FRANKLIN TEMPLETON INVESTMENTS
Beyond Bulls & Bears

ALTERNATIVES

Third-Quarter Hedge Fund Strategy Outlook: K2 Advisors

August 19, 2016

David Saunders
Founding Managing Director
K2 Advisors®, Franklin Templeton Solutions®

Robert Christian
Senior Managing Director, Head of Research
K2 Advisors®
Franklin Templeton Solutions®

Brooks Ritchey
Senior Managing Director
Head of Portfolio Construction
K2 Advisors®, Franklin Templeton Solutions®

K2 Advisors, Franklin Templeton Solutions, seeks to add value through active portfolio management, tactical allocation and diversification across four main hedge strategies: long short equity, relative value, global macro and event driven. In the third quarter (Q3) of 2016, K2 Advisors' Research and Portfolio Construction teams continue to have high conviction for long short equity and merger arbitrage strategies, and within the global macro strategy, the teams have elevated emerging markets into their top three convictions.

You can learn more about these types of hedge strategies in our prior blog, "Solidifying a Case for Liquid Alts." Here, we present the team's "Q3 2016 Hedge Fund Strategy Outlook."

The Tide Recedes … and Alpha Emerges?

As an industry, when we talk about alpha, we often use terms like "generate," "produce," and "create," as if alpha were something that can arbitrarily be conjured at will. In our view, this language is misleading. Alpha is neither produced nor generated—it is captured. (Reminder: "Alpha" refers to the difference in return for an investment compared to a relevant benchmark. Higher alpha is preferred.)

This is an important concept to bear in mind in terms of hedge strategy investing—or any active investment for that matter. Alpha is not something readily available for the taking in all environments and all conditions. In some market circumstances it may be easier and more readily captured, while in others it can be much more elusive.

So where are we today? We believe the potential for alpha capture is improving. Following the market low in February of this year, we have seen a significant and broad recovery in equity markets. The rally, however, has been somewhat indiscriminate across sectors, geographies and market capitalizations. There has been little in the way of differentiation between a good company or a bad company, a good sector or a bad one. The rising tide has lifted all boats, so to speak. Going forward we anticipate this will likely change.

Today, economic uncertainty is high. There is uncertainty surrounding the aftermath of Brexit and the potential for contagion to other countries in the European Union (EU). There is uncertainty surrounding the Federal Reserve's (Fed's) actions and interest rates globally. There is political uncertainty in developed economies, and geopolitical unrest in many emerging nations. At the beginning of the third quarter of 2016, S&P 500 earnings were showing negative growth, and price-earnings (P/E) ratios were near a 12-year peak.[1] Given these conditions, we anticipate choppy markets for the remainder of 2016. The resulting volatility and dispersion should lead to a more attractive environment for stock picking—and hence for the capture of elusive alpha as well.

Long Short Equity

When we look at strategies, long short equity specifically, we anticipate the market will be more discerning with regard to fundamentals like revenue growth and valuations. This could potentially separate the weaker companies and sectors from the strong. In this way, equity long short managers may continue to own the companies they like, but they may also "go short"—that is sell short—the companies that they feel are mediocre and may come under pressure going forward.

If we consider the energy and raw materials sector as an example, we have seen some very weak performance over the last five quarters. But when you look at the forward earnings estimates and some of the valuations on energy and raw material equities, they are quite compelling. Many of the strategy managers we use are mentioning that those might be good long positions, a good sector and area to buy securities.

Conversely, if you look at health care and technology stocks, they have had a very nice run. But the sector may be considered by some hedge fund managers to be overvalued, or showing slowing revenue and earnings growth. In this circumstance, hedge strategies have the ability to make money independent of market trends. While they can still buy in pockets of value, they can also short—or hedge out market risk—using companies they feel have deteriorating fundamentals.

Merger Arbitrage

Another attractive strategy is merger arbitrage. Last quarter, high corporate cash levels, low interest rates, and merger deal spreads remaining at healthy levels served as a good tailwind to merger arbitrage. These factors are all still in play, and the fundamentals may have strengthened following the Brexit vote. Because of the United Kingdom's decision to leave the EU, we believe it is less likely the Fed and other central banks globally will look to hike interest rates in the near term. Low interest rates have historically been very positive for merger arbitrage strategies.

Emerging Markets

Lastly, for managers pursuing strategies in the global macro space, in our view, emerging markets continue to present a favorable environment. The recent recovery in commodity prices has relieved some of the emerging economies' economic pressures that had been evident during 2015. We believe valuations of select emerging-country equity and sovereign bond investments remain attractive relative to those available in developed markets.

Learn more about K2's strategy and watch videos featuring K2's Brooks Ritchey on our website.

Comments, opinions and analyses expressed herein are for informational purposes only and should not be considered individual investment advice or recommendations to invest in any security or to adopt any investment strategy. Because market and economic conditions are subject to rapid change, comments, opinions and analyses are rendered as of the date of the posting and may change without notice. The material is not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy.

This information is intended for US residents only.

To get insights from Franklin Templeton Investments delivered to your inbox, subscribe to the Beyond Bulls & Bears blog.

For timely investing tidbits, follow us on Twitter @FTI_US and on LinkedIn.

What Are the Risks?

All investments involve risks, including possible loss of principal. The identification of attractive investment opportunities is difficult and involves a significant degree of uncertainty and there is no assurance any such strategies will be successful. An investment in these strategies is subject to various risks, such as those market risks common to entities investing in all types of securities, including market volatility.

The market values of securities held in the K2 liquid alternatives portfolios will go up or down, sometimes rapidly or unpredictably. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in developing markets involve heightened risks related to the same factors, in addition to those associated with their relatively small size and lesser liquidity. Hedge strategy outlooks are determined relative to other hedge strategies and do not represent an opinion regarding absolute expected future performance or risk. Conviction sentiment determined by the K2 Research Group is based on a variety of factors and may change from time to time.

For more information on any of our funds, contact your financial advisor or download a free prospectus. Investors should carefully consider a fund's investment goals, risks, sales charges and expenses before investing. The prospectus contains this and other information. Please read the prospectus carefully before investing or sending money.

---

1. The price-earnings (P/E) ratio for an individual stock compares the stock price to the company's earnings per share. The P/E ratio for an index is the weighted average of the price/earnings ratios of the stocks in the index.

Posted in Alternatives Tagged alternative investments, Brooks Ritchey, David Saunders, Franklin Templeton Solutions, K2, liquid alts, Robert Christian

Important Legal Information

FINRA's BrokerCheck

You can check the background of your investment professional on FINRA's **BrokerCheck**.

Links can take you to third party sites/media, directly or through new browser windows. We urge you to review the privacy, security, terms of use, and other policies of each site you visit. You use any third-party site, software, and materials at your own risk. Franklin Templeton does not control, adopt, endorse or accept responsibility for content, tools, products, or services (including any software, links, advertising, opinions or comments) available on or through third party sites or software.

Franklin Templeton welcomes your feedback on this blog. To keep the conversation respectful and focused, please follow our current Commenting Guidelines. We review comments and reserve the right to block any comment or commenter, including those that we may deem inappropriate or offensive. We may block any comment or commenter whose posts include investment testimonials, advice, or recommendations, or advertisements for products or services, or other promotional content.

Questions or comments about your Franklin Templeton account or customer-service issues? Please contact us directly but never include account or personal financial information in your comments.

The comments, opinions and analyses are the personal views expressed by the investment manager and are intended to be for informational purposes and general interest only and should not be construed as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy. It does not constitute legal or tax advice. The information provided in this material is rendered as at publication date and may change without notice and it is not intended as a complete analysis of every material fact regarding any country, region, market or investment.

All investments involve risk, including possible loss of principal.

Investors should carefully consider a fund's investment goals, risks, charges and expenses before investing. To obtain a summary prospectus and/or prospectus, which contains this and other information, talk to your financial advisor, call us at (800) DIAL BEN/342-5236 or visit franklintempleton.com. Please carefully read a prospectus before you invest or send money.

Data from third party sources may have been used in the preparation of this material and Franklin Templeton Investments ("FTI") has not independently verified, validated or audited such data. FTI accepts no liability whatsoever for any loss arising from use of this information and reliance upon the comments, opinions and analyses in the material is at the sole discretion of the user.

Franklin Templeton Distributors, Inc.