

# Strategy Outlook

UBS Hedge Fund Solutions **Third Quarter 2021**

For professional / institutional /  
qualified investors only



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# Macro thoughts and portfolio themes

When writing this note three months ago, the situation around COVID-19 appeared hopeful from where we sat, amid a brisk vaccine rollout campaign in the US and many other developed countries.

Surging COVID-19 cases in emerging markets were extremely worrying. However, a few blueprints for containing COVID-19 bore results, and with time and resources, could ideally be applied more universally. Investors were looking ahead, eager to put this chapter behind them, and asset prices were pulling forward the expected growth and inflation. We also noted “The longer the pandemic lasts in any region subjects the global population to the risk of future variants that can evade vaccines.” The Delta variant is unfortunately making that statement ring somewhat true, though it appears to be those who are unvaccinated—many due to scarcity and others by their own choice—who are bearing the pain of this resurgence.

Our path to normalcy was never going to be straightforward. Taking one step back after moving two steps forward should not be a surprise, nor will the

path be uniform across regions. In the US, we’re witnessing an enduring regime change in terms of growth and inflation. Supercharged growth is losing momentum but will likely stabilize above the past decade’s levels. The largest question is how much inflation is cyclical versus secular? Our view is that inflation is unlikely to be transitory.

COVID-19 temporarily disrupted logistics and the effects of that are still being felt; however, the ebbing tide of globalization may be a long-lasting trend. It is reshaping supply chains and localizing production of critical goods which adds costs that are passed onto buyers. The incongruity between high US unemployment despite record job openings suggests compensation will need to increase to attract workers back to the industries—and locations—that need them. The Biden administration’s physical and social infrastructure

objectives as well as its pro-labor stance which seeks to lessen inequality, could also contribute to inflation if they are successfully enacted. Last but not least, ESG concerns are rightly receiving more attention in investment and business decisions, particularly in the effort to internalize carbon and waste costs, which were previously tolerated as negative externalities.

## Portfolio positioning

**Despite a challenging year for Trading strategies, and mixed results in Equity Hedged, we are maintaining our current strategy weights with only minor adjustments**

- Factor volatility remained high with multiple reversals in Q1 and Q2, and the market struggled to digest the impact of rapidly changing US interest rates (discount rates) on future earnings and valuation models. This environment continues in early Q3, but we believe it should eventually wane in coming quarters.
- Most notably, we may increase allocations to Agency MBS due to a widening in mortgage derivatives, perhaps the only market that experienced unique risk premia expansion in Q2.
- In turn, we are likely to trim long-biased Corporate Credit or Asset-Backed strategies (also long-biased) where spreads and risk premia continue to compress.



Supercharged growth is losing momentum but will likely stabilize above the past decade's levels.

# CIO model portfolio and sub-strategy outlook

Strategy	Sub-strategy	Q3 2021 Forward looking target weight %
<b>Equity Hedged</b>	Fundamental	20
	Equity Event	6
	Opportunistic Trading	9
	<b>Equity Hedged total</b>	<b>35</b>
<b>Credit / Income</b>	<b>Distressed</b>	⊖ 2
	Corporate Long / Short	6
	Asset Backed Securities	5
	Reinsurance / ILS	1
	CLO / Corporate Lending	—
	Other Income	1
	<b>Credit / Income total</b>	<b>15</b>
<b>Relative Value</b>	Merger Arbitrage	2
	Capital Structure / Volatility Arb	8
	Quantitative Equity	6
	Fixed Income Relative Value	6
	<b>Agency MBS</b>	⊕ 4
	<b>Relative Value total</b>	<b>26</b>
<b>Trading</b>	<b>Systematic</b>	⊖ 1
	Discretionary	19
	<b>Commodities</b>	⊕ 4
	<b>Trading total</b>	<b>24</b>

⊕ Positive Outlook    ⊖ Negative Outlook

## Distressed ⊖

- Given the material rally across corporate credit and more attractive long-biased opportunities in other segments of the credit market, HFS plans to have limited exposure in Distressed and selectively trim Corporate Long-Biased strategies

## Agency MBS ⊕

- HFS may tactically increase Agency MBS exposure
- Agency mortgage derivatives underperformed year-to-date relative to other spread assets and are now one of the few asset classes which, in our view, offers reasonable upside from both carry and potential spread tightening

## Systematic ⊖

- In recent quarters, signals within Systematic Trading were mostly aligned with the reinflation trade
- Although managers using faster models and signals could adapt to new regime over a period of time, CTAs may be challenged when faced with sudden movements in rates, currencies, equities and commodities

## Commodities ⊕

- We maintain our conviction in Commodities, which are expected to benefit from today's macro environment and policy objectives
- Commodities trading is a challenging, cyclical strategy that is fraught with manager turnover; nonetheless, we may add here as we find managers that meet our high criteria

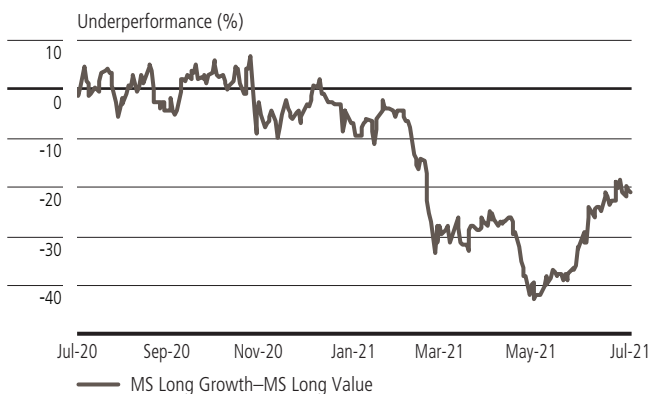
# Strategies

## Equity Hedged

**In Equity Hedged, we maintain our full-sized allocation and our focus on US sector specialists in high conviction areas like healthcare and on style agnostic managers more likely to rebalance towards value as rates move higher.**

Intensifying Chinese regulation in key private sectors such as education and technology are changing the landscape for alpha generation in the region. As such, our focus in APAC is shifting to tactical, low net managers that can pivot away from impacted industries until the dust settles. We continue to believe that fundamentals will come to the forefront as economies normalize and reopen, hopefully allowing managers to make up for the long and especially short alpha that proved elusive year-to-date. Factor volatility remained high with multiple reversals in Q1 and Q2, and the market struggled to digest the impact of rapidly changing US interest rates (discount rates) on future earnings and valuation models. This environment continues in early Q3, but we believe it should eventually wane in coming quarters. However, to achieve balance between value and growth, we are examining managers who can potentially benefit from exposure to cyclical sectors and value-oriented stocks.

### Long Growth vs. Long Value spread



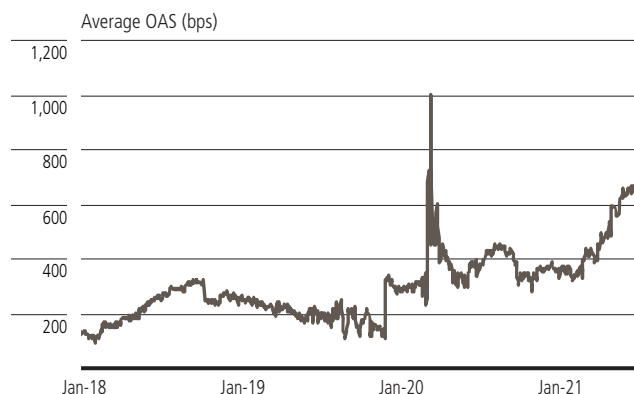
Source: Morgan Stanley, HFS; Daily data; Jul 15, 2020–Jul 15, 2021. Data illustrates the spread between Morgan Stanley US Growth Long Basket index (MSQUUGRL Index) and the Morgan Stanley Value Long basket index (MSQUUVLL Index). Indices are for illustrative purposes only. Please see end notes for index descriptions. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.**

## Credit / Income

**Our Credit / Income strategy will maintain core allocations to the ABS, Agency MBS and Corporate Long / Short sub-strategies, with the potential to increase Agency MBS.**

In Agency MBS, faster-than-expected prepayments for higher coupon collateral, yield curve flattening and new prepayment model assumptions released from YieldBook, a widely utilized model, resulted in material widening in option-adjusted spreads (OAS). Our ABS allocations seek to capture carry while minimizing duration; this means we must be selective and concentrate on only a few high conviction segments. Similarly, co-investments allow us to be surgical in allocating to idiosyncratic opportunities. In Corporate Long / Short, our focus remains on more trading-oriented approaches, particularly since corporate credit has broadly recovered and spreads are near all-time tights, appearing priced to perfection. HFS is also exploring ways to hedge for a risk-off scenario or catalysts that could cause credit spreads to widen.

### Residential Agency derivatives option-adjusted spreads (OAS)



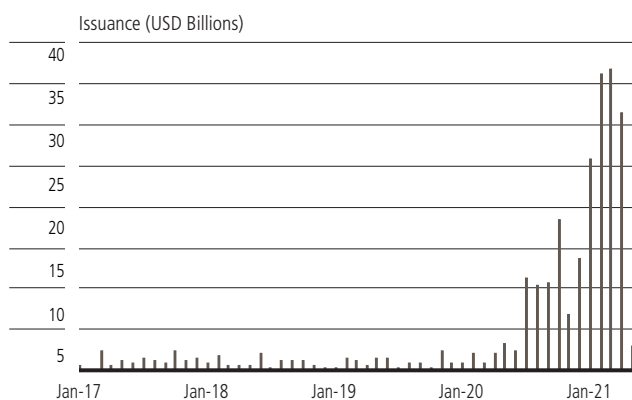
Source: Morgan Stanley, HFS; Daily data; Jan 2, 2018–Jun 30, 2021. Data illustrates average OAS, which is an aggregate OAS intended to be representative of spread levels for various Fannie Mae, Freddie Mac and Ginnie Mae residential mortgage derivatives. Indices are for illustrative purposes only. Please see end notes for index descriptions. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.**



## Relative Value

**In Relative Value, we allocate to a diversified mix of sub-strategies and employ targeted manager selection within those.** As such, we are unlikely to make major changes in Q3. Capital Structure / Volatility Arbitrage, which includes SPACs, was the latest focus of our top-ups in Q2. For Fixed Income Relative Value (FIRV), we will watch for steeper yield curves and new guidance on the removal of quantitative easing to assess whether to increase our allocations. As mentioned last quarter, we will leave Merger Arbitrage allocations unchanged and rely on event-focused Equity Hedged and Multi-Strategy managers to increase exposure to event-driven approaches, based on their judgment. As the world hopefully becomes less COVID-19 impacted, Quant Equity returns might improve relative to the recent past. However, their models and historical data sets will have to navigate the higher inflation and eventual rate hike regimes, wherein it's possible a lesson learned from COVID-19 is that faster repositioning and proactive intervention can complement fully systematic investment processes.

### SPAC new issue

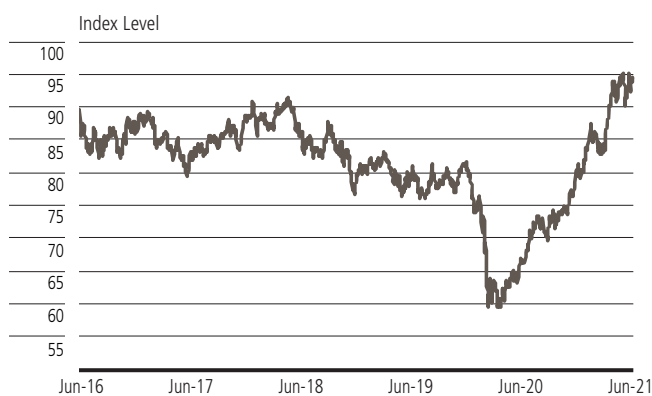


Source: Bloomberg; Monthly data; Jan 1, 2017–Jun 30, 2021. Data includes new SPAC issues by month (no greenshoe, USD 100mn minimum and North America only). **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.**

## Trading

**HFS maintains a moderately positive outlook on Discretionary Trading.** We expect episodic volatility from central bank communications and upcoming data releases to provide opportunities for developed market (DM) managers. These sometimes conflicting economic signals on the bumpy path toward reopening will likely bring a healthy level of volatility, which may make it difficult to hold large structural positions. Managers who can move positioning more dynamically and implement strong portfolio construction should be better placed to outperform. We also maintain our conviction in Commodities strategies, which are expected to benefit from today's macro environment and policy objectives. Commodities trading is a challenging, cyclical strategy that is fraught with manager turnover; nonetheless, we may add here as we find managers that meet our high criteria.

### Bloomberg Commodities Index



Source: Bloomberg; Daily data; Jun 30, 2016–Jul 15, 2021. Please see end notes for index descriptions. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.**

# Endnotes

## Index descriptions

*The use of indices is for illustrative purposes only.*

### **BCOM Index**

The Bloomberg Commodity Indices are a family of financial benchmarks designed to provide liquid and diversified exposure to physical commodities via futures contracts. The Bloomberg Commodity Index is composed of commodity futures contracts and seeks to track futures price movements. The Index is calculated on an excess return basis and reflects future price movements. The Index rebalances its holdings annually, weighted two-thirds by trading volume and one-third by world product and weight-caps applied at the commodity, sector and group level for diversification. Roll periods for the Index typically occur from the sixth to the tenth business day, based on the roll schedule. The Index was formerly known as the Dow Jones-UBS Commodity Index.

### **MSQUGRL Index**

The Morgan Stanley US Growth Long Basket selects the top 15% of the most liquid stocks from the Russell 3000 index based on standard growth measures. The basket is designed to be highly liquid and is rebalanced quarterly. At rebalance, stock weights are subject to a 2% maximum and aggregate sector weights to a 25% maximum.

### **MSQUVLL Index**

The Morgan Stanley US Value Long Basket selects the top 15% of the most liquid stocks from the Russell 3000 index based on standard value measures. The basket is designed to be highly liquid and is rebalanced quarterly. At rebalance, stock weights are subject to a 2% maximum and aggregate sector weights to a 25% maximum.

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The strategies described herein are speculative and entail substantial risks which may place your capital at risk. An investment in these strategies includes the risks inherent in an investment in securities, as well as specific risks associated with limited liquidity, the use of leverage, short sales, options, futures, derivative instruments, investments in non-US securities and illiquid investments. The Fund invests largely in other unregulated hedge funds. Such a portfolio of hedge funds may increase an investor's volatility for potential losses or gains.

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