



Hedge Funds 2019 Outlook Report

A Hedgeweek special report

In association with





Introduction...

With some much welcomed market volatility in Q4 2018, 2019 could well shape up to be a year for the active trader and give hedge funds a chance to reinforce their value proposition to investors.

As Paul Tudor Jones, founder and CIO of Tudor Investment Corp, told Bloomberg recently, 2019 might be a better time to be a trader than to just hold. “I don’t know if we’re going to have a huge amount of trends. It could just be an enormously volatile period with a lot of back and forth,” he said.

To get a steer on how managers are thinking about the markets – where are the risks and the opportunities – and how the macro backdrop is shaping the way they generate trading ideas, we thought it beneficial at Hedgeweek to put together a *Hedge Funds 2019 Outlook Report*. In which, readers will find a plethora of views and opinions from some of the leading managers in the industry.

As well as market comments, the report provides insight on how the fund raising environment may develop this year, with contributions from FoHFs including Optima Fund Management and Old Farm Partners, and, of increasing interest, what role technology innovation may continue to play and how managers view the ever changing cyber threat landscape.

We value the time and willingness among the hedge fund community to contribute to this report and bring it to life. As captains of active investment management, we would personally like to extend our gratitude to all those who agreed to participate.

We hope you enjoy reading the report and if it sparks discussion and debate within your respective organisations – managers and investors alike – then we will have succeeded in our task.

I wish everyone a prosperous, alpha-generating 2019 and continued success.

*James Williams,
Managing Editor, Hedgeweek*

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Chapter 1

Macro / Geopolitical Outlook

“Brexit uncertainly will be a lesser impact on markets as most of the downside of reduced trade seems to have been priced in given the political mess that Brexit has become.”

Mark Yusko, Morgan Creek Capital Management

How do you think the global economic environment will impact hedge fund investors in 2019?



JEFF HENRIKSEN

Founder and Managing Partner, Thorpe Abbotts Capital

Economic predictions are always tough, but understanding where you are and how that will shape what is to come is important.

Keeping that in mind, I will offer this: Much of the current economic cycle has been driven by a wealth effect vis-à-vis asset price inflation. If last three months have taught us anything, it is the effect that central banks have had on asset prices throughout this bull market. We therefore believe that central bank policy going forward will be the tail that wags the dog in terms of global economic growth. As we have seen, a normalisation in rates and quantitative tightening have been met by selling and renewed risk aversion, while hints by the Fed of slowing the unwind have been met with buying and risk-seeking behaviour.

It is our view that investor psychology – especially with regards to risk aversion towards economic and political developments – is going to be affected by central bank actions. Despite the recent respite, central banks have further to go in terms of policy normalisation. For those reasons, hedge fund investors should expect a more volatile environment in 2019, although that should be good news for long/short fundamental strategies.



ALI LUMSDEN

Chief Investment Officer, East Lodge Capital

In a world of slowing global growth and inflation, High Yield corporates are likely to come under pressure, especially in cyclical industries. European CLOs will not be immune to such risks, although they have structural features that give managers the tools to add value in such conditions given their ability to reinvest, the term nature of the financing and the lack of mark-to-market triggers. We expect the default cycle to remain somewhat idiosyncratic given the flexibility afforded to corporates borrowing in the loan market, which suits the protection provided by CLO structures.

Ultimately, this default cycle should be dampened in time through a reopening of the liquidity faucet by central banks. Whilst the medium-term outlook may be “cloudy,” CLO structures provide investors with plenty of embedded optionality, and provide exposure to a diversified pool of assets with larger coupons than those available in any other equivalently rated part of the performing credit universe.

This, combined with an in-depth analysis of both the underlying credit and the CLO manager, make European CLOs robust investments even if credit conditions deteriorate.

MARK YUSKO

**Founder, CEO and CIO,
Morgan Creek Capital Management**

Slowing global economic growth and the increasing risk of a global recession will provide a target rich environment for Hedge fund managers and investors. For the first time in many years, short selling was viable (and profitable) in 2018 and we would expect the same in 2019 as the Great Separation (good from bad) continues. Hedge Funds perform well historically during periods of Central Bank withdrawal of liquidity and the planned change from QE to QT should be a tailwind for Hedge Fund strategies. Long/short equity should lead relative value and market neutral strategies in 2019.

**DAVID MENERET**

Founder & CIO, Mill Hill Capital

We anticipate potentially choppy markets in 2019 with several catalysts for volatility. Credit indices currently imply a default rate of ~3.3% for US high yield companies in 2019, more than the 1.81% default rate realised in 2018. Meanwhile, select large BBB-rated companies are very levered and at serious risk of downgrade, potentially leading to a dramatic increase in the size of the high yield market and funding challenges for what many investors consider “safe” companies. Globally, markets face many other catalysts for volatility. Growth in China is slowing, and trade negotiations with the US are far from done. British Parliament can't agree to the terms of the country's exit from the EU, increasing the likelihood of a “hard Brexit.”

Energy prices have been volatile, with implications for many other sectors. The headwind of quantitative



tightening could get stronger, depending on Mario Draghi's replacement in June. All these events will create trading opportunities for nimble and market neutral hedge funds.

Sources: LeveragedLoan.com | Moody's Analytics

**JEAN-FRANCOIS COMTE**

Managing Partner, Lutetia Capital

What we have seen in the second half of 2018 is a much wider dispersion of returns among traditional hedge fund strategies, and even within the strategy

categories. Some of the largest categories by asset allocation, such as long / short equity may have been a source of disappointment to investors due to their unexpectedly high correlation to the equity markets.

In the hedge fund space, a legitimate question from investors is “why should I pay for protection if I'm not really protected?”. This question is not new but it comes back every time market conditions deteriorate and hedge fund strategies are put to the test.

What we see in this first quarter is most allocators and investors debating how much they should reduce or further reduce their market exposure, particularly given the rebound through mid-February. In theory, this should favour hedge fund strategies that have passed the 2018 stress test successfully and have proven their resilience over the years and not just in bull market conditions.

What effect might the US/China trade war and ongoing Brexit uncertainty have on the way you think about investment opportunities?



JEFF HENRIKSEN
Founder and Managing Partner,
Thorpe Abbotts Capital

More and more we have been thinking of both Brexit and US/China trade relations from a game theory perspective. With regards to the US/China issue we feel that both sides are sufficiently incentivised to get a mutually beneficial deal done more quickly than many people might think. On the matter of Brexit, I find it difficult to believe that a worse case hard Brexit will be allowed to transpire. It certainly could happen, but we would view a delay of Article 50 and some softer version of Brexit as being the higher probability scenario. In this sense we think that both issues are a bit overblown.

To us the real story is with quantitative tightening by central banks and what this will mean for asset prices. In that sense we think that any asset that has seen excessive selling due to concerns surrounding US/China trade relations or Brexit warrants a hard look.



MARK YUSKO
Founder, CEO and CIO,
Morgan Creek Capital Management

The US/China Trade War (or threat thereof) will increase uncertainty and volatility in global equity markets and should provide fuel for strong long/short managers to extract alpha. The challenge will be to maintain discipline in buying value and shorting momentum as the liquidity cycle changes and global growth slows as global trade ebbs.

Brexit uncertainty will be a lesser impact on markets as most of the downside of reduced trade seems to have been priced in given the political mess that Brexit has become.



DR SAVVAS SAVOURI
Chief Economist and Partner, Toscafund

In both cases the issue is how do currency movements play out. Trump's ambition is to make Beijing devalue the dollar (upwardly revalue the yuan). The impact of this on bond markets will prove considerable and so too the implications for equities. In both instances these "shocks" are arguably very poorly priced in. The same can be said for what form of Brexit markets are being pricing-in; in my opinion how Brexit will look is not being factored in. We will get a deal being agreed and this will send the pound higher and so too the FTSE250, with the FTSE100 slipping. The gilt market will also strengthen.

What is the biggest risk to hedge fund performance in 2019?



**THOMAS S. T. GIMBEL
& MICHAEL SPELMAN**
Chief Portfolio Risk Officer and
Chief Investment Officer, respectively,
Optima Fund Management LLC

At Optima, we believe that active management is rapidly becoming more important for successful investing. This is particularly true for hedge funds which we believe are the best, most flexible and most comprehensive expression of active management. Our

analysis shows that rising interest rates combined with lower correlations amongst individual stock returns is a “sweet spot” for hedge funds to generate alpha – and something we believe we will see more of in 2019.

Within equity long/short, measures of dispersion and correlation have become more favourable, performance leadership stronger within certain sectors and ‘value gaps’ more pronounced across regions. We continue to favour aspects of the equity long/short universe:

- The addition of equity market-neutral as a diversifier and alpha-driver;
- Growth over Value as a return-driver given favourable secular trends; and
- Regional plays in Asia as sources of deep value particularly in India and selectively across the continent where structural growth provides opportunity despite short-term setbacks that 2018 may have posed.

We also expect that Global Macro and associated “long volatility” strategies incorporating elements of tail risk protection should deliver much needed diversification and downside protection.

This is especially likely given the confluence of rising inflation expectations, higher interest rates and elevated bond valuations which could spark more aggressive trends across asset classes. Finally, Equity Market Neutral is useful in the middle ground between Hedged Equity (a variably “offensive” tool) and Macro/Tail Risk (a long volatility tool and therefore somewhat more of a “defensive” tool).

Choppy markets with harsh reversals are one of the biggest challenges for most asset managers. We now face a global macroeconomic environment full of event risk catalysts – economic slowdowns in leading economies, trade wars and possible cold war, Brexit, hawkish central bank policies, capital flow inconsistency, government inertia in certain countries, and more. Event risk catalysts and the related violent market reversals are one of the bigger risks at present.



DAVID MENERET
Founder & CIO, Mill Hill Capital

A shift to a more dovish Fed policy, along with continued QE from central banks, could limit volatility and trading opportunities; a challenging environment for active managers generally.

Different challenges face each sector. US Credit Hedge Funds focused on securitised products tend to be long-biased. For these funds, an increase in high-yield default rates could lead to a sell-off in the loan and CLO markets. We see early signs of weakness in the commercial real estate market, accelerated by a severe reduction in US real estate by Chinese investors (WSJ). Retail adds further uncertainty, with Sears and Mattress Firm in bankruptcies, and JC Penney in trouble.

We also see signs of early weakness in the residential real estate market, as Existing Home Sales are at near a 3-year low and major banks have reduced exposure to construction loans.

Lastly, Hedge Funds face the ever-present risk of being positioned in crowded trades, as we saw in the Equity Long/Short community in 2018.



Chapter 2

Market Dynamics

“ We currently see several pockets of opportunity in technology to find companies that have structurally flawed business models that will never make money and are, in fact, burning through a lot of money as rates slowly rise.”

Ben Axler, Spruce Point Capital

What are your expectations for the volatility regime in 2019?



NEALE JACKSON
Portfolio Manager,
36 South Capital Advisors

Asset managers enter 2019 with a challenging outlook. On one hand, acceptable yields outside of equities and US bonds are difficult to come by. Furthermore, given the majority of mandates or requirements to reach fully funded levels demand annual returns upwards of 4-6 per cent, all the while the recent effect of volatility is a reminder that years of yield and return can be erased in a matter of hours, rendering underfunded

levels back to unachievable status. On the other hand, the conundrum becomes magnified by the volatility outlook in equities, such as the futures curve of the VIX. The July 2018 VIX futures curve opposite (blue) is somewhat normal. We saw February volatility and forgot it in light of the missed opportunity that being underweight equities presented.

Curiosity can be just as lethal for humans too. Taking a moment to understand the fundamental causes (and consequence) of one large wave crashing, followed by the sea level withdrawing further out than usual is useful in the decision to explore the new dry land or not. And similar to pre-Lehman 2008 there is every chance that the slightly elevated volatility levels during the fourth quarter of 2018 were merely an acknowledgement of the existence of uncertainties surrounding the imbalance in global macro rather than the precipitous consequence of rebalance.

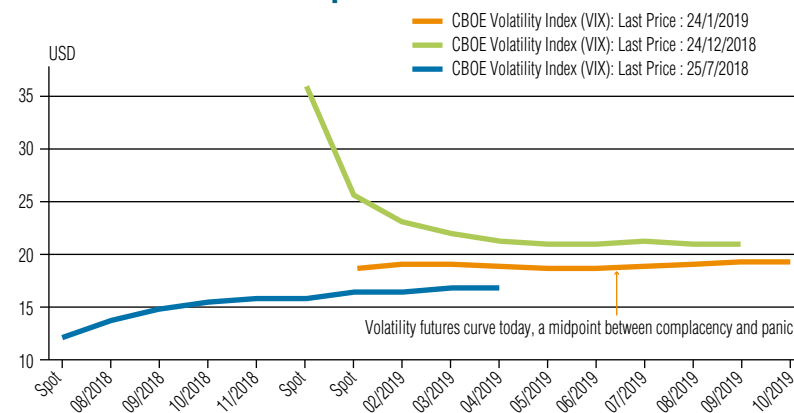
Correlation between the S&P 500 and high yield bonds is a tool for measuring sentiment towards risk-on risk-off, a forecaster of volatility. Historically this has been a reliable indicator of future volatility, current readings imply that October and December were merely the early tremor warnings.

This is just one of the warning signs, equally worrying is the trend in long-

duration volatility. Volatility is an emotion, it is an expression of how unsure we are about the future of pricing. Like all emotions, it is easy to get a bit hot under the collar and react in a way that we should not, and then with a little reflection, become calmer. This is typical of a volatility response to market moves, a bit hot and flustered in the short duration in response to market stress, but with a more sanguine outlook, longer duration volatility usually remains calmer. "Usually", unless there is a deeper emotion brewing beneath the surface. Our proprietary Long GIVIX (Global Implied Volatility Index) shows the volatility implied in long-duration pricing (pan asset class). Applying technical analysis to this index has given us a reliable reading on the state and trend in long-duration options. Using trend line breaks as a forward indicator of potential moves up and down in long-dated implied volatility has worked pretty well historically. When the trendline broke in February 2018 it became likely that we would see some volatility in 2018, but the continued uptrend in long-duration volatility is a much more troubling sign of a deeper imbalance in the markets.

Our view is that there is enough warning signals to hedge any curiosity about the future of 2019 - volatility itself looks poised to be the outperforming asset class.

VIX forward curve comparison



Source: Bloomberg

Which asset classes/market sectors are likely to offer the best investment opportunities over the coming 12 months?



ALEX ANTEBI
COO, Carmot Capital

First, we are in a more hypersensitive market. We note that our complex political economy lives in a 'critical state'. The leveraging and money printing which rescued us from the Great Financial Crisis has put us in a fragile state that requires a fine mix

of deleveraging and inflation. The risks are high that a small event can set this system on a path that leads to system wide chaos.

Second, at Carmot we see volatility as a shadow of liquidity.

Volatility and liquidity can be seen as 'states' of the market that are intricately linked. In meetings with allocators, we very frequently get asked, "what volatility do you target?" We find this question somewhat perplexing. Allocators presume that one is possible to target a level of volatility. Volatility targeting is a euphemism for 'volatility avoidance'. And the problem with it is that if everyone seeks to exit the market at the first signs of volatility, the 'exit' door will simply not be big enough to accommodate them.

In summary, we live in a fragile system. And in part the enemy is us. Volatility now has a 'feedback' mechanism. The more assets are engaged in vol targeting, the steeper the feedback.

As volatility increases, people are willing to part with exposure at lower prices. We like to think of this as a liquidity discount. While market participants see liquidity is an elusive concept, they are paradoxically marketing volatility as something we can consistently target. The notion of volatility targeting and the derivative of that notion, a risk parity model seems like something that only works as long as very few people are doing it. We suggest buyer beware in these approaches.



IRENE PERDOMO
Principal & Founding Partner, Devet Capital

At Devet we focus on systematic trading and we pride ourselves on being asset class agnostic; we believe that dividing the tradable universe in various asset classes is an arbitrary action that can lead to oversimplification of the investment process. In order to be as asset class agnostic as possible, we prefer approaches focusing on specific quantitative techniques that allow to characterise the tradable assets in terms of the statistical features shown over different time horizons. The results are sometimes surprising as, adopting this approach, you sometimes end up gathering in the same group things that, based on simple intuition, you would assign to different ones.

The other strong advantage of this approach is that it allows us to handle less traditional assets that often escape the conventional subdivision in asset classes, such as hybrids.

BEN AXLER
Founder and CIO, Spruce Point Capital

We currently see several pockets of opportunity in technology to find companies that have structurally flawed business models that will never make money and are, in fact, burning through a lot of money as rates slowly rise. As the equity risk premium increases, the cost of equity rises too.

On the other side of the spectrum, we are also looking at low growth companies that have the potential to transition to declining growth. There are a lot of cyclical companies that can swing quite meaningfully and if you lay on the debt component as well that can lead to significant changes in market valuations.

So we're taking a bar-bell approach: companies where growth targets may never be hit and companies which are moving from low growth to no or declining growth.



Where are you most bullish, from a risk perspective, and where in your portfolio are you most defensive?

JEAN-FRANCOIS COMTE

**Managing Partner,
Lutetia Capital**

We are optimistic with respect to M&A activity and arbitrage spreads, which are the main performance drivers of our strategy. Merger arbitrage spreads have increased over the past year, on average. This is the result of higher interest rates in the US, which are reflected in the spreads as investors should be paid for risks but also for time (i.e. the duration of an announced M&A deal through closing).

But more importantly, the risk premium portion of the spreads has also increased due to higher market volatility. As the VIX fluctuates around much higher levels than a year ago, implying more fear in the market, investors get more yield for the exact same risk in the context of merger arbitrage. As a matter of fact, implied completion probabilities on pending M&A deals have remained constant. And given the healthy outlook for M&A activity, we are confident that the strategy will continue to deliver attractive uncorrelated returns this year.

In the context of our investment process, we have become more defensive on cross-border deals as we witness a form of growing protectionism globally. We are also closely monitoring the credit markets, particularly on the high yield side, where deteriorated conditions could affect LBO transactions.



ALI LUMSDEN

**Chief Investment Officer,
East Lodge Capital**

We are most constructive on regions and sectors that demonstrate strong fundamental credit characteristics. Over the last few years, we have identified a broader set of opportunities that meet these criteria in Europe due, in part, to the full recourse nature of mortgage lending that has meant that deals in Europe, and particularly in the UK, generally experienced lower losses than similar deals in the US.

One of our favourite products in this category has been UK pre-crisis RMBS, where we see very low loan to value, discount bonds that are also 100% floating rate. We have tended to look for pools of loans that are well protected with a healthy slice of borrower equity beneath us and technicals that are significantly in our favour. For example, we like to see significant upside optionality in the structure, such as the call feature that exists in many pre-crisis UK RMBS bonds.

In some cases, these bonds are already 'in the money' (i.e. they have the potential to be called immediately), whilst in other cases, the call is further out and thus has gone unpriced by the market.

In the latter case, we can generally source the bonds more cheaply. This allows us to layer the portfolio with bonds that are likely to be called at different points in time. We feel this demonstrates one of the best risk/reward opportunities in our markets at the moment.

We also feel that sovereign risk in both France and Italy is greatly mispriced, relative to German bunds, given the high debt/GDP ratios, structural budget deficits and increase in support for populist politics set against slowing growth in both countries.



A person's silhouette is visible in the foreground, looking out over a city at night. The city lights are visible in the background, creating a bokeh effect. The overall scene is dark with blue and orange tones.

Chapter 3

Investor Expectations

“ Things are more volatile, it could go either way, but I think a lot of managers who are geared towards volatility and thrive, come what may, could do very well this year.”

Kieran Cavanna, Old Farm Partners

How do you think the fund raising environment for hedge funds will play out in 2019?



DON STEINBRUGGE

Founder, Agecroft Partners

We expect to see very little positive net flows to the industry in 2019. We expect most allocations to come from redemptions from other managers. The volatility in the capital markets we saw this past year highlighted the performance difference between good and bad managers within each strategy which should increase manager turnover. Overall 2019 should be a good fundraising environment for the top 5 per cent of managers that rank well across multiple hedge fund investor valuation factors, but will be an extremely difficult asset raising environment for others.



ALEXANDER KALIS

Managing Partner, Milltrust International LLP

The fund raising environment will remain challenging in 2019 after most funds posted another disappointing year in 2018, triggered by non fundamental-based macro events such as global trade tensions, threats of sanctions, rising US interest rates and higher oil prices.



PÁRAIC COSGRAVE

Global Head of Sales, Abbey Capital

Despite the difficult environment for hedge funds last year, 2019 has the potential to be positive for certain strategies. Hedge funds who offer excellent service, investment transparency, educational partnerships and demonstrate an ability to capture alpha are likely to benefit in 2019. Niche diversifying strategies such as Managed Futures may benefit where investors seek diversification from high equity and fixed income valuations.

While we would expect that existing Managed Futures investors will retain some or all of their current exposure, we are also likely to see some sophisticated allocators increasing their holdings, in the hope of benefitting from any post-drawdown rebound. In our experience, most allocators have historically favoured investing when managed futures is below the high water mark.

What should investors expect from a performance perspective in 2019?



KIERAN CAVANNA

Co-Founder, Old Farm Partners

No-one can ever know how the markets will perform but I do think it's a good time for hedge funds. The small and mid-sized space looks really attractive, from my perspective. We are allocating to a number of strategies including equity long/short, event-driven and global macro and I'm positive on 2019.

You saw big dislocations in Q4 but risk assets have ripped back up in the last few weeks; biotech as a sector is up 11 or 12 per cent alone. Things are more volatile, it could go either way, but I think a lot of managers who are geared towards volatility and thrive, come what may, could do very well this year.



DON STEINBRUGGE

Founder, Agecroft Partners

This is a difficult question to answer given the fact that hedge funds are a fund structure and not an asset class. In 2019 we expect the Federal Reserve to raise interest rates at least one to two more times and expect global economic growth to continue to slow.

Given this backdrop we expect headwinds for strategies that have significant equity and fixed income beta and expect these type of strategies to generate somewhere between 5 to 8 per cent.

This should make strategies that are uncorrelated to the capital markets like arbitrage strategies, relative value, and reinsurance more attractive in 2019.



PÁRAIC COSGRAVE

Global Head of Sales, Abbey Capital

Looking ahead for a strategy like managed futures, the key determinant of performance is likely to be the market environment and, specifically, the extent we see sustained trends in markets. Although it is difficult to forecast what factors may lead to trends, there are many macro factors such as Federal Reserve balance sheet reduction, the unfolding slowdown in China and the ongoing trade negotiations between the US and China which have the potential to prompt greater moves in markets.

However, there is no guarantee that managers will be positioned to benefit from potential trends in 2019. We continue to see a merit in maintaining an allocation to a strategy which can potentially benefit from dislocations in markets.

**THOMAS S. T. GIMBEL &
MICHAEL SPELMAN**

**Chief Portfolio Risk Officer and
Chief Investment Officer, respectively,
Optima Fund Management LLC**

As we head into 2019, we acknowledge a growing list of risks, particularly in the UK, Europe and China, but we see the US economy as fundamentally strong. In addition, three key drivers that have often been precursors to recession – speculative valuations, unsupportable balance sheets and economic over-heating – are not yet visible though some metrics suggest caution is warranted. Nevertheless, on the policy front, we believe that three recent changes could move us in a positive direction:

- China is now deploying stimulus to shore up its economy;
- The Fed has “pivoted” to a more flexible posture; and
- White House rhetoric has become more optimistic about settling trade disputes with China. Further progress on these fronts could serve to lengthen the current cycle.

To help put things into perspective, neither tight monetary conditions nor discordant politics are anything new. As we move further into the latter phase of the economic cycle, we should naturally expect that tighter financial conditions will begin to more forcefully separate the weak from the strong. This applies to asset classes, geographic regions and individual companies alike (and we began to see this in earnest during 2018).

While we do not expect a recession as our base case any time soon, our positive economic view is tempered by rising risk and uncertainty. We therefore believe it is important for investors to consider a wider range of outcomes than what has been experienced in recent years and configure their portfolios accordingly.

Investors wishing to maximise gains while at the same time protecting capital may want to add diversifiers and hedges because we believe investors should look at portfolio allocations not simply through the lens of asset class diversification, but also through the lens of strategy and “skill type” diversification. Along these lines, we see evidence of significantly improving conditions for active management. This is particularly true for hedge funds, which we believe are the best, most flexible and most comprehensive expression of active management.



ALEXANDER KALIS

Managing Partner, Milltrust International LLP

Going forward, we are expecting a strong rebound in emerging markets specifically, which is Milltrust International’s key area of investment focus, as they are coming off from a low base and are well positioned to rally if the dollar eases on less aggressive monetary tightening. Indeed, this would relieve some of the pressures that emerging economies typically face from paying higher prices on imports from the US when the dollar is strong.

The MSCI Emerging Markets Index currently trades at around 10 times earnings while the developed markets trade at 18 times earnings. The gap between valuations is near all-time highs. Emerging markets that still look particularly attractive from a valuation standpoint are China (trade war), South Korea (China offshoot) and Russia (Cold War 2.0). Asia is also trending up as most of the larger Asian economies are benefiting from a cheaper oil price which is providing a boost to their terms of trade.

Those investors who are able to position themselves well from a country allocation standpoint and from a bottom-up stock picking standpoint, will perform best in this environment.

We are overweight Brazil, China, Russia, Saudi Arabia, and South Africa in particular.

Chapter 4

Technology & Cyber Trends

“The promise of AI is no doubt exciting, but we are not there yet. Even learning the principles behind human intelligence is still a long way off.”

Xuan Sun, Hathersage Capital Management

How do you expect next generation technologies to influence hedge fund management activities in 2019?



IRENE PERDOMO

Principal & Founding Partner, Devet Capital

From the point of view of technology applied to systematic trading, we believe that in 2019, similarly to the past few years, we may continue to witness a certain level of fatigue of simple quantitative techniques, such as pure trend following, that may keep on struggling to generate sustainable alpha.

We believe that in 2019 firms will put additional efforts to deploy more sophisticated techniques to systematic trading applied to higher capacity strategy. This is because, if on the one hand it is clear that some niche strategies may allow to achieve low correlated returns vis-à-vis the most traditional systematic strategies, on the other hand the lack of a significant capacity is often a key factor preventing large investors from looking into niche strategies despite the frustration with more traditional (but large-scale) systematic strategies.

Next generation technologies will inevitably have to focus on attempts to deliver improved returns on larger scale investments.

Is there a danger that too much hype is being placed on AI/machine learning applications in the front-office? Or is this just the tip of the iceberg?



CHRISTOPHER REEVE

Director of Investment Solutions, Aspect Capital

These are not new techniques and we have been using them for a while. However, there has certainly been some hype recently and the recent vast growth in data available to look at and the computing power to throw at it does mean that artificial intelligence methods are starting to come of age and be useful in various different front office applications.

Technology has evolved and AI techniques are being developed and used far more widely outside the finance industry in our everyday lives, and this has led to greater acceptance from investors and less 'algorithm aversion'.

However the secret remains, and will always be, the human input into the machine: designing and researching the appropriate models or techniques to use in the first place, whether they are AI / machine learning in nature or more traditional algorithms.



MIKE HARRIS

President, Campbell & Co

We believe that AI/machine learning will revolutionise our industry over time but the real question is when and how. The pace of advancement in other industries, like online retail, is driven by the availability of massive data sets that are not comparable to those available for financial markets/securities. These more common applications of AI benefit us in two main ways, technology advancement and investor perception.

The technology used in different industries can be leveraged for financial services applications.

Investors are becoming more and more comfortable with AI in their daily lives, which eases traditional concerns with AI in their investment portfolios.

In the near term, we see potential to use AI for cleansing data sets that have not historically aligned well with the quantitative investment process. In terms of using AI for alpha generation, we believe the prudent approach in the near term is focus on supervised machine learning techniques.

Unsupervised AI or truly “Black Box” approaches still appear to suffer from dangers that many inexperienced Quants encounter such as overfitting, spurious correlations, non-stationary and optimisation bias.



XUAN SUN

Vice President and Portfolio Manager, Hathersage Capital Management

When attempting to incorporate Artificial Intelligence (‘AI’)/Machine Learning (‘ML’) applications or any latest technology into your front office, it is important to not lose sight of who you are and what you need. Beware of straying from the path that made you successful in the first place.

A discretionary manager should look at any new technology with some scepticism. The core of his investment process is human judgment based on knowledge and experience. He should not expect AI/ML to replace that any time soon.

At the same time, he must be open-minded: some AI/ ML applications can play a role in areas such as security and compliance.

Alternatively, for quant traders, it’s natural to have a ‘fear of missing out’ when reviewing new technology that might improve pattern recognition, optimisation, and the like – areas where AI/ML excels. For instance, a new nonparametric methodology might help in handling unstructured data in a big data environment.

While buzzwords such as ‘Artificial Intelligence’ and ‘Machine Learning’ are currently in vogue, the reality is that the techniques underlying these approaches have been used in portfolio management for decades, most of the time referred to under the broad heading “Quantitative Trading”. There are constant efforts in the industry to leverage any potentially promising statistical system.

Bottom line: sometimes the effort pays off and the new technique works. Other times it’s useless and one can struggle with issues such as overfitting.

The promise of AI is no doubt exciting, but we are not there yet. Even learning the principles behind human intelligence is still a long way off.

What are your thoughts/fears regarding global cybersecurity threats for the next 12 months?



CHRISTOPHER REEVE
Director of Investment Solutions,
Aspect Capital

Companies can't ignore the danger; you have to take steps to be prepared and robust from a cybersecurity perspective and I fear that we will see examples where complacency comes unstuck. But I don't see it as a massive danger facing the industry as long as sensible precautions and appropriate steps are taken.

MIKE HARRIS

President, Campbell & Co

Cyber security is quickly becoming one of, if not the largest, focus area for Operations Due Diligence (ODD) Teams, with good reason. The pace and scope of malicious cyber activity has done nothing but expand for well over a decade. The level of sophistication with cyber criminals continues to grow as they define new methods of attack focused on new and different potential vulnerabilities. A major trend in the last year has been the expansion of the ODD inquiries to include all potential vendors or counterparties involved in the servicing of their account with a given investment manager.

This is compounded by the continued expansion of outsourcing and the integration of 3rd party service providers for all investment managers.

As a manager we're only as strong as our weakest counterparty, so we dedicate significant resources to managing those relationships and performing the due diligence needed to give our investors' confidence that their data is as secure as possible.



XUAN SUN

Vice President and Portfolio Manager, Hathersage Capital Management

In 2019, global cybersecurity will necessarily be focused on two areas: mobile devices and the cloud. With the capabilities of smartphones becoming more advanced by the day, hackers will raise the stakes in trying to gain access to these portable devices. Cloning of phones is likely to become a big problem again as the use of 'secured' text passcodes to authenticate accounts can allow hackers to see what you see and gain access to what does not belong to them. This, in turn, could also allow unauthorised access to confidential information including that stored online in the cloud.

Portfolio structure, investor information, proprietary models and a host of other confidential data are at risk if it falls into the wrong hands, with potentially devastating results. With cybercrime increasingly becoming a problem in the financial markets, chances are high that at some point everyone will experience an attempted hack. Staying alert to anything out of the ordinary, around the clock monitoring, and regular security updates are a must. Adding two-factor authentication for all users is a good preventative measure, while encryption is key for both data in the cloud and at the user end.

As more companies migrate data to the cloud, efforts to keep it safe will continue. The best defence is always a good offense.

Chapter 5

Regulatory Outlook

“There are a lot of positives for MiFID II, but on balance, I think there are still material issues to clarify over a year since implementation.”

Phillip Chapple, Monterone Partners

Is too much regulation stifling the fires of innovation in the hedge fund industry?



JOHN RENDE

Founder and Portfolio Manager, Copernicus Capital Management

I think it is healthy, frankly. We are SEC registered and operate under best practices and I think more oversight is healthy for the hedge fund industry and will allow those who run good operations to succeed over the long term. Obviously, this all came to a head around the Madoff scandal, and while I think regulation is making it more expensive to run a hedge fund it is bringing more credibility to the industry. That's important and warranted in my view.

If you could change/remove one element of the current regulatory environment, what would it be and why?

PHILLIP CHAPPLE

COO, Monterone Partners

MiFID II continues to provide challenges for European based managers which could have longer term competitive and structural issues. Although MiFID II has increased the transparency around research and other costs - which is a positive development, the regulation has not been applied consistently across Europe, with different interpretations and focus points applied by local regulators.

There is still a lack of clarity around some of the key policies, with guidance around what is an acceptable cost for research still awaiting guidance, this has a material effect on research usage as many managers avoid deals for research which may be "too cheap" to be in compliance with the requirement to unbundle.

The effect of MiFID II on the competitive environment between European and US managers is still in a state of flux. It was hoped by European Managers that the extra transparency provided by MiFID II firms would drive investors to request the same level of transparency from all investment managers, but the reality seems to be that some see this as a positive, but many also see MiFID II as an increase in costs, viewing US managers as better value, especially on the back of previous increased costs on European firms to comply with AIFMD.

The final potential challenge MiFID II creates is a focus of research services on those companies most traded - as the use of research becomes more focused, the coverage of research also narrows. This may well mean less coverage and transparency for some companies over time, which could reduce market transparency and reduce tradeflow on less covered names.

There are a lot of positives for MiFID II, but on balance, I think there are still material issues to clarify over a year since implementation.

