Survey of Allocators' Investment Trends Post COVID, June 2020

Carl Berg, Catalyst Financial Partners
Susan Weerts, Research Analyst

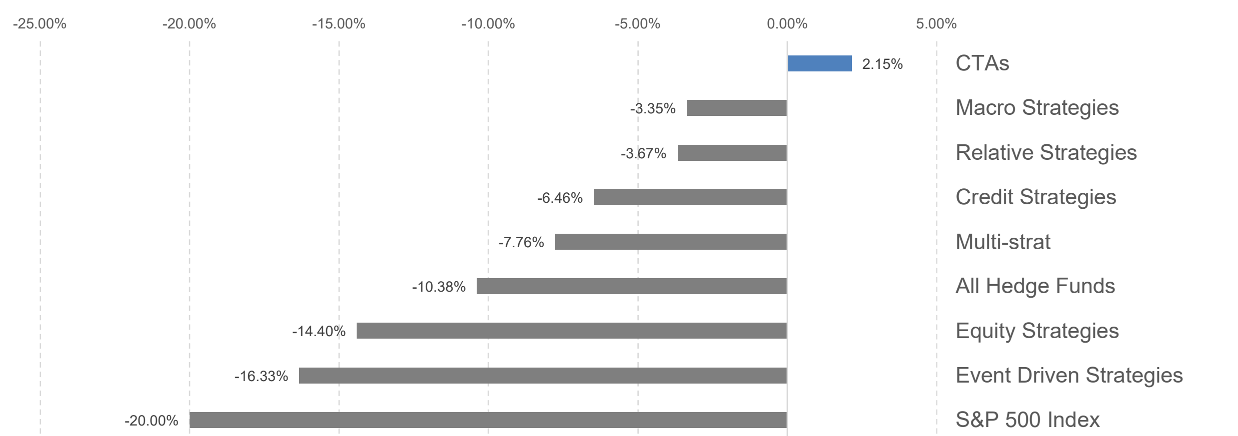
Industry Background and Analysis

Well, so far, 2020 has *really* turned out into the Year of the RAT. We have all been holed up, hoarding stuff, avoiding social contact with almost everyone. The economy has fallen off a cliff as businesses have been closed and people have been in quarantine, with phased re-openings starting in early summer. The broad market ended with a 20% drop in the first quarter of 2020, suffering a 34% decline from an all-time-high of 3,386 on February 19th to 2,237 on March 23rd. The oil market collapsed during the turmoil, with a barrel costing -$37 (minus!) at the end of April, as priced by crude oil futures for May.

The global investment industry has faced a triple whammy of margin calls, redemptions, and whipsawing markets. $33bn was withdrawn from hedge fund industry in the first quarter of 2020[1] corresponding to 1% of total industry AUM and the fourth largest quarterly capital outflow ever.

Despite the volatility, the hedge fund industry fared relatively better than the broad market (see graph below). Compared to a 20% loss in the broad market, the HFRI Fund Weighted Composite index fell 8.3%[2].

Net Returns of Top-Level Hedge Fund Strategies in Q1 2020 vs S&P 500 Index



Source: Preqin

1. "The Hedge Fund Class of 2020 is more Resilient Than in 2008" Financial Times
2. https://www.hedgefundresearch.com/family-indices/hfri

As one of Warren Buffet's quotes says: "You will find out who is swimming naked when the tide goes out". The report by HFR researchers showed an unprecedent performance dispersion among investment managers in March 2020, with an average gain of 18.5% by the top-decile HFRI constituents compared to -30% loss of bottom decile. Among them, for example, Universa Investments which specializes on tail risks, posted a whopping 3,612% net return in March.

To prevent a depression, global governments launched a concerted effort to provide liquidity and bolster the economy at all costs. The equity markets have responded favorably to this Fed put. As a leading economic indicator, the stock market has rallied and erased the steep losses in March and the S&P 500 posted its best 50-day return to the 3rd of June, closing within 8% of its record high in February. Similarly, in April, hedge funds posted their biggest monthly gain in more than a decade. The diversion between Wall Street and Main Street is however extremely stark, with over 23m people being unemployed in April – about one in seven of American workers.

Many market participants draw comparisons between the current crisis to the 2008-2009 global financial crisis. During the crisis back then, the broad market suffered a 50% loss from its all-time high in Oct. 2007 to its low in March 2009. Yet, S&P 500 was up by 26% one month later. Fed's quantitative easing ushered the era of "lower for longer" interest rates, which in part fueled the longest bull run in equity market with steadily increasing multiples and GDP growth.

The public remedy for both crises has been quite similar, with swift monetary and fiscal responses. Given the still-developing scale of the current crisis, it is impossible to gauge the longer-term impact on industry performance. Much will depend on the duration of the lockdown, the success of the phased re-openings and the shape of the subsequent recovery.

Survey Summary

The survey shows some clear trends emerging in the immediate post COVID investment environment:

The hedge fund industry has performed relatively well during the crisis and **reignited investors' interest in the alternative investing space**. Many fund managers have demonstrated their ability to provide risk-adjusted returns during the market turmoil, i.e. **adding alpha**. For the moment, **hedge funds enjoy being the most appealing investment opportunity**. The wide performance dispersion among fund managers is compelling investors to be increasingly picky in being able to select the "right" manager.

There is a **surge of interest in Credit and Fixed Income strategies**, signaling that investors want to take advantage of undervalued asset prices and cheap credit in a Post-Covid era. Policymakers have essentially thrown the kitchen sink to prevent economy from seizing up. The Fed has lowered interest rates near to zero and acts not only as "the lender of last resort" but virtually as "the lender of all". This unprecedented monetary and fiscal response to the crisis have certainly stabilized and propped up the financial market (the SP 500 gained 35% to the end of May from the market low on March 23), but **asset pricing dislocations are huge**. Some long term, high conviction fund managers probably view the recent sell-out as once in lifetime opportunity to buy assets cheaply.

On the back end, investment destinations that are perceived riskier, like **Emerging Markets and to a degree also Macro strategies, have fallen in investor interest**.

Similar to the crisis in 2008/09, **liquidity is king.** There is a high degree of uncertainty of how the next quarters will develop (**V-shaped, U-recovery, W-shaped or L-shaped recovery?**), and long lock up investments are currently difficult to rationalize and forecast. This is reflected in long lock-up strategies like **Private Equity are out of favor** while **highly liquid products like ETFs are in**. As such, an ETF/mutual fund can also offer a flexible trading option even when liquidity in the underlying securities is constrained or temporarily unavailable. A trading-oriented manager can easily incorporate them in their tactical allocation to take advantage of the fluid trading environment.

Private Equity will likely hold a larger role in the upcoming recovery, when government support subsides and the Private Equity industry's $1.5trn dry powder stands ready to rescue selected businesses caught by the COVID crisis, firms which may be highly leveraged and at risk of defaulting otherwise.

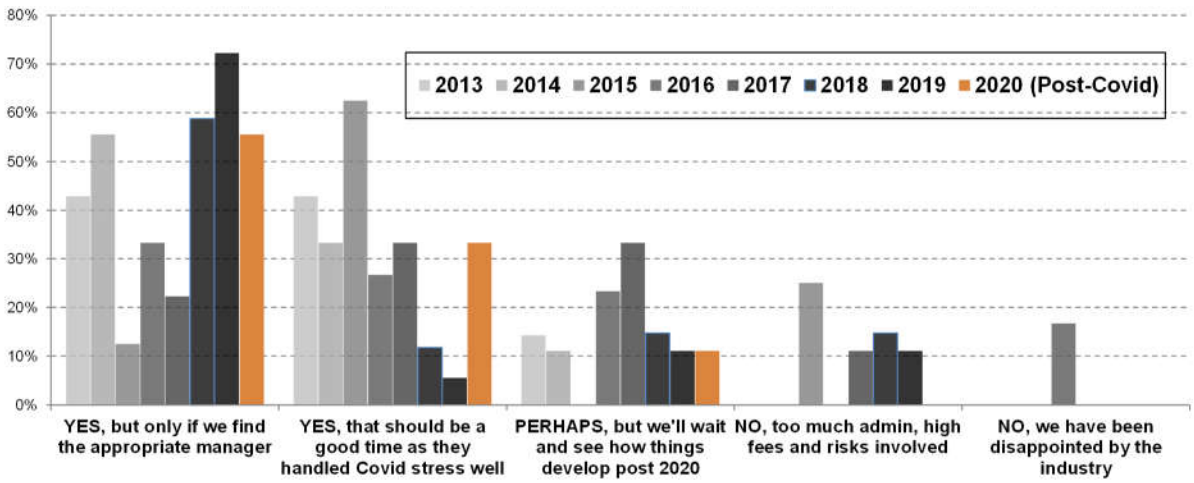
While liquid investments are currently in favor, investors still prefer to deploy their assets. **Holding cash outright seems to be a sub-optimal solution,** especially given the increasing risk of a deflationary environment.

On the fund level, portfolio characteristics such as non-correlation is key – and **investors seem open to look at new manager talent** as reflected in decreased importance of having a large AUM base or long-track record. This is contrasted with the increasing importance of finding the 'right manager' and making sure they do not style drift in time of crises.

For our group of investors surveyed, while hedge funds have performed relatively well, a majority seems disappointed with alternatives, with 40% indicating to likely withdraw capital in the near future. About 33% of the investors hold a favorable view of alternative investing space and likely to add some capital allocation going forward.

Survey Results

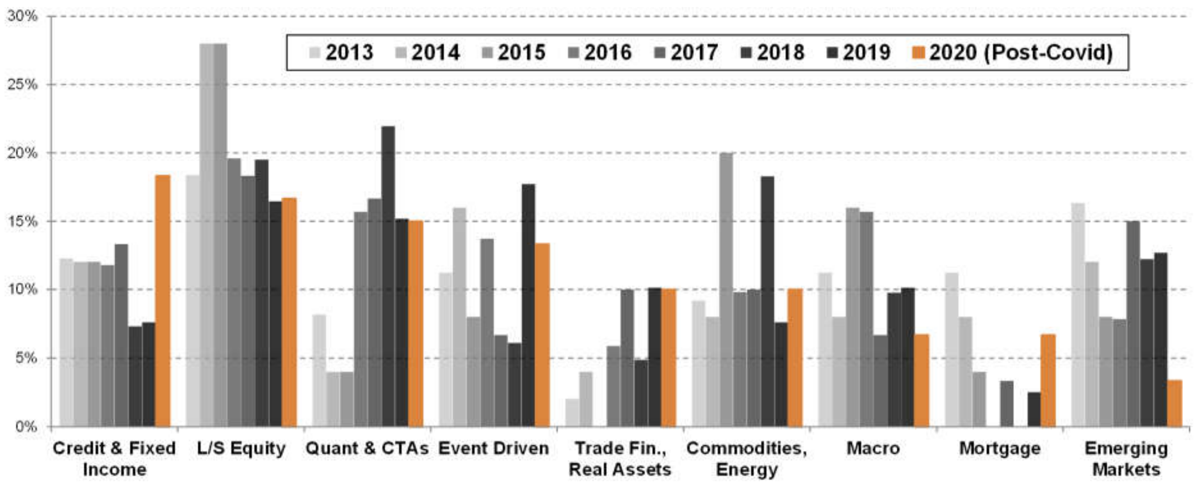
1. Post COVID, would you consider allocating to alternative investing funds?



- **The hedge fund industry's performance during 2020 has to some degree vindicated them and shown that they can provide uncorrelated out-performance during a period of market turmoil.**

- **Investors continue seeking the appropriate manager to meet their investment objective.** How an investment product fits in an investor's portfolio and what portfolio benefits it may bring, continues to be a crucial determinant.

2. Post COVID, what strategies do you think would be especially interesting within the hedge fund space?



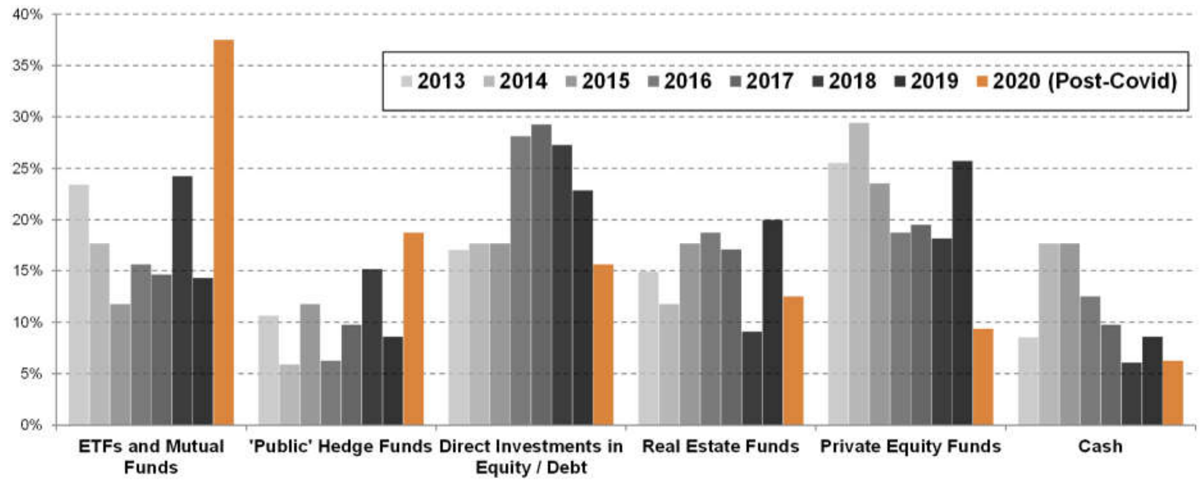
- There is substantially **increased interest in Credit & Fixed Income and Mortgage** strategies. Increased interest in Mortgage strategies likely reflects the condition of ultra-low interest rates. Investors are seeking undervalued assets after the market rout. In today's "lower for longer" era, cheap debts make Credit & Fixed Income opportunities attractive.

- **Emerging Markets strategies have suffered a steep drop in interest**. As the pandemic is still rampant worldwide, it appears to be a good idea to stick closer to home. EM-focused strategies have fallen more than 20% in the first quarter of 2020.

- Interests in L/S equity, Quant & CTA strategies and Trade Finance & Real Asset strategies are in line with 2019.

- There is a drop in interest in Event Driven and Macro strategies as compared to 2019.

3. Post COVID, what other investment opportunities would you prefer over hedge funds?



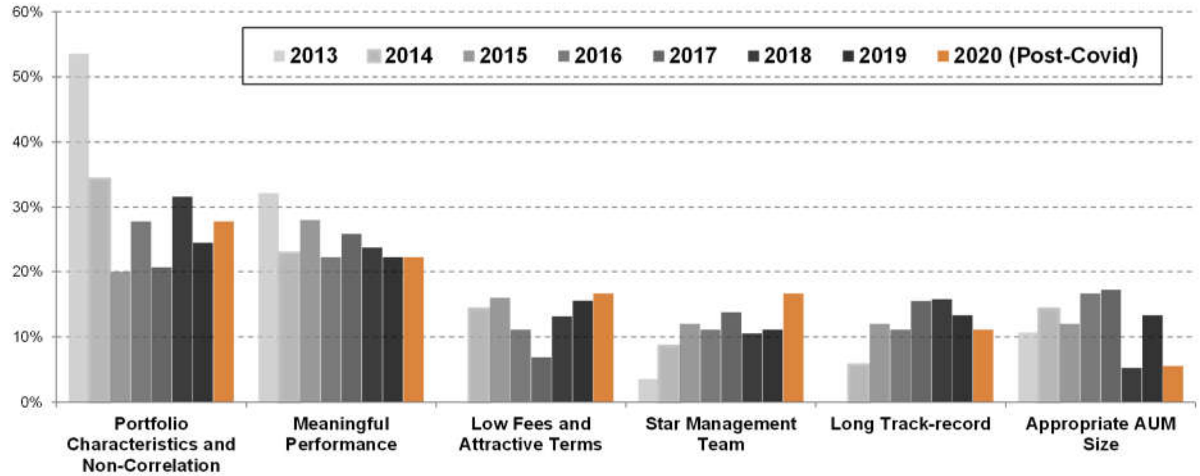
- There is a **surge of interest in ETFs and Mutual Funds and Public Hedge Funds**. ETFs, some of mutual funds and public hedge funds give investors certain sector or strategy exposure without longer redemption period. It would reflect that more managers swift into more trading-oriented strategy to take advantage of swift market environment. ETFs and Mutual Funds wrap's fee structures are more beneficial for active trading strategies.

- **Investor interest have dropped significantly in all type of long lock-up assets**: Direct Investment investments in Equity/Debt, Real Estate Funds, and Private Equity Funds. Some investors have suddenly become wary of the long-term lockups required by private equity. Investors often must maintain certain ratios in their overall portfolio mix, and, with equities so beaten down, some investors may need to reduce their exposure to private equity.

  However, Private Equity likely holds a larger role in the upcoming recovery, when government support subsides and the Private Equity industry's $1.5trn dry powder stands ready to rescue selected businesses caught by the COVID-19 crisis.

- There is minor interest in holding Cash, as **investors still want to deploy their capital**.

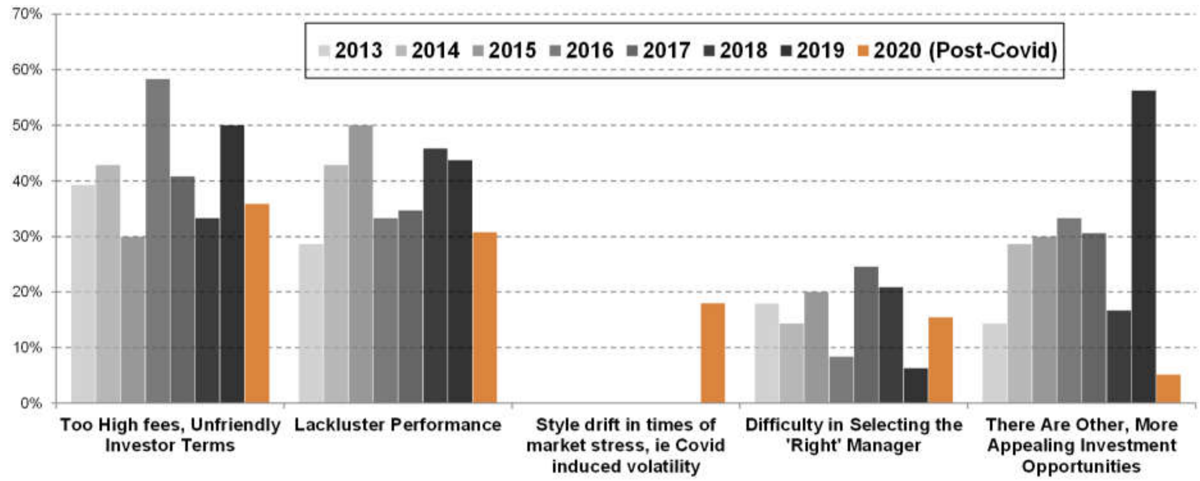
4. Post COVID, what would be the most important criteria for a hedge fund that you would consider investing in?



- It is relatively consistent that even in a Post-Covid world, **Portfolio Characteristics and Meaningful Performance remain the foremost important criteria** in selecting a fund to invest in**.**

- Investors seem **open to look at new manager talent** as reflected in requiring having a large AUM base or long-track record.

5. Post Covid, what consideration(s) would discourage you most in investing in hedge funds?

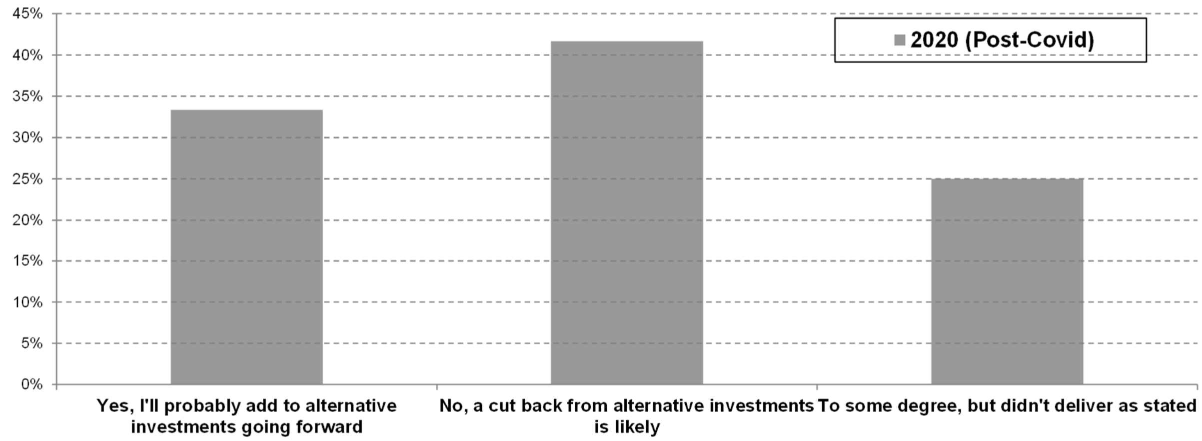


- For the moment, **hedge funds enjoy being the most appealing investment opportunity**. That is a first since we started publish our surveys in 2013.

- The wide performance dispersion among fund managers is compelling investors to be increasingly picky in being able to select the "right" manager.

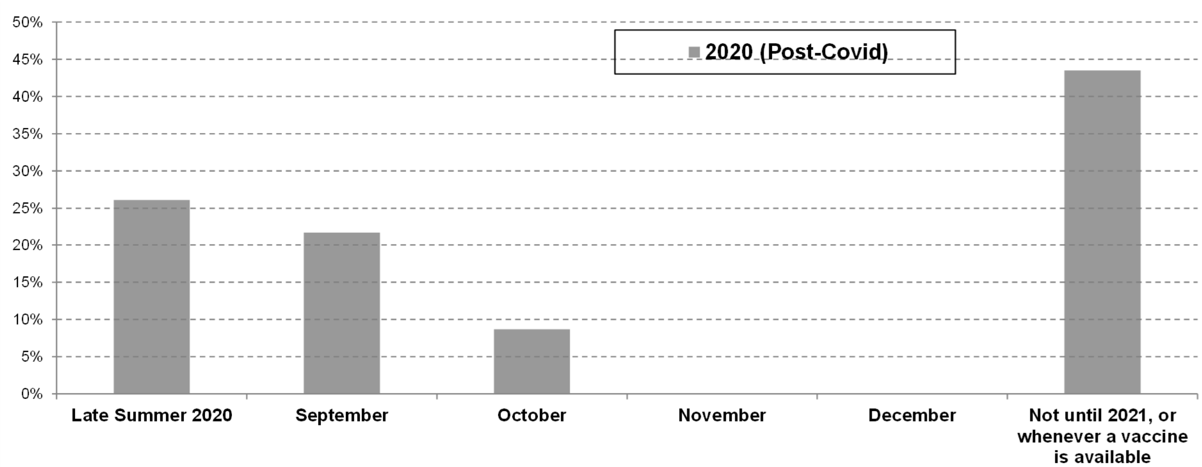
- High Fees, Unfriendly Investor Terms and Lackluster Performance continue to keep allocators away.

6. Special Question 1: Did your alternative investments help your overall portfolio during the on-going market turbulence?



- Despite investors mainly positive views on the alternative investing industry (as shown by question 1 earlier), over 40% of investors indicate they are likely to cut back.
- 33% of responders hold a favorable view of alternative investing space and are likely to add some capital allocation going forward.
- 25% of responders had a mixed view of alternative investing. Although alternative investing helped their investment objectives, they did not achieve their intended purpose

7. Special Question 2: When do you think you will attend in-person investor conferences again, modified for social distancing?



- Over 40% of responders indicated that they will not be able / want to attend in-person conference until 2021 or whenever a vaccine is available.
- Still, almost 60% are keen to return to conferences in the early fall period.

The survey was made at the end of May 2020 and sent to over 500 allocators and investors in the alternative investing industry, of which a portion responded.

About the Authors

Carl Berg runs Catalyst Financial Partners, an investor events firm for the private funds industry. The firm links alternative investment managers and investors together through investor events. It has established itself as one of the leading, independent cap intro event providers.

He also works with selected alternative investment firms in a capital raising capacity through Catalyst Fund Advisors and consults with investors on their allocation decisions.

He also runs **COIN** – the **C**atalyst **O**nline **I**nvestor **N**etwork - which is members-only capital introduction platform tailor-made for qualified investors and institutional allocators who focus on alternative investing. 'COIN Funds' are hand-picked alternative investment funds with a focus on alpha-oriented, institutional-grade small to mid-sized managers.

Susan Weerts is an independent research analyst, investment consultant and a contributing writer to Seekingalpha.com. Current research areas are strategic trading games on ETF and its underlying index, market-neutral L/S strategy. She is also a consultant on China-related business. szweerts@yahoo.com

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Catalyst Financial Partners LLC
1345 Avenue of the Americas, 33rd Floor.
New York, NY 10036
T: +1 212 966 2993
E: info@catalystforum.com