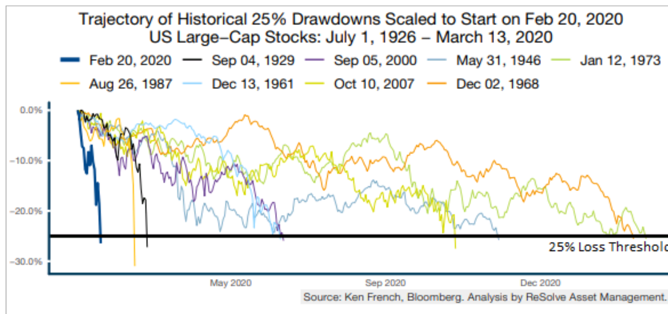
Newsletter April 2020
Overview Alternative Investments

The Corona Crisis

We had been expecting a correction on the stock markets for some time, but it was a surprise to everyone that it would trigger a panic that goes beyond all historical dimensions. Not only was it the fastest correction on the equity markets ever observed, it was also the most massive expansion in credit spreads and the most extreme movements in the VIX volatility index.



Such a shock is a huge challenge for any portfolio manager, and especially for managers who use leverage as part of their investment strategy. Some relative value managers had problems to cope with the situation. Their risk models are based on historical data and reach their limits when a crisis shows a completely new pattern, as it was the case in this corona shock. The losses in a diversified hedge fund portfolio were manageable, even if the capital could not be fully preserved. The environment has improved significantly for many strategies after the correction. We do not expect a rapid recovery in the equity and credit markets, although the short-term bear market rally was above expectations due to record-high government aid. The coming recession will leave its mark and hedge funds can show that they will make money in a difficult and volatile market environment.

Stefan Steiner

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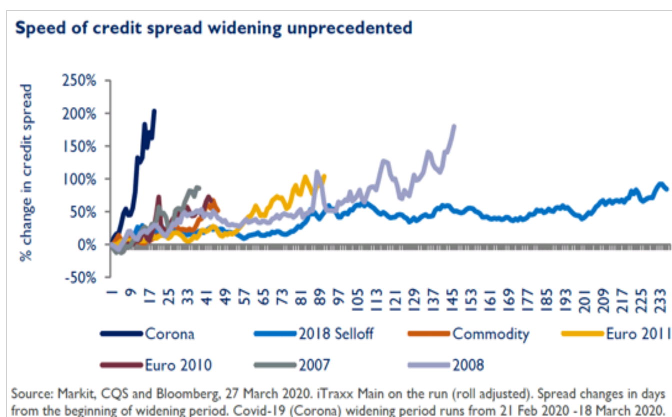
Fixed Income (USD)	Q1 2020	2019	2018	3Y CAGR	5Y CAGR	5Y Std Dev
Switzerland Gov Bonds 1-10Y TR	-0.02%	3.05%	3.52%	2.63%	2.06%	2.19%
FTSE WGBI (ex-Citi WGBI All Maturities)	2.00%	5.90%	-0.84%	4.27%	2.96%	5.34%
Barclays Global HY TR	-15.02%	12.56%	-4.06%	-0.59%	2.28%	8.37%
HFRI Event-Driven Index	-15.28%	7.53%	-2.13%	-2.18%	0.09%	7.36%
HFRI Relative Value Index	-6.97%	7.61%	-0.43%	0.78%	1.98%	4.17%
Crossbow Credit Distressed Portfolio	-11.32%	5.92%	-0.75%	-1.33%	-1.05%	6.31%
Crossbow Alpha Portfolio	-0.65%	7.35%	1.77%	3.63%	3.21%	2.17%
Equities (USD)	**Q1 2020**	**2019**	**2018**	**3Y CAGR**	**5Y CAGR**	**5Y Std Dev**
SMI TR Index	-10.45%	34.05%	-4.17%	8.78%	6.12%	11.74%
MSCI AC World TR	-21.36%	26.60%	-9.41%	1.50%	2.85%	13.69%
MSCI EM TR	-23.60%	18.42%	-14.57%	-1.62%	-0.37%	17.57%
HFRI Equity Hedge Index	-12.93%	13.71%	-7.14%	0.09%	1.30%	7.89%
HFRI Macro Systematic Diversified Index	-0.15%	7.08%	-6.62%	1.06%	-1.30%	7.26%
Crossbow Equity Hedged Portfolio	-1.04%	9.68%	-3.83%	3.34%	1.36%	4.80%
Crossbow Trading Portfolio	-4.84%	4.04%	1.70%	1.89%	1.98%	3.72%
Crossbow Trendfollowing Portfolio	2.08%	12.39%	-0.64%	5.71%	3.22%	5.94%
Others (in USD)	**Q1 2020**	**2019**	**2018**	**3Y CAGR**	**5Y CAGR**	**5Y Std Dev**
BVG-25 Plus	-6.40%	14.04%	-0.13%	3.81%	3.67%	4.66%
BVG-40 Plus	-9.88%	17.23%	-1.49%	3.54%	3.78%	6.33%
BVG-60 Plus	-13.99%	21.75%	-3.31%	3.35%	4.01%	8.70%
SXI Real Estate Funds TR Index	-2.90%	24.30%	-2.40%	6.84%	6.18%	7.83%

News from Our Fund Managers

Credit Opportunities

Ivo Felder

The low interest rate environment and investors' hunt for yield had resulted in historically tight credit spreads and Crossbow had been of the opinion that investors do not get adequately compensated for the risks they take. In March 2020 the COVID-19 crisis led to massive liquidations across the whole credit spectrum which resulted in a liquidity crisis and the fastest credit spread widening ever.



Source: Markit, CQS and Bloomberg, 27 March 2020. iTraxx Main on the run (roll adjusted). Spread changes in days from the beginning of widening period. Covid-19 (Corona) widening period runs from 21 Feb 2020 -18 March 2020.

Central bank interventions and government stimulus programs have averted the worst and investment grade credits have recovered more than half of the losses. However, spreads of US Senior Loans which were +461 bps in December and widened to +974 bps in March are currently still at +806 bps, similar to US HY Bonds which moved from +414 bps to +793 bps. Structured credit like ABS, MBS and CLO have fared even worse. Some specialized funds investing in such instruments have reported large losses and announced that they are restricting redemptions in order to avoid a fire-sale at unfavorable prices.

Although it is highly likely that default rates will increase in the coming 12-18 months, investing in liquid or semi-liquid credit has become attractive at current levels. As the panic and forced selling phase of the market subsides, we are focused on finding and taking advantage of opportunities with dislocated valuations and asymmetric risk reward. At this stage, we favor trading-oriented fundamental credit pickers with a long-bias. In the next 6-12 months, allocations to distressed managers and structured credit funds could become attractive for investors with less stringent liquidity needs.

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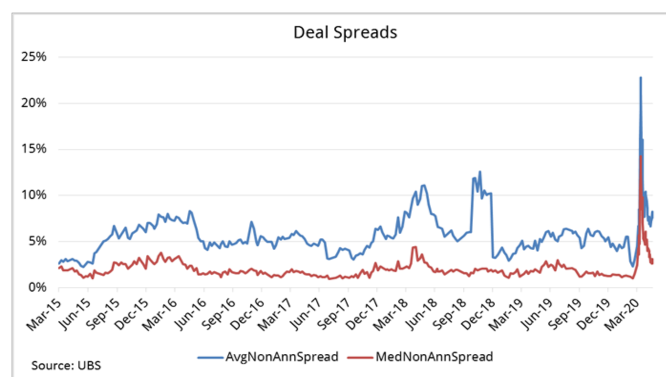
Merger Arb Opportunities

Davor Cvijetic

March was a historical month in financial markets. The dislocations were far reaching and have not spared the merger arbitrage space where deal spreads widened across the board to unprecedented levels (average spreads were higher than in 2008).

The panic selling in March caused setbacks in merger arbitrage portfolios as their holdings sold off irrespective of fundamentals. As a result many platforms and quant funds have reduced or completely exited the space which is positively contributing to the opportunity set as less capital chases the same opportunities.



Source: UBS

Markets have calmed a bit in April but deal spreads continue to trade at very wide levels. In the past weeks a few large deals have been announced, which shows that corporate boards are more optimistic than the market and are taking advantage of the reduced prices. While the path of economic recovery remains unclear, the volatility of spreads will likely persist allowing experienced merger arbitrage funds to take advantage of the opportunity set. In the current uncertain time, merger arb funds have shifted their exposure towards "safer" deals such as shorter duration deals involving a strategic buyer with a longer term view. The opportunity set has also increased on the short side where deals with stressed buyers in troubled industries have a higher risk of deal failures.

Merger arbitrage funds with a differentiated approach and in-depth fundamental analysis of the complex issues and risks involving mergers will be able to capitalize on the increased spreads. The advantage of such strategies is that they do not rely on the equity markets going up or down.

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Preferences and Skill in Sustainable Investing

Andreas Brogger and Alexander Cronies from the Copenhagen Business School document a positive Environmental Social Governance (ESG) premium amongst stocks with high socially unconstrained ownership. Socially unconstrained investors are defined as mutual funds, hedge funds and other independent investment advisors. This premium is not existing with high socially constrained ownership.

They conclude that generally, there is no evidence of an ESG premium amongst all owners, but conditioning their ESG factor on stocks in the largest quantile of unconstrained ownership, such as hedge funds, it emerges. They also see that for stocks with a high ownership share of socially constrained investors, such as endowments and public pension funds, the ESG premium disappears.

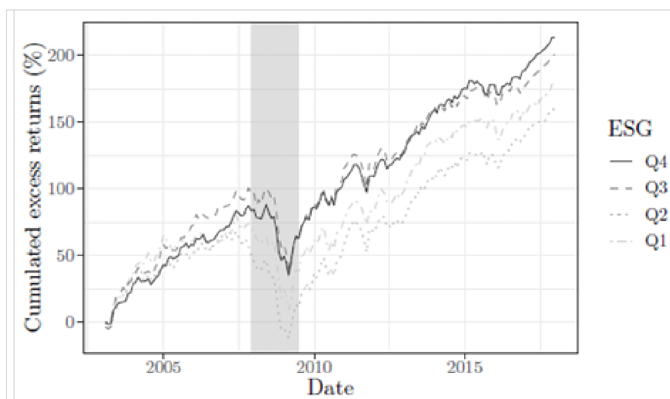

Figure 1: Cumulative returns for different ESG levels for stocks with high amounts of socially unconstrained ownership (top quantile). The shaded area denotes the Global Financial Crisis 2007/08.

This is consistent with the idea that unconstrained investors thoroughly research companies and invest in stocks they think will increase their ESG scores over the next period, and through the sustainability premium therefore increase in value, leading them to their second finding.

The second finding shows that unconstrained ownership predicts increased ESG scores in future, whereas constrained ownership does the opposite, albeit to a lesser degree.

Their third finding arises from the time series of long-short ESG strategy returns: abnormal returns increase during a recession. This means, sustainability is a hedge for bad times. They show this by regressing the excess returns of the sustainability strategy of unconstrained investors on the risk factors and an alpha that is allowed to be different in a recession. The resulting alpha is much larger during a recession.

Armin Vogel

Illiquidity in Hedge Funds

Evaporating liquidity is a central feature of many financial crises. Daniel Barth and Phillip Monin from ‘The Office of Financial Research - OFR’ (U.S. Treasury Department) try to answer questions about the importance of illiquidity and the distribution of illiquidity exposure across financial market participants. They use regulatory data on hedge funds - who, unlike public mutual funds, often invest in illiquid markets - to address three empirical questions: (1) how large is the illiquidity premium; (2) how important is this for hedge fund returns, and (3) who ultimately captures the premium, fund managers or investors?

They estimate a relatively large annual illiquidity premium of 56 basis points for an additional log-day needed to sell assets without price impact. Investors capture most, but not all, of the illiquidity premium. They receive 77% of the premium associated with illiquid assets, and receive a similar amount of the premium associated with the illiquidity of their shares. The illiquidity premium is also important for explaining hedge fund returns: portfolio illiquidity explains 27% of average estimated alpha, whereas investor share illiquidity explains 55%.

Consistent with compensation for undiversifiable illiquidity risk, managers of illiquid funds charge higher incentive fees. The findings suggest the costs and risks associated with illiquid assets are substantial and require significant compensation. Moreover, the returns of some funds are highly dependent on the illiquidity premium, which may indicate these funds have significant exposures to illiquidity. However, through share restrictions much of this exposure is passed to fund investors, who are likely better able to diversify across many asset classes.

If you wish additional information on any of the above, please contact av@cb-partners.com.