HDF

STRATEGIES

September 2009

October 28th, 2009

Equities continued their positive trend, with most indices sharply up in September. For the S&P, it has been the 7th consecutive positive month (+56% since the March lows). China resumed its uptrend and the only exception was Japan, penalized by the strength of the JPY.
For US Treasuries, it has been the 4th consecutive positive month, despite stronger economic data and higher equities.
In the currency markets, Yen was again the strongest currency, up 3.5% vs. USD, but also up over 1.5% vs. the Euro. Europe, Japan and the UK have all begun to use verbal intervention in order to influence market perceptions about over/under valuations.
Gold and metals were higher yet again, benefiting from the US Dollar weakness, but oil had a negative month despite the strong equity markets and weak US Dollar.

Many participants now consider that we face an ideal scenario for asset price inflation. Economic data have improved, but central banks continue to clearly indicate that they will keep monetary policy loose for an extended period of time. Nevertheless, recent data have clearly shown some easing in global growth momentum: global manufacturing PMI surveys stalled last month and the latest US payroll report showed greater than expected September job losses. These economic releases are reminding us of the downside risks of the recovery trade.

Direction wise, managers are generally concerned about the overbought conditions for risky assets after such a strong rally. But most of them don’t see a clear and immediate trigger to cause anything other than a technical correction, as the fundamental improvement in the world economy over the past six months has been consistent and global. As well, according to various surveys, there is a “wall of money” on the sidelines, seeking returns that cash assets are not providing.

All HDF funds of funds registered a strong positive performance in September with little directional exposure. Amongst the different strategies, the best performers in September were credit specialists, low beta equity managers and Systematic Trading.

Fixed Income and Relative Value Strategies

Fixed Income Arbitrage & Long/Short Fixed Income

All Fixed Income Relative value managers generated positive performance as they benefited from their flattening and steepening positions on the US and European curves respectively. They remain vigilant and monitor closely the financial sector, US banks in particular, which may provide an early signal for a deterioration of the market environment.
In the US, expectation is that the front end of the yield curve will be at its steepest level just prior to the Fed starting its hiking cycle.
In currencies, the long Asia currencies against USD continued to deliver performance, although our fund managers believe that this trend should slow down as Asian central banks are fighting against the appreciation of their currency that could dampen their growth.

Long/Short Credit

Long/Short Credit managers had a strong positive month in September, driven by the long side of their portfolios. The $84bn of bond issuance was not enough to satiate the market’s appetite, as High Yield index tightened 118bps to 7.94%. Long positions in Telecom, Finance and Tech performed best, particularly in low dollar priced bonds and distressed debt. Short positions in both high yield and investment grade lost money. Our managers remain wary of the credit spread levels and keep a market neutral positioning. They increase the beta of their short book, while buying higher quality names.
Meanwhile, fundamentals continued to deteriorate, particularly in the commercial real estate market.

Capital Structure Relative Value – Event Driven

The environment proved to be favorable to all our managers in September. As credit outperformed, investors moved down the credit curve in order to pick-up yield, triggering profit from spread compression arbitrage trades, especially in financial names such as ING or BNP-Fortis.
In Distressed, one of our managers still sees Icelandic banks offering opportunities of outsized gains with little downside. On the volatility front, the convertible market reopened in September after the summer lull, with 12 deals totaling €4.1bn: our managers did participate in a number of attractively priced deals like the €1bn Alcatel (5% coupon and 35% premium), and took advantage of the credit market outperformance to monetize gains in their existing portfolios. Our managers see the US convertible market as fully valued, and stand aside for now.

Equity Strategies

Long/Short Equities

U.S.

Despite the strong sell off on the first day of the month, the S&P 500 picked off where it left and made new highs, frustrating the bears which have been predicting a big down move.
Until now the market was mainly driven by liquidity and by the marginal improvement in earnings from very low levels. Everyone agrees on the fact that earnings improved because of cost cutting. The big discussion between bulls and bears lies on top line growth. Managers argue both sides, and the overall sentiment is not too bearish, not too bullish. Some managers are also finding that the market is normalizing and that stock picking is better rewarded.

Asia

The MSCI AC Asia Pacific USD Hedged Index was up 4.5% despite a difficult month for Japanese equities. The rest of Asia performed very well especially in Taiwan (technology sector) and India. In China, many IPOs were priced very aggressively and their subsequent performance upon listing was quite poor, but the markets held firm.
Our managers are still positive on Asian markets. There are so many bottom-up stock picking opportunities that they can keep a manageable net long bias (+20%) with low gross exposure.

Europe

Financials once again led the market, although this month saw a reversal between insurance (best performing sector this month, +7.2%) and banks (+1.7%). Cyclical sectors also performed strongly, notably travel & leisure (+5.1%) and industrials (+4.1%). Defensive sectors lagged one more time, with retail being the worst performer (-0.1%), followed by utilities (+1.3%) and health care (+1.8%).
The small caps index performed very strongly (+6.2%) once again this month (year to date, the MSCI Small Caps Europe is up 48.9% whereas the MSCI Europe is up 21.4%).
The level of net and gross exposures of our funds continue to increase gradually, as our managers see a lot of opportunities on both sides of their book.

Macro and Trading Strategies

Global Macro

Global macro managers contributed positively to the performance. All our macro managers were up this month except one because of a directional long oil position. S&P 500 was up 3.6% hitting all time highs for the year, gold price was up 5.6% passing the $1000/oz mark, and dollar continued its free fall against most currencies.
Our macro managers believe that global economic growth is likely to beat consensus over the coming few months confirming the common observation that deep recession are typically followed by steep recoveries beefed up by the inventory cycle.
Inflation is not likely to be a risk for the short term, as there is still a deflationary pressure on wages. Although there are still a lot of uncertainties concerning the structural shape of the global economy and the consequences of the future withdrawal of the fiscal and monetary stimuli, our managers believe there is money still to be made in normalization trades. However they are cautious, as they avoid risky assets and favor tactical trading positions rather than long term directional bets.

Systematic Trading

In September, all our systematic trading funds posted positive returns, ranging from +2% to +3%.

For medium/long term trend followers, the strongest contribution came from the FX sector, benefiting from the falling US Dollar trend. Bonds, short term rates, equities and precious metals added to the performance. Energy was the main negative contributor, as the oil market remained choppy.

For short term oriented funds, statistical arbitrage was the main driver of the performance. The price-based models proved to be a very robust contributor to the monthly gain, especially outside Asia. The fundamental models also added to performance, more notably in the US and Europe.

Our short term CTA manager was also positive, with all asset classes but commodities contributing to the performance.

