ALTERNATIVES

First-Quarter Hedge-Fund Strategy Outlook: K2 Advisors

January 24, 2017


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


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


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

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 their first-quarter (Q1) 2017 outlook, K2 Advisors' Research and Portfolio Construction teams break down the market's "Trumpflation" rally and other key market events they have an eye on ahead.

Watch a video featuring K2's Brooks Ritchey, who shares his view of potential market challenges and opportunities ahead.

Q1 Outlook: A "Yuuuuuge" Change for the Markets?

On Tuesday, November 8, 2016, the world changed meaningfully, and with it the sentiment that had been driving global markets for the previous eight-plus years. Overnight the prevailing macroeconomic narrative was rewritten. A future once defined by predictions of limited growth, "lower-for-longer" rate expectations, and concerns over deflation/stagflation was suddenly turned on its head. By the evening of November 9, less than 24 hours following US presidential election results, base-case expectations turned from deflation to surging reflation, from stagnant gross domestic product (GDP) to explosive growth. Assets around the globe quickly and forcefully re-priced an assumed new world order. In short, the so-called "Trumpflation" rally was on.

Since the US election, markets have confidently placed their bets squarely on hope, and essentially little else. There is hope that the Trump campaign promise to do "great" things for America will indeed come to fruition. Hope that proposed massive infrastructure spending, aggressive tax cuts, repatriated earnings and potential for less onerous regulation will succeed in galvanizing the US economy. Hope that the Federal Reserve will be able to normalize rates without any ill effects. Hope that Europe will not see any political fallout from the Italian referendum or from the French and German elections later in 2017. And hope that emerging markets will stabilize and not be burdened by the US dollar's surge.

Is this level of hope (optimism) rational? It certainly seems like a lot to expect. But truth is indeed often stranger than fiction, and even the most gifted of storytellers would likely never imagine a more fantastic yarn than the reality of this election cycle. Perhaps we will get real and tangible growth in America. Or perhaps not.

Regardless, our job is to manage in and through the environment as we see it unfolding. One thing we feel certain about is that the path forward will be marked by uncertainty and market volatility—and this is generally a good thing for hedge strategies. Remember, alpha[1] is a byproduct of an inefficient market, and in our view, higher volatility is an indication of greater market inefficiency. Clearly, Trump's victory did represent a seismic shift, and while markets are discovering how this shift will change the landscape, we anticipate sharp market moves along the way—and in both directions. We also anticipate large asset rotations, like the significant move out of bonds and into stocks that we have been witnessing. And, we expect measurable dispersion on a sector and security basis. In these circumstances, investment managers with more latitude in trading and access to more esoteric or non-traditional securities may be better able to capitalize on price dislocations and trends.

Trumpflation: An Improved Environment for Long-Short Equity

We were optimistic about long-short equity last quarter, and our conviction in the strategy has been strengthened going forward. We believe the aforementioned sea change in the markets we have observed following the Trump victory has provided an added tailwind to the strategy, as has the expectation for a normalization of interest rates. We expect that long-short equity managers will be able to capitalize on idiosyncratic opportunities that may develop as a result of these changes. For example, fundamentally weak companies may face increased pressures on their financials in a rising rate environment, allowing managers to profit if they can correctly pick winners and losers. Cyclically sensitive companies and sectors may do well against a backdrop of increased infrastructure spending, while defensive sectors may lag as investors shift out of yield-oriented names.

When the Repatriation Levee Breaks: Event Driven

We remain very positive on the event-driven hedge strategy. There are a host of elements driving our conviction in this strategy. Deal levels have remained high over the last several years as the result of extremely low interest rates, accommodative credit markets, and high corporate cash balances. This quarter, however, we anticipate another potential tailwind to the strategy. Following the surprise Trump victory, a new narrative has emerged regarding the possibility of repatriating trillions of dollars in cash held by US corporations overseas. This outcome is only speculative of course, and the time frame of any such transfer as well as the precise amounts of capital remaining overseas are unknown. Nonetheless, the prevailing sentiment is that potential regulatory and tax code changes implemented by the new Trump administration could incentivize corporations to bring some or all of this liquidity back onshore.

Naturally, this would serve as a significant catalyst to the event-driven strategy, as we could see this cash being used for a variety of corporate transactions including special stock dividends, increased dividends, potential share buybacks, mergers and acquisitions, corporate restructurings and potential increased research and development expenditures. The bottom line is chief financial officers would be flush with cash, and this would likely create a very compelling opportunity set for corporate activity and growth.

You can learn more about the types of hedge strategies referenced here and others in our prior blog, "Solidifying a Case for Liquid Alts."

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.

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 alternative investment 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. It is always possible that any trade could generate a loss if the manager's expectations do not come to pass.

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. Alpha is a risk-adjusted measure of the value that a portfolio manager adds to or subtracts from a fund's return.