Crossbow Partners
Experience & Discipline

Newsletter July 2019
Overview Alternative Investments

More Fuel to the Fire


Stefan Steiner

The Federal Reserve Bank (FED) and the European Central Bank (ECB) announced a surprising change of course in June 2019. After years of explaining the necessity of normalized interest rates, they made a 180 degree turn and will cut interest rates in the second half of this year. The move is stunning as the economy in the USA seems to be on full steam with a nominal growth rate above average and record low unemployment numbers. Additionally, interest rates in the USA are only at 2.00% and therefore significantly below their long-term average. In Europe, the economy appears a bit less dynamic and interest rates are still negative at -0.4%. The plan is to go from negative to more negative. It seems that the Central Banks fear deflation and stagnation similar to what we have seen in Japan for the past 20 years. Furthermore, most governments are so heavily indebted that they need very low interest rates in order to fulfil their debt service without major impact on their budgets. What does it mean for the financial markets? Investors will shift back to a risk-on strategy as the Central Banks seem to guarantee some downside protection, keep supporting equity and debt markets by offering super cheap liquidity, and start buying securities for their own balance sheet again. It is crazy as it avoids a functioning market system for longer and one day the bill will have to be paid for. In the meantime, the rich will get richer and the majority does barely benefit. We strongly doubt that this will turn out well.

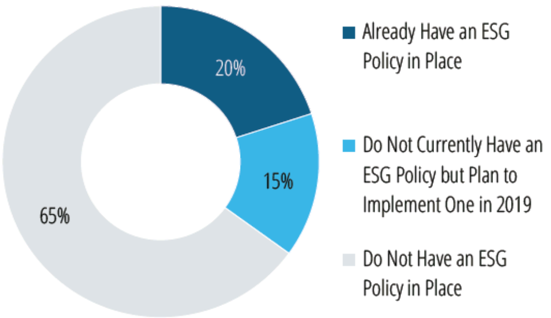
Please contact ss@cb-partners.com if you wish additional information.

Fixed Income (USD)	June YTD	2018	2017	3Y CAGR	5Y CAGR	5Y Std Dev
Switzerland Gov Bonds 1-10Y TR	2.82%	3.52%	1.49%	2.28%	2.66%	1.82%
FTSE WGBI (ex-Citi WGBI All Maturities)	5.38%	-0.84%	7.49%	1.00%	0.85%	5.42%
Barclays Global HY TR	9.49%	-4.06%	10.43%	6.83%	3.99%	5.81%
HFRI Event-Driven Index	5.61%	-2.13%	7.59%	6.36%	2.81%	4.57%
HFRI Relative Value Index	5.38%	-0.43%	5.14%	4.98%	3.29%	2.85%
Crossbow Credit Distressed Portfolio	3.30%	-0.75%	3.51%	3.60%	0.89%	2.95%
Crossbow Alpha Portfolio	4.37%	1.77%	3.94%	4.12%	3.47%	2.09%
Equities (USD)	**June YTD**	**2018**	**2017**	**3Y CAGR**	**5Y CAGR**	**5Y Std Dev**
SMI TR Index	23.11%	-4.17%	20.25%	13.69%	8.43%	12.09%
MSCI AC World TR	16.23%	-9.41%	23.97%	11.62%	6.16%	11.79%
MSCI EM TR	10.58%	-14.57%	37.28%	10.66%	2.49%	15.78%
HFRI Equity Hedge Index	9.47%	-7.14%	13.29%	6.84%	3.47%	6.50%
HFRI Macro Systematic Diversified Index	5.82%	-6.62%	2.12%	-1.42%	1.44%	7.44%
Crossbow Equity Hedged Portfolio	6.52%	-3.83%	7.86%	2.41%	2.82%	4.95%
Crossbow Trading Portfolio	2.76%	1.70%	5.94%	4.61%	4.77%	3.50%
Crossbow Trendfollowing Portfolio	6.22%	-0.64%	4.45%	3.44%	4.19%	6.15%
Others (in USD)	**June YTD**	**2018**	**2017**	**3Y CAGR**	**5Y CAGR**	**5Y Std Dev**
BVG-25 Plus	9.57%	-0.13%	7.31%	5.97%	5.75%	3.43%
BVG-40 Plus	11.42%	-1.49%	9.72%	7.49%	6.52%	5.00%
BVG-60 Plus	14.05%	-3.31%	13.17%	9.58%	7.57%	7.34%
SXI Real Estate Funds TR Index	14.75%	-2.40%	8.75%	7.22%	8.86%	7.53%

ESG Hedge Funds: An Oxymoron?

Hedge funds are generally not known for being a paragon of sustainability. Conventional wisdom refers to hedge funds as „locusts“, seeking to maximize their short-term and excessive investment returns by playing hardball and without worrying too much about the social and ecological collateral damage of their actions. Today, hedge funds still lag traditional long-only funds when it comes to systematically applying ESG criteria (i.e. evironmental, social and governance) and thinking to their investment decisions.

Fig. 2: Hedge Fund Managers with an ESG Policy in Place



Source: Preqin Fund Manager Survey, November 2018

But this is changing fast and many hedge funds are about to launch their own ESG-compatible products. Hedge funds are loosely regulated and can draw on a wide range of investment techniques in search for alpha. So why should they limit themselves to ESG criteria in their investment decisions, since they might affect their returns and their investment style?

Challenges in Implementing ESG Strategies

Even though the impact of ESG on performance is equivocal and varies from period to period, some recent studies suggest that investors do not underperform over the long-term if they systematically apply ESG criteria to their investment process. Many investors therefore believe that fears over an underperformance of ESG investments are unjustified. In their view, an ESG approach can actually contribute both to risk minimization and to outperformance over time. And, what is more, investors might even benefit from an „ESG momentum“, as ESG moves from niche to mainstream. Massive money flows into „good“ companies with positive changes in their ESG profile may help to push the stock and deliver an ESG outperformance.

Franz Odermatt

Hedging can also be a challenge. Taking short positions is standard skill and practice for hedge funds and part and parcel of their investment strategies. To go long „good“ companies and to short „bad“ companies at the same time could be a simple ESG strategy. Yet some institutional investors have drawn up policy statements that prevent them from taking any positions at all in companies that are excluded from the investment universe. Hedge fund managers are therefore forced to compromise, but typically willing to find bespoke client solutions.

It is a challenge for all investors that no unequivocal and universally accepted definition of sustainable investing exists. What all definitions share is the aim of infusing ESG criteria with the investment process. In its simplest form this could be an exclusion list of sectors, stocks, and countries that are out of bounds („sin stocks“). In a more sophisticated approach ESG thinking and criteria are systematically integrated in the investment process or investors will only allocate money to the „best of class“ securities with the highest ESG scores. Yet, in most cases, when making ESG investment decisions fund managers will have to draw on third party data providers, often facing inadequate data and poor data quality.

Despite all the obstacles, hedge funds actively respond to the growing demand for ESG products. In the longer term, sustainable investing can help to drive outperformance, to minimize risk, to more easily attract new assets, and to build up a solid ESG reputation over time.

Crossbow Survey

In summer we conducted a survey amongst our universe of equity long/short managers in order to find out how managers deal with ESG issues. From the 65 respondents 40% of the hedge funds had already launched an ESG-compatible product. Another 40% is currently in the process of implementing an ESG policy with the goal of having an ESG-compatible product available by 2020 or so. Only 20% of the hedge funds responded that they are not interested in sustainable investing. Hedge funds with their strategies, their skills, and their techniques, are very well positioned to make a significant contribution to ESG investing. They can deliver diversification and an alternative alpha source to existing ESG strategies.

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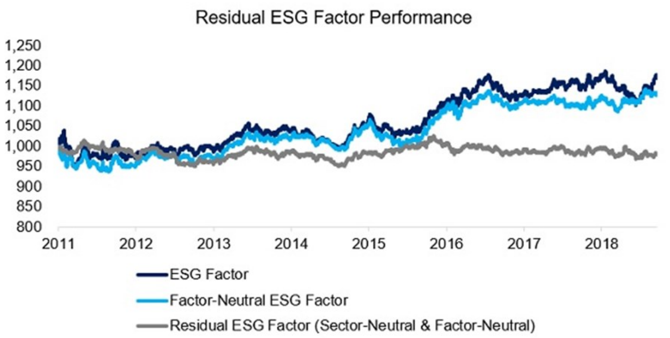
ESG: What's under the Hood?

Nicolas Rabener at Factor Research analysed the impact of ESG investing into single stocks. They utilized data from a U.S. provider that aggregates ESG scores from multiple other providers, which results in a comprehensive data set that covers most of the stocks listed in the U.S. stock market. They created a beta-neutral long-short portfolio composed of the top and bottom 10% of U.S. stocks sorted by ESG metrics, which comprised four major categories: citizenship, employees, environment, and governance. The ESG factor in the U.S. stock market showed a positive performance since 2011, essentially implying that investors were rewarded by investing in good corporates and avoiding bad corporates. The returns are not particular volatile and relatively consistent, making the strategy highly attractive.

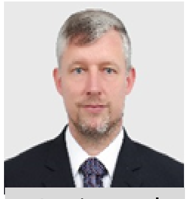
Given the exposure to common equity factors like Quality, investors might question if ESG can be viewed as a factor in its own right or is more akin to a multi-factor portfolio with structural factor tilts. Interestingly, the performance of the factor-neutral ESG portfolio does not differ much from the original ESG portfolio.

However, the factor-neutral ESG factor will still exhibit sector biases like an overweight to technology and underweight to energy stocks as noted earlier. Therefore they created a sector-neutral and factor-neutral ESG portfolio that highlights the residual returns from ESG investing. The resulting portfolio generated essentially zero returns since 2011, implying that the strong performance of the ESG factor is indeed explained by sector biases.



Hedge funds increase co-investment and customise offerings

Results from a survey undertaken by AIMA and RSM show the classic '2 and 20' fee model is no longer the standard structure charged by the hedge fund industry. As fund managers and investors focus on customisation and deeper partnerships to align interests, attention is no longer solely on fees.


Armin Vogel

The survey shows a new average management fee of 1.3% of assets under management (AUM) and 1.4% for new funds launched in the past 12 months. Discussions with managers and investors during the research reveal a shared belief that managers' share of alpha should be about one third.

Findings demonstrate that a maturing industry and institutional investor base now require hedge funds to deliver customised solutions, closer collaboration and closer communication.

Other key findings:

- Over 75% of managers see a mutual desire for a long-term investment commitment or an exchange of knowledge with investors as essential.
- The importance of 'skin in the game' to demonstrate partnership was confirmed by 76% of surveyed managers, who revealed they have significant personal capital invested in their funds.
- Nearly all respondents have a performance fee high-water mark with their investors and almost 40% use hurdle rates to set a minimum return for client(s) before a performance fee can be charged.
- Nearly 80% of managers would reduce management fees in return for a greater share of performance.

Next Crossbow Events

We are planning our next semi-annual event for October / November, discussing ESG and its impact on hedge fund investments and will send you an invitation in due course.

Furthermore, Franz Odermatt will speak at the coming „ZHAW Investor Fachtagung" on Thursday, August 29th, 2019 in Zunfthaus zur Saffran about ESG in the Hedge Fund universe.

If you wish additional information on these studies or the events, please contact mm@cb-partners.com