

# HDF

## STRATEGIES

May 2010



June 25<sup>th</sup>, 2010

### Equity Strategies

#### Long/Short Equities

##### *U.S.*

The S&P 500 Index lost 8.2% in May, giving back the strong gains in the three preceding months, and pushed the index down to negative territory for the year. All sectors turned in negative performance, with those most levered to growth suffering the greatest: Energy (-11.8%), Industrials (-9.8%), and Materials (-9.7%).

Fears of European sovereign debt contagion came to a head in the first week of May with the S&P 500 declining 7.6% during the last 4 trading days of that week – that's the majority of the loss for the month. May 6<sup>th</sup> was particularly bad as the index lost 8.6% intraday before recovering strongly and closing down by only 3.2%. Clearly, equity volatility has returned. Part of the price movement also likely came from algorithmic trading programs that behaved strangely.

Equity market conditions remained volatile the rest of the month. There appeared to be a camp of investors who were buying on the big dips, which served to temporarily prop up prices, but eventually the sellers won out. Whereas the attention in February through April was on the incremental improvements in US economic data and anticipation of further good news, May was characterized more by the worries over the debt crisis in Europe, slowdown in China, and the still problematic employment/wages/housing situation in the US. Commodity prices suffered as well as investors realized that the growth recovery could be bumpier than anticipated.

Our portfolio of US equity long/short managers performed relatively well. Our bias towards managers who are flexible in setting their fund's market exposure stance helped substantially during a month like May. In conversations with these managers during the first quarter, they expressed optimism regarding the US economic recovery but were also cognizant that macro or even technical factors could lead to a 10%-15% correction. Thus, while their funds were running at the higher end of their historical net exposure range, they were prepared to make drastic cuts when warranted. A few of these managers also had put option positions bought cheaply (when the market was ebullient) that served to automatically reduce the fund's net exposure as equity prices deteriorated. This is precisely what transpired in May and these managers were able to substantially mitigate losses during the month as they quickly reduced market exposure.

Two of our US equity managers were actually able to generate positive returns – one runs a short biased fund, and the other, an event driven fund. The latter fund, in addition to being agile in May, also benefited from positions that traded more based on the events associated with the companies rather than broad market movements. The majority of our US equity managers continues to maintain a cautious stance for now but is optimistic regarding their short books. Earlier in the year, the liquidity flowing into equities made it difficult to produce returns/alpha from the short side as poor fundamentals were ignored. But now, investors appear to be paying more attention to not only macro risks that still exists, but also to individual company risks.

##### *Asia*

May was another difficult month for equity markets around the world and, this time, Asia was not immune. However, our fund had a limited drawdown thanks to a low net exposure (below +20%) and no leverage (gross at 75%). Our global emerging managers suffered more than the others. One manager was up 5%, despite having a net long exposure, thanks to a very good stocks selection in Japan and Korea.

In China events around Foxconn had a negative market impact, but the recent wage increases are likely to help and restore consumer confidence. This is actually unlikely to remain a China phenomenon but could soon be true throughout Asia, a stark contrast to the developed world.

A strong expectation of our managers is Asian FX appreciation; China's Yuan should be the first to move then other Asian currencies will follow. On the equity side, our managers are still focused on local consumption stocks.

##### *Europe*

May was an extremely volatile month where the European equity market was significantly down (-5.7%).

All sectors were negative this month, but generally cyclicals underperformed significantly. Spain notably underperformed with a -10.8% performance as fears on its debt repayment capability mounted. Defensive sectors outperformed, in particular food and beverage (-1.3%). This month, we had only 4 positive managers. There was a high correlation among stocks during the month, which made it hard for our fundamental long/short equity funds to make money. Several of them have turned the portfolio towards defensive companies with good fundamentals and a high dividend, such as some tobacco or telecom companies, which have been sold indiscriminately in the sell-off. Risk arbitrage spreads widened significantly, but our underlying funds were not too affected. Our managers generally find good value in equities at a bottom-up level, and company fundamentals are generally sound. At the beginning of the month, we invested in a new fund recently launched, which manager has an impressive track record. The fund has a flexible exposure. We reduced our position in an aggressive directional Long/short fund.

## Fixed Income and Relative Value Strategies

### Fixed Income Arbitrage & Long/Short Fixed Income

The performance of our managers for the month of May was spread around neutral. Those concerned by tail risk events made money overall, while those running a somewhat short volatility bias lost. May was a month of dislocation, not only in equities markets, but also in sovereign debt, with the Greek situation coming to a head with an emergency package of €750 bln provided by the EU and IMF, and the ECB having to abandon its former policy and start to buy European sovereign bonds in the secondary markets. However, risk-assets – corporate credit, stocks and commodities - kept deteriorating, while a flight to quality occurred in Treasury bonds, implied volatilities spiked, US and German curves bull-flattened, and FRA/OIS spreads widened. Relative value fixed income strategies did perform: our managers made money in German debt vs. swaps and other European bonds - Gilts and Spain primarily -, as well as in flattening positions in the US, Canada and Australia. Our managers made money on FX, as short Euros positions performed, but lost on long Asian currencies vs. USD. Finally, short volatility and negative convexity positions lost across the board, and were reduced or stop-lossed over the course of the month.

### Long/Short Credit

Long/Short Credit managers had a slightly negative performance in May, when the ML High Yield index decreased by 3.5%. Greece's bailout was received by increasing scepticism in the market. Western economies are questioned about the sustainability of their sovereign debt and their exit strategies. Although corporations are reporting improved numbers, looming structural deficiencies, global imbalances and political unrests (in Korea and the Gaza strip) threaten the global economic recovery and stability.

Long high yield positions were losers, although our managers prudently rotated their portfolio to higher quality paper. Risk level has been further reduced in the course of the month, although already reduced since March 2010. Given the uncertainties facing the world, our fund managers are expecting volatility to remain high in the markets and believe that the best credit opportunities remain in the shorts and the short-term catalyst driven long credit opportunities.

### Capital Structure Relative Value

The Capital Structure Arbitrage compartment did contribute negatively to the portfolio in May. With the acute sovereign crisis, liquidity dried in some OTC products; and convertibles, distressed bonds and special sits did suffer most. Our managers did reduce significantly their gross exposure to all underlyings, even if it meant crossing wide spreads in illiquid markets. In volatility arbitrage, dislocation had our managers reduced their positions by half, while mitigating losses with short term gamma gains. In convertibles, long-only funds that had been the main buyers for the past year suffered redemptions and had to sell in an illiquid market: the basis is negative again, and our managers entered into liquid short-dated positions while exiting longer-dated low-delta converts. The bulk of the underperformance of May was concentrated in Capital Structure Arbitrage and Distressed Situations, particularly in the financial sector: debt/equity trades widened for 2 large Spanish banks, as well as the secured/unsecured spread, hitting the stop-loss of one of our managers. Overall, distressed books were reduced, and market hedges increased.

## Macro and Trading Strategies

### Global Macro

Global Macro funds contributed negatively in May although performance among them was very heterogeneous. The rather crowded long emerging market currencies theme lost money and was subsequently reduced, while long developed market currency positions and the short risk assets theme made money. Steepeners in the US and UK curve were detrimental to the overall performance.

Our macro managers are less optimistic now about the economic recovery than a few months ago, as it has been observed that growth rates are now stabilizing rather than accelerating. China's property market is

cooling down, while declining shipping rates, consumption in base metal and other commodities indicate that the activity is slowing. Additionally, cheaper Euro is detrimental to China's trade balance with Europe. The US recovery is challenged as stipulated by lower job creation than anticipated, still high unemployment rate, slowing ISM and PMI figures.

The coming G20 meeting in June could lead to FX volatility and adjustments. Our macro managers have taken a cautious stance as they believe markets will remain choppy for a while. They keep their portfolio very liquid, and have simplified them with very straightforward directional components.

### **Systematic Trading**

Our Systematic Trading funds average performance was positive in May.

Profits came from short term directional trading and contrarian models. Mid/long term trend following and statistical arbitrage exhibited losses. For the mid/long term strategies, the worst performing sectors were equity indices and energies where long positions were hurt by the strong downwards moves. Risk allocations to those sectors have now been significantly reduced from their peaks. In the shorter term space, directional trading was significantly profitable. A tumultuous month such as May is generally beneficial for this style of trading, with good volatility and high liquidity enabling high frequency systems to trade efficiently. Most profitable sectors were currencies and bonds.

Statistical arbitrage had a negative return. Both technical and fundamental components had a difficult time in a shifting environment and suffered, while adjusting to the new risk-averse trend.