

# HDF MONTHLY STRATEGIES UPDATE

June 2010



July 29<sup>th</sup>, 2010

## Equity Strategies

### Long/Short Equities

#### *U.S.*

The S&P 500 Index declined further in June with a return of -5.4%, putting YTD return firmly in negative territory at -7.6%. Defensive sectors continue to generate the best relative performance over the past two months. In June, Consumer Staples, Healthcare, Telecom Services, and Utilities were down only 1% to 3% while Consumer Discretionary, Industrials and Materials suffered losses of 7% to 10%.

Much like in May, macro factors were once again the drivers for the month's poor performance. The fiscal troubles in Europe, the slowdown in China and the continued labour woes in the US obscured the healthy earnings growth of US companies. As a result, the S&P 500 Index is now trading at around 13x estimated 2010 earnings, still materially lower than the historical average of about 16x.

Signs of fear and declining confidence in equities abound. Investors withdrew money from the equity markets and opted for the safe haven of US Treasuries and gold: while the 10-year US Treasury yield dropped to below 3%, the S&P 500 yield surpassed 7%. Talks of a double dip recession were revived and the possibility of a sustainable recovery was given less credence. Investors brace themselves for the eventual end of the various stimulus packages. Thus, commodity (i.e. oil, copper, etc.) prices slumped. The VIX took a wild ride during the 2nd quarter, moving from about 15 in mid-April to about 45 in May, and finally settling at about 35 by the end of June.

In June, the majority of our US long/short equity managers were able to perform relatively well in the face of continued deterioration in the equity markets. During the first half of this year, most of these managers have delivered flat to slightly positive performance while the S&P 500 Index fell by almost 8%. Our managers prudently reduced exposure and did not fight the market in May and June. Rather, they put on short positions that have become viable again after investors stopped pumping liquidity into the markets. They also took some profits on the long side with an eye towards re-entering at lower prices. They believe that there are many companies that have been dragged down by broad market movements despite strong earnings growth and clean balance sheets, and that this disconnection between price movement and earnings power can be taken advantage of at attractive entry points. These managers remain conservatively positioned but poised to take more risks as macro issues take on more clarity and fundamentals start to matter more. The ability to change exposure stance is something that we continue to focus on, both in our current group of equity managers and in those that we are analyzing for potential investment: we are exiting one manager who we feel has too much assets to remain effectively nimble.

#### *Asia*

Markets continue to be hit by the sovereign debt crisis in Europe, concerns over a slowdown in Chinese growth and increased fear of a "double-dip" in the US and global economy. Within the region, the much anticipated un-pegging of the RMB had little positive effect on Chinese equities (as well as Asian equities generally), which underperformed the region on concerns over property tightening and growth slowdown during the 2nd quarter.

As expected our Fixed Income and macro managers clocked positive performance with a good positioning in Asian FX and low equity exposure. Most our managers tend to agree that the following months will remain challenging, and that trading capability will be the key.

Exposure wise, we didn't see any major shift with net below +20% and gross around 80%.

#### *Europe*

Performances among European Long/short equity funds were first positive but suffered in the last week to finish in slightly negative territory for the month, with quite some divergence among managers. The month was indeed still dominated by macro factors, as fears of a double dip mounted.

Cyclical sectors had the worst performance and in particular oil & services (-9.6%), and basic resources (-6.1%). Defensive sectors outperformed: health care returned +4% and food & beverage +3.4%.

One of our flexible managers reported a more than 3% performance as it moved smartly its net exposure intra-month and finished the month net short, while having some good stock picking success on the short side. We continue to notice a disconnection between macro fears and solid company fundamentals. Our managers continue to run both moderate gross (about 125%) and net (close to 30%) exposures, as volumes are very thin and the predictability of prices still relatively low. However as they overall expect a good Q2 earnings season, some of them have started to reintroduce risk in the portfolio, but to a limited extent. M&A activity in Europe finally had a long-expected pick-up, with deals happening noticeably among larger companies (NewsCorp's takeover on BskyB, sale of Axa UK to Resolution). This bodes well for a good activity pick-up in Autumn.

## Fixed Income and Relative Value Strategies

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

Once again, our fixed income managers performed strongly over the month, focusing on directional and relative value strategies in all currencies.

As the news flow seemed to validate softer growth in the US, the fixed income markets rallied throughout the month, with US and European rates below 3% at the 10 year tenor, and the curve flattened, led by a rally in the intermediate sector: in the US the 2yr/10yr flattened by over 18bp over the course of the month.

Our managers did make money in directional and curve flattening trades, mostly at the front end of the curves, and benefited from supply arbitrage both in Europe and the US. In Asia, Korean and Taiwan steepeners added to performance, while bearish Hong Kong trades vs. the US did not work and were sized down.

In FX, our managers made money in Asia, from CNY, INR and IDR, thanks to the de-pegging of the Chinese currency, but those were broadly offset by losses in G3, with a rally in the yen and the euro.

Finally, volatility positions were profitable, as long convexity positions in foreign exchange did more than mitigate a small short bias in euro and US rates. Furthermore, as implied volatilities reached the low end of their historical range, one of our managers started to accumulate long positions in GBP, AUD, TWN and short-dated gold options.

### Long/Short Credit

Long/Short credit managers had a negative contribution to the portfolio in June, as stress kept percolating in risky assets. Credit markets traded in a volatile range, but closed the month only marginally wider, with the Merrill Lynch High Yield Index at 705 bps, +16 bps in June. Given the wide spreads and the rally in government bonds, the total return was nevertheless a positive 1.3% for the indices. Managers focusing on the most liquid part of the universe did better, as they could better cope with the large daily swings. High yield and leverage loans performed, while distressed suffered.

Our managers tried to increase the convexity of their positions, and one did increase significantly his short book, as he felt uncompensated for the risk given the valuation of the investment grade space. An example of paired positions would be longs in GECC and Morgan Stanley vs. Austrian government bonds and Lafarge CDS.

### Capital Structure Relative Value – Event Driven

The Capital Structure Arbitrage compartment had a marginally positive contribution in June, with volatility and equity strategies adding, while credit did detract from performance. Our managers increased the hedges of their long book, and decreased leverage overall, while rotating to liquid positions.

In volatility space, our managers made money, even if volatility levels were unchanged on the month with VDAX and VSTOXX broadly stable. Opportunities lied in single name selection, as implied correlation remained high, as well as in convertibles. Books are now bifurcated, with short-dated, positive carry positions, and credit-hedged gamma positions. Mandatories did perform during the month.

M&A did contribute positively to performance, even if spreads are still tight. Our managers found the opportunities where the market was over-estimating the regulatory risk – Talacris in the US – or when a bidding war erupted – ABB and Emerson on Chloride.

In credit, our managers struggled, and reduced their directional trades, as little differentiation is priced in. Systemic risk is equally priced across all names, and interesting trades are spotted by our managers in financials, where pair trades of a good quality bank in a similar sovereign vs. a challenged bank in a debt-challenged sovereign. The cash bond/CDS basis is starting to normalize, indicating that the supply/demand imbalance between dealers and investors is levelling off, and providing good opportunities for the summer months for our managers.

# Macro and Trading Strategies

## Global Macro

The overall performance of the Global Macro bucket was negative, with a large dispersion of returns. The most prevalent theme in June was the reassessment of the growth outlook for the 2nd half of the year, with a double-dip scenario gaining credibility in the US. The US dollar consolidated lower, while government securities strengthened throughout the month, irrespective of their yields.

Our managers mostly made money in FX and Fixed Income directional strategies. Canadian and Singapore dollars were profitable trades on the long side, as well as the pound sterling: the UK authorities delivered a fiscally credible budget, helping the pound rally, and alleviating fears of a UK downgrade.

Commodities and equities mainly detracted from performance, as macro themes overwhelmed idiosyncratic results. Our managers still see fundamental value as supportive, be it prospective earnings and growth for equities, or inventories and demand for commodities.

Overall, our managers remain cautious, and reduced leverage going into July. They are not outright bearish, as China started to adjust its currency, pegging it to an undefined basket, as the Europeans will publish stress-tests for their financial industry, and as the earnings season should be supportive of further gains going into the summer months.

## Systematic Trading

Systematic trading funds average performance was down -0.64% in June.

Performance contributions in June contrasted with May, as profits came exclusively from medium/long term trend following. Short term trading and statistical arbitrage exhibited losses.

For the medium/long term strategies, the best performing sector was Fixed Income, with US and Japanese government bonds continuing to rise. Energy was the worst contributor as short positions suffered from the rally in crude oil.

In the shorter term space, directional trading was significantly down. The numerous hiccups of the equity indices were generally not captured by the models, and generated losses.

Statistical arbitrage also had a negative return as our manager's US portfolio lost this month and technical strategies were hit by marked regime shifts.