four follow an Alternative Equity Market Neutral strategy. As a result, anyone wanting to get into the realms of higher Sharpe ratios needs to focus their due diligence on a few select strategies.

Careful due diligence rewarded with higher Sharpe ratio (five years)

Proportion of funds with...	...SR > 0	...SR > 1
Absolute Return	78,8%	0,8%
Absolute Return Bond	82,2%	-
Absolute Return Other	100,0%	-
Alternative Credit Focus	92,1%	2,6%
Alternative Currency Strategies	25,0%	-
Alternative Dedicated Short Bias	-	-
Alternative Equity Market Neutral	76,9%	30,8%
Alternative Event Driven	73,3%	-
Alternative Global Macro	78,9%	5,3%
Alternative Long/Short Equity	92,0%	12,0%
Alternative Managed Futures	68,0%	-
Alternative Multi Strategies	64,7%	3,9%
Alternative Other	87,5%	-
Alternative Relative Value	60,0%	-

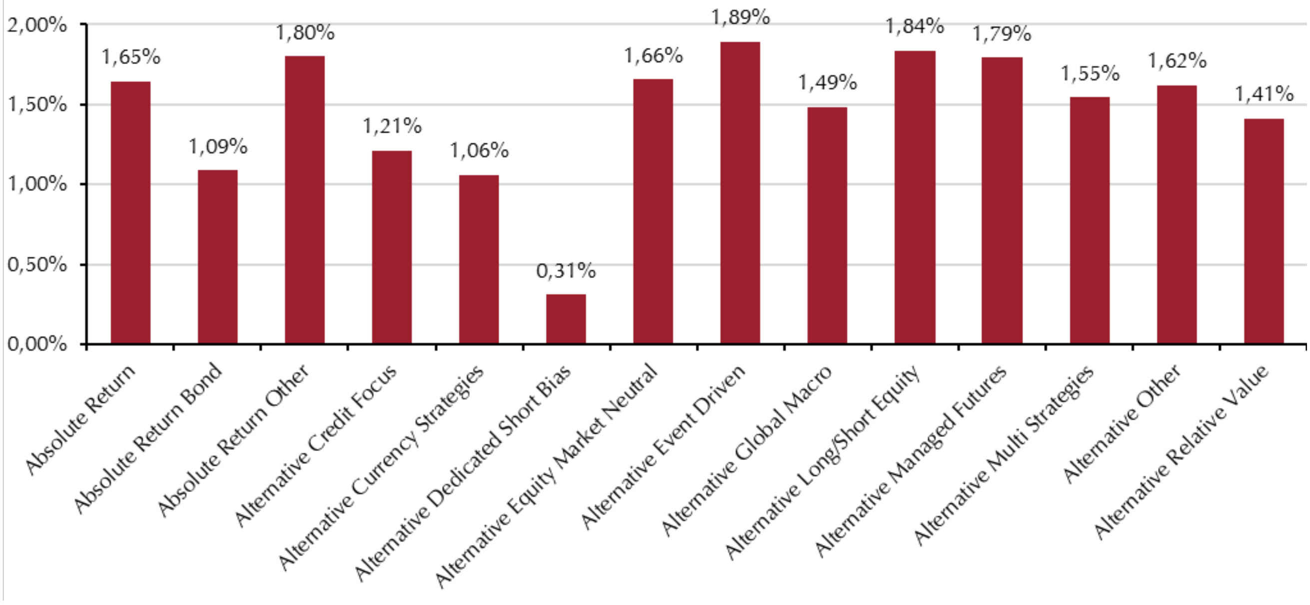
Low maximum drawdowns

At an average of -3.25%, maximum drawdowns were significantly lower in 2021 than when taking a long-term view over five years (-14.08%). This suggests that most of the funds considered had a larger maximum loss in at least one year during this 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.

Costs largely unchanged

Costs have remained largely stable on average across all strategies since 2018, amounting to 1.56% in 2021 (2017: 1.62%). 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

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 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.
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, 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.

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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.