MULTI-ASSET

Fourth-Quarter Hedge Fund Strategy Outlook: K2 Advisors

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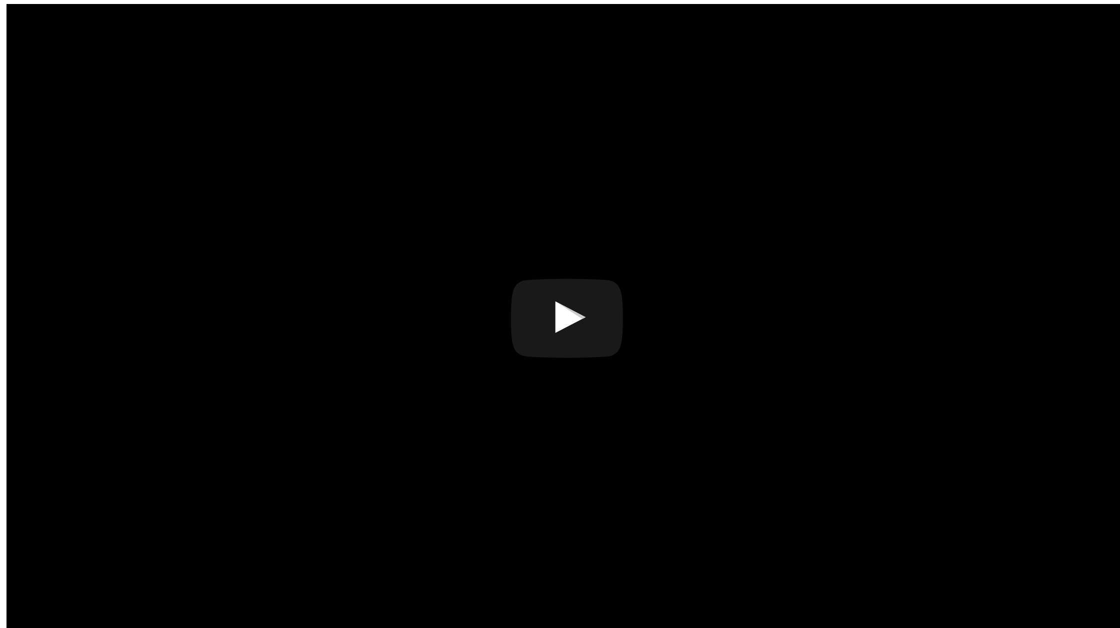
K2 Advisors seeks to add value through active portfolio management, tactical allocation and diversification across four main hedge strategies: long short equity, relative value, global macro and event driven. In the fourth quarter (Q4) of 2016, K2 Advisors' Research and Portfolio Construction teams report that favorable dispersion has created reasons for optimism and strengthens their conviction in select hedge strategies. 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 "Q4 2016 Hedge Fund Strategy Outlook."

Watch a video featuring K2's Brooks Ritchey, who shares his view of potential market challenges and opportunities ahead—including the UK Brexit, the US presidential election and global monetary policy.



Q4 Outlook: Favorable Dispersion Presents Opportunity

Dispersion in valuations, dispersion in security prices, dispersion in currencies, dispersion in earnings. The point is, ladies and gentleman, that dispersion—for lack of a better word—can be good for hedge strategies. No, we are not talking about "greed" (thank you, Gordon Gekko), but as we look toward the fourth quarter of 2016 and identify our top convictions for the remainder of the year, we are most definitely talking about dispersion; or more specifically, increased dispersion. For hedge strategies, this can indeed be a good thing.

When considering statistical measurements that are significant in terms of the efficacy of any active investment—and the ability of hedge strategies to capture alpha—the first that often comes to mind for investors is correlation.[1] While correlation is an important measure—it only tells part of the story. Dispersion is a significant part of the narrative as well. While correlation can show the directional movement of a stock or asset relative to others, it does not indicate the magnitude of that movement. The magnitude of movement is demonstrated by dispersion—and this is implicitly a meaningful factor in terms of the ability of hedge-strategy managers to capture alpha. In a high-dispersion environment stock prices can vary significantly, which, in theory, would allow skilled fundamental stock-pickers to differentiate themselves greatly. In a low-dispersion environment it is less common for stocks to move substantially against each other, despite any idiosyncratic fundamental changes that may be present.

Dispersion Trending Upward: Opportunities for Long Short Equity Hedge Strategies

Broadly speaking, we view the equity market cycle as somewhat extended, as we are nearing the end of an almost eight-year run of positive performance, with price-earnings (P/E) ratios nearing 12-year peaks.[2] This far along in the recovery cycle, some sectors—and individual companies within sectors—are waning in terms of earnings-growth prospects. Many of the hedge-fund managers we've chosen to manage portions of our funds are noting a meaningful differentiation in the outlook for some companies versus others.

While the first half of 2016 was challenging, over the third quarter stocks have increasingly reacted to company-specific developments. We anticipate this continuing as we move forward. In addition, there exists the potential for a rise in interest rates as well. Historically, rising rates have created more opportunities for long short managers to harvest alpha. As rates rise, fundamentally weak companies typically face increased pressures on their balance sheets, and this often leads to an increase in a fundamental gap in valuations, P/E ratios and price-to-book values.[3] These dispersions may allow managers to capitalize on idiosyncratic opportunities on both long and short trades, profiting from correctly picking winners and losers.

Another meaningful factor at play is of course the upcoming US presidential election, and what impact that may have on regulatory changes in certain industries. For example, as many have probably seen in the headlines, there is potential for change in the regulation of pricing for health care products and pharmaceuticals. Equity long short hedge-fund managers seek to assess how this may play out in either a Democratic or a Republican regime and to identify what companies may benefit or be hurt from any potential regulatory changes.

Lastly, we believe that hedge strategies pursuing a market-neutral orientation are well-positioned to capitalize in the potentially volatile, low-growth environment we face going forward. Things like uncertainty relating to the upcoming presidential election and Federal Reserve interest rate policy meetings could cause market volatility to spike during the fourth quarter. Market-neutral strategies' typically low correlation to equity markets should help insulate them from large equity market drawdowns, while at the same time the strategy may be able to systematically capture alpha by exploiting factors, trends and liquidity.

Tailwinds for Merger Arbitrage

Similar to last quarter, we remain very positive on the event-driven hedge strategy, specifically in the area of merger-and-acquisition (M&A) activity. There are a host of elements driving our high-conviction in this strategy. Deal levels have remained high over the last several years as the result of a strong tailwind to the strategy in the form of extremely low interest rates, accommodative credit markets and high corporate cash balances. We anticipate this tailwind should persist. Cross-border activity has also remained robust due to Chinese activity and consolidation in health care and in technology.

In addition, there is increased pressure on companies to increase earnings. A convenient way for them to do this is through strategic M&A, where businesses with substantial synergies can be brought together to lower costs. This can be very accretive to earnings. Furthermore, there is a high level of uncertainty globally, both economically and politically, so companies have been hesitant to make long-term capital expenditures.

Lastly, spreads and pricing remain favorable because there is less proprietary capital on the street—due to Dodd-Frank and other regulations incurred since 2008—chasing the same deals. So the spreads (dispersion again) appear very attractive, and the quality of deals remains strong as well. For example, there are no tax-inversion mergers, and leveraged buyouts have remained low. Additionally, many of the high-profile riskier deals have already been terminated.

Global Macro: Emerging Markets

Finally, we continue to view global macro as one of our top convictions, specifically within the area of emerging markets. We are seeing a divergence (yet more dispersion) in growth in emerging-market countries. Associated with this is a divergence in central bank policies, as some are on a hiking cycle (e.g., Mexico, Columbia, Egypt) and have raised rates recently, while others are on the cutting and accommodative side (e.g., India, Kazakhstan, South Korea). So we are seeing a separation in economic growth which is triggering a division in central bank monetary policy, and all can be good things for the potential for alpha capture and global macro hedge strategies. In addition, geopolitical risk is arguably at an all-time high; we have impeachments in Brazil, Brexit in the United Kingdom, unrest in Turkey, persistent conflicts in the Middle East, a tempestuous election cycle in the United States, aggressive rhetoric from North Korea and posturing from Russia. In short, we expect overall volatility to increase across the global markets, and often emerging markets are more volatile than their developed counterparts. With this volatility we anticipate the arrival of opportunity, and we believe it will likely be manifest across all three major asset classes—equity, fixed income and currency.

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

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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.

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1. Correlation measures the degree to which investments move in tandem and will range between 1 (perfect positive correlation, moving in the same direction) to -1 (perfect negative correlation, moving in opposite directions). Alpha is a risk-adjusted measure of the value that a portfolio manager adds to or subtracts from a fund's return.

2.The price-earnings (P/E) ratio for an individual stock compares the stock price to the company's earnings per share.

3. For an individual company, the price-to-book (P/B) ratio is the current share price divided by a company's book value (or net worth) per share.

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