ALTERNATIVES

Third 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 their third-quarter (Q3) 2017 outlook, K2 Advisors' Research and Portfolio Construction teams share the key market events they have an eye on, along with the select strategies that represent their "top convictions." We believe offering these insights will help investors better understand the rationale for owning retail mutual funds that invest in hedge strategies.

Q3 Outlook: A Leap of Faith

As we move into the third quarter we find our attention focused on the actions of the US Federal Reserve (Fed). The Fed has now raised interest rates four times as part of an apparent normalization of monetary policy that began in December 2015. From an investment perspective, we view the Fed's decision to move interest rates higher as a positive one, particularly as it pertains to a divergence between US policy and that of central banks globally like the European Central Bank (ECB) and Bank of Japan (BOJ), which remain loose with their monetary programs. This dispersion should help create fertile opportunities for active hedge-fund strategies to capture alpha-centric[1] performance.

From a macroeconomic view, however, we see the Fed's decision in a more circumspect manner. That is not to suggest we believe the move was wrong; we do not presume to know better than Yellen, et al. what the best course of action may be.

From their seat—and tasked with the mandate of promoting a healthy economy—one could say they had little choice other than to act. Still, there are those who believe the Fed should not be raising rates when core US inflation is so low. In fact, Minneapolis Fed President Neel Kashkari disagreed with the decision. Kashkari observed that the market has been sending mixed signals of late. That is, tightening labor data but weakening inflation. In a June 16 letter, he explained his dissent as follows: "On one hand, intuitively, I am inclined to believe in the logic … a tight labor market should lead to competition for workers, which should lead to higher wages. Eventually, firms will have to pass some of those costs on to their customers, which should lead to higher inflation. On the other hand, the data are not supporting this story … core inflation is actually falling even as the labor market is tightening."

So, the data do not entirely support the Fed's thesis. In some ways it could be said the decision to raise rates reflects a leap of faith. That is, faith in economic theory versus reality, because despite labor-market tightening since March, we do not appear to be moving much closer to the Fed's inflation target.

In our view, there is a certain “let’s see what sticks” mentality involved. We suggest this because frankly, who could really know what to expect? The business of economics is decidedly complex. Irrespective of the sophistication or depth of intellect applied to the various models used by modern academics, their analysis will generally fall far short of providing sound insight into real-world behavior. In the same way that meteorology has made little progress over the last several decades in improving its probability for weather prediction, (despite an exponential spike in computing power over the same period) the business of modeling economies remains, for all intents and purposes, fuzzy at best.

With an infinite number of factors at play against a dynamic backdrop of ever-evolving markets, predicting cause-and-effect outcomes is virtually impossible. In the immortal words of Albert Einstein, “as far as the laws of mathematics refer to reality, they are not certain; and as far as they are certain, they do not refer to reality.”

Inflation expectations appear flat and may even be drifting lower. Perhaps we should have waited for more data to see if the recent drop in inflation is indeed “transitory” as Yellen’s statements seem to suggest. Perhaps not. Only time will tell.

European Long Short Equity

Irrespective of what surfaces in terms of economic growth and inflation in North America, we maintain confidence in the directional tailwind supporting long short equity trading in Europe.

European equity markets have continued to benefit from relatively favorable valuations, improving earnings growth, and overall global reflation. With most of the banking issues resolved, Europe appears to be in a position to grow again. Additionally, we anticipate the alpha environment will likely remain robust as certain companies, sectors and countries are positioned to benefit more significantly than others. Despite a lack of market volatility, correlations have declined and dispersion has increased, creating a fertile environment for fundamental stock selection.

The significant depreciation of the British pound, for example, has created better separation and earnings variances between those companies that benefit more from exports versus those that do not. And as interest rates start to increase in the region, the environment for long short investing should improve further.

Over the last several months, we have also witnessed interesting sector rotations, such as into financials and technology, while some of the defensive energy sectors and commodity-related investments have lagged. This dynamic has presented managers with the opportunity to employ quality long positions against relatively efficient market hedges.

Central Bank Policy Divergence: A Potential Benefit to Relative Value – Fixed Income

The diverging paths of central banks in the major global economies are expected to help present improved directional opportunities. Participation from directional buyers and sellers of bonds should result in greater market inefficiencies between cash, bonds and futures, benefiting less directional relative-value trading.

Specifically, managers in this strategy are finding opportunity in two primary areas: cross-country arbitrage and cross-sector arbitrage. With the Fed now having hiked interest rates four times since December 2015, they are clearly telegraphing their intent to normalize interest-rate levels going forward.

Simultaneously, the ECB and the BOJ remain somewhat stimulative in their approach. This divergence may create dispersions that present hedged opportunities, such as being short US government bonds versus holding long eurozone bonds.

Macro Commodity Trading Advisor (CTA)

CTA strategies refers to systematic trend-following and momentum-type trading**.** We are optimistic about macro CTA strategies based on a combination of stronger trend-following conditions and reduced cross-asset correlations. Low volatility across all major markets remains a headwind (particularly for price-based systematic managers), but we also like the strategy’s low correlation to traditional asset classes and the potential risk-mitigating characteristics in certain market environments.

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

Learn more about K2's strategy on our website.

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

Hedge-strategy outlooks are determined relative to other hedge strategies and do not represent an opinion regarding absolute expected future performance or risk of any strategy or sub-strategy. Conviction sentiment is determined by the K2 Advisors' Research group based on a variety of factors deemed relevant to the analyst(s) covering the strategy or sub-strategy and may change from time to time in the analyst's sole discretion.

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.

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

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