# Alternative UCITS: delivering on diversification

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Europe's Alternative UCITS funds have delivered on their diversification promise during the coronavirus-related market turbulence of 2020.According to Bernadette Busquere Arnal, European Head of Hedge Fund Research and Nathanael Benzaken, Chief Client Officer, the Alternative UCITS sector will continue to grow and Lyxor is positioning its fund platform to benefit clients in future.

## What impact has the coronavirus crisis had on alternative UCITS?

**Bernadette Busquere Arnal:** Overall, the performance of Alternative UCITS so far this year has been relatively positive. These funds have delivered on their diversification promise, as well as demonstrating resilience and a capacity to adjust to rapidly changing market conditions. During the sharp equity market sell-off that started in February, many of the managers were able to protect capital using efficient short books, relative value trades and hedges. Over the first quarter, the HFRI Liquid Alternative UCITS index was down 7.49%, while the MSCI World index was down nearly three times more (-20.94%).

So far this year, the performance of Alternative UCITS has been in line with that of the broader global hedge fund industry. Despite suffering a Q1 decline, the HFRX Global Hedge Fund index is now well over last year levels and finished up 1.14% by the end of August 2020.

## Which categories of alternative UCITS did well and which not so well?

**Nathanael Benzaken:** Actually, most strategies did the job since the coronavirus struck. You could say though that commodity trading advisors (CTAs), long-short equity funds (including market-neutral strategies), merger arbitrage, discretionary equity, credit and relative value fared particularly well on average. You'd expect CTAs to do well in a sharp sell-off as they are supposed to cut exposure as soon as volatility spikes and asset class correlation increases. This is broadly what happened in March. Structurally, most arbitrage funds should be relatively uncorrelated to overall market movements. And, by design, equity market-neutral funds should be hedged. Helpfully, some funds' risk models also gave them advance warning of a problem: many systematic equity funds had already reduced their exposure before the crisis happened, as the rising market volatility in early to mid-February caused them to cut back on positions. The categories of funds that did less well during the coronavirus related sell-off were global macro, as well as volatility and risk premia strategies. For example, some of those using variance swaps, implied volatility trades and equity risk premia have lagged in performance terms. Unsurprisingly, such average performances hide a wide dispersion within each sub-strategies. Manager selection matters as always.

## How can alternative UCITS act as a catalyst for diversification going forward?

**NB:** We believe allocating to liquid alternatives makes even more sense in the current context. In fact, against all odds, with major indices rallying back to near pre-crisis levels, it may even be more relevant now to consider building or adding to a "diversification" portfolio. Despite risks and uncertainties remaining high, the coronavirus crisis has created major dislocations that can be monetised by hedge fund managers.

As an example of the unevenness of performance across markets, it is interesting to look at the correlation of national equity market performance since mid-February with the measures of the severity of each country's lockdown.

In national government bond markets, countries with more restrictive lockdowns have seen a more substantial steepening of their yield curve (expressed as the difference between 10-year and 2-year government bond yields), reflecting greater perceived default risk.

This kind of dispersion of returns and market valuations creates lots of opportunities for relative value trades, which hedge fund managers are best placed to exploit. While most financial markets recouped a large portion of their losses in March, the Covid-19 outcome still remains uncertain for global economies. Recent trends could create a temporary disconnect between the market consensus and some macro and micro economic performance, certainly evidenced by elevated volatility and significant volatility swings.

## Which asset classes offer particular opportunities?

**BBA:** In credit markets, there are now lots of inefficiencies, particularly since we are just at the beginning of post-Covid restructurings of businesses. Central bank interventions have created lots of disparities between different credit instruments and there are also some large liquidity risk premia to exploit. In equity markets, there will be plenty of inertia at the individual company level . We observe now that it will be harder to get things back on track than it was to close things down, despite government support and significant liquidity injections. Going forward, it seems reasonable to expect a greater dispersion of performance from individual shares.

Currencies and sovereign bonds appear well ranked as attractive asset classes for relative value trades, given the large disparities amongst fiscal and monetary policies implemented by central banks and local governments around the globe. Global macro strategies will be particularly inclined to seize those arbitrage opportunities. Going forward, investors may also want to favour more liquid alternative strategies over less regulated and illiquid strategies, some of which sometimes lock up capital for several years.

Using liquid funds like Alternative UCITS will allow them to keep some flexibility in their capital allocation.

## How have the alternative UCITS on Lyxor's platform been performing?

**NB:** In the last five years, assets under management in the Alternative UCITS platform market have risen 47%, compared with a rise of 3.5% in assets for the whole sector. The popularity of platforms reflects the fact that they offer in-built diversification and easy access to a wide range of strategies, while allowing investors to benefit from the advantages offered by a platform's infrastructure, such as extensive investment research, in-depth due diligence and rigorous independent risk management. Lyxor's platform also had the strongest asset growth rate in the industry in 2019, with funds under management rising 54% during the year, compared to a 1% decline in assets for the overall Alternative UCITS market. This growth rate reflects several strengths. Lyxor is extremely focused on manager selection. We build partnerships for the long term: what matters to us, irrespective of short-term performance swings, is that managers demonstrate their ability to create value for investors across various market cycles. Our hedge fund platform is nearly two decades old and we have an extensive track record of selecting and carrying out due diligence on managers. Lyxor has a strong track record of acting as a gateway to Europe for some of the best names in the alternative funds industry, allowing European investors to gain access to alpha engines and sought-after hedge fund strategies in the liquid and transparent UCITS format.

## How are you positioning the Lyxor alternative UCITS platform for the future?

**NB:** We believe our business model is well-suited to navigating the new market cycle ignited by the coronavirus pandemic. Our bottom-up hedge fund manager selection process, which focuses on manager quality, makes for a robust platform that creates value for our clients over the long term. We also expect the growth in the Alternative UCITS market to continue. An increasing proportion of the world's largest hedge funds are looking to diversify their client base away from North America into Europe, Asia and Latin America. Private banks, wealth managers, insurance companies and pension funds will likely also support market growth.

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