Ayaltis INSIGHT – December 2017

Topic of the Month:

The Lessons of 2017

2017 has been marked by an almost never-ending equity rally. As of early December, the S&P 500 had registered more than fifty record closes since the beginning of the year, while volatility reached historical low levels, with the S&P 500 recording the longest run without a 3% drop (the last one happening prior to Trump's election).

Chart 1: S&P 500 Record Closes in 2017

Source: Wall Street Journal

What are the lessons of this year and what can we expect from the future? We would like to pick up the subject with Andrea Luzzi, Ayaltis' Chief Risk Officer.

2017 brought some surprises, but also failed to surprise on other ends. Looking back at financial markets in 2017, what do you think will stuck in investors' minds?

The interesting part of the question is in the first two words: "looking back". The usual mistake of investors is the reliance on statistics that are backward-looking. The evolution of the financial markets, instead of reducing the pernicious effects of the human being's propensity to believe that

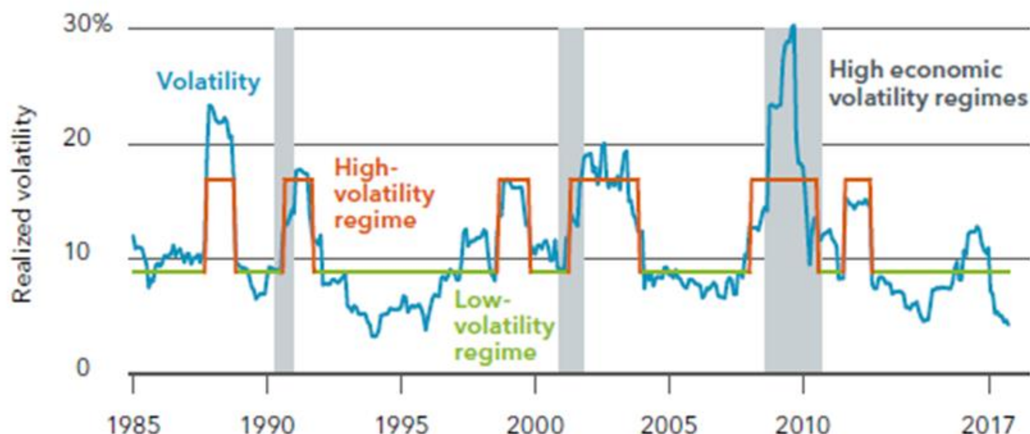
the future will be a replication of the past, multiplies the number of wrongdoings by financial players and conceals the risks. Let's see how.

First came the regulators. After the widespread critics of the Greenspan prolonged low-rate policy, all the major Central Banks have purposely created a sort of global gigantic put option that is forcing investors to constantly buy the dips. This pernicious side-effect of a loose monetary policy that was designed to support the economy while the credit sector was slowing down investments accelerated across all asset classes. In 2017, in particular, this relentless trend and the unprecedented low volatility emerge as the consequences of a massive move from prudence to complacency. This movement is only partially (sometimes not at all) understood by market participants. ETFs, Risk Parity, Constant Volatility, Equity Risk Premia and the large majority of trading algorithms are at the epicentre of this phenomenon.

2017 has seen an enormous increase in passive investments. With very low fees and long biases, they are the natural born killers of wisdom. In a bull market, driven by the power of the Central Banks' balance sheets, savvy investors can only succumb to the new fashion. Passive investments are disconnected from fundamentals by nature. They are designed to increase their supply based on inflows, in a circular loop that lifts valuations, usually favouring winning stocks (for instance large caps in 2017) versus losing stocks.

Momentum has been the other natural winner in 2017 and systematic strategies are putting more fuel into the self-sustained process, developing an artificial mentality that has been named "buy the dip". The new paradigm has become so strong that the S&P 500 losses have become shallower over time.

Chart 2: Realized Monthly US Equity Volatility



Source: Blackrock

On top of that, the low volatility environment, combined with the never-ending low-yield bond market, is pushing long only systematic strategies, like Risk Parity or passive long-only, to use more leverage. We are not only talking about short volatility, the best performing strategy of the last years, but we believe a large number of strategies, overwhelmed by large inflows, are

constantly short volatility, short asset class correlation and short gamma (the tendency to increase losses when losses occur). The world itself has been transformed in a negative convex bet on the real economy. If one card falls, the whole house will fall apart.

Quantitative strategies and traditional risk management models are doubling up the traditional human propensity to increase the size of a bet when risks are unanimously perceived to be low. Volatility is a largely used misleading indicator of risk. As a backward-looking indicator, its capacity to forecast risks ahead of time is close to zero. Despite that, the asset management industry is making large use of investment models that measure risk in terms of volatility. Almost at the end of a year that has been surprisingly peaceful, the opportunity cost for those (active market neutral managers) who do not want to join the party is almost unsustainable.

Is there still value in market-neutral strategies?

Most certainly there is! The massive reward that came in 2017 for all those who are long “everything”, from stocks to bonds, from M&A targets to high yields, from real estate to private deals has moved more and more investors out of the woods and into the party. A hiccup on fundamentals may suddenly redraw the landscape.

We will all be surprised, when the day comes, of the very low number of actual market neutral strategies that are still up and running. To find them and stick with them is what makes you wear trunks when the tide recedes.

It seems like it has been a challenging year for a relative value approach?

On one side, it was. Staring at the markets from the top, a decisive bull trend compresses some of the key drivers of relative value trades. Low volatility and low dispersion, intra and across asset classes, blow strong headwinds against purely market neutral trades. Market neutrality has many connotations. There is no doubt that the devil is in the details and the secret of the recipe stays in the balance of the ingredients.

The other side of the coin shows a more promising environment. Behind the curtains of a market where beta-seekers are the winners, new opportunities are popping up. The reversal of the reflation rally, high sector dispersion and the low price of credit risk hedging have been the main drivers of a successful year. We have been able to dampen the swings of our monthly return numbers without reducing our capacity to make performance. Not only do we keep performing, but we do it by reducing our correlation to the credit and equity markets.

We deepened our understanding of the market microstructure, thanks to our wide network of specialized managers who give us the most valuable pieces of advice on the market trends. This intangible asset is what we believe makes a difference, at the end of the day. We have the privilege to cherry-pick some of the most valuable propositions. We aim for a stable, resilient and performing investment, with a long-term horizon.

All sub-strategies were positive contributors to the overall performance. A consistent driver of performance was derived from the Structured Relative Value space. In particular, trading between

structured credit solutions, which originated prior to the crisis, where able to generate good returns.

On the Systematic Relative Value side, the focus has been to dig deeper into new strategies and create an overall resilient portfolio to shocks of different kinds. No allocation is alike in this part of the portfolio and they all have their particular features and tweaks. In this fast growing and rapidly evolving space, you need to dedicate time and effort in order to gain a solid understanding of how the components will complement each other.

2017 has been an excellent example of herd behaviour. As I mentioned before, to run with the crowd is not where we aim to make money. However, the dislocations that emerge through such developments can be monetized in several ways: While we generally express a highly critical stance on passive investments, opportunities emerge around this trend for example in terms of arbitrage opportunities between indices and their constituents.

We also intensified our efforts on the Relative Value Fixed Income side. As the end of easy money is closer than ever, the space has experienced more activity across the spectrum of available instruments. Central banks will tune down their degree of involvement and with this, some of the "smoothness" of these markets is likely to disappear.

We are entering the tenth year of Ayaltis with a high degree of confidence on the choices we made recently. Numbers never lie and if you spend time looking into our most recent track record, you'll immediately figure out the high quality of our allocation.

Thoughts and News:

Hedge Funds Performance in 2017

Hedge fund strategies have all performed positively in 2017. Hedge funds focusing on Emerging Markets had the most success, surging 17.55% until end of November. Global Macro funds have lagged, ending with a disappointing gain of only 1.60%.

Chart 3: HFRI Indices Overview YTD 2017 (without December Numbers)

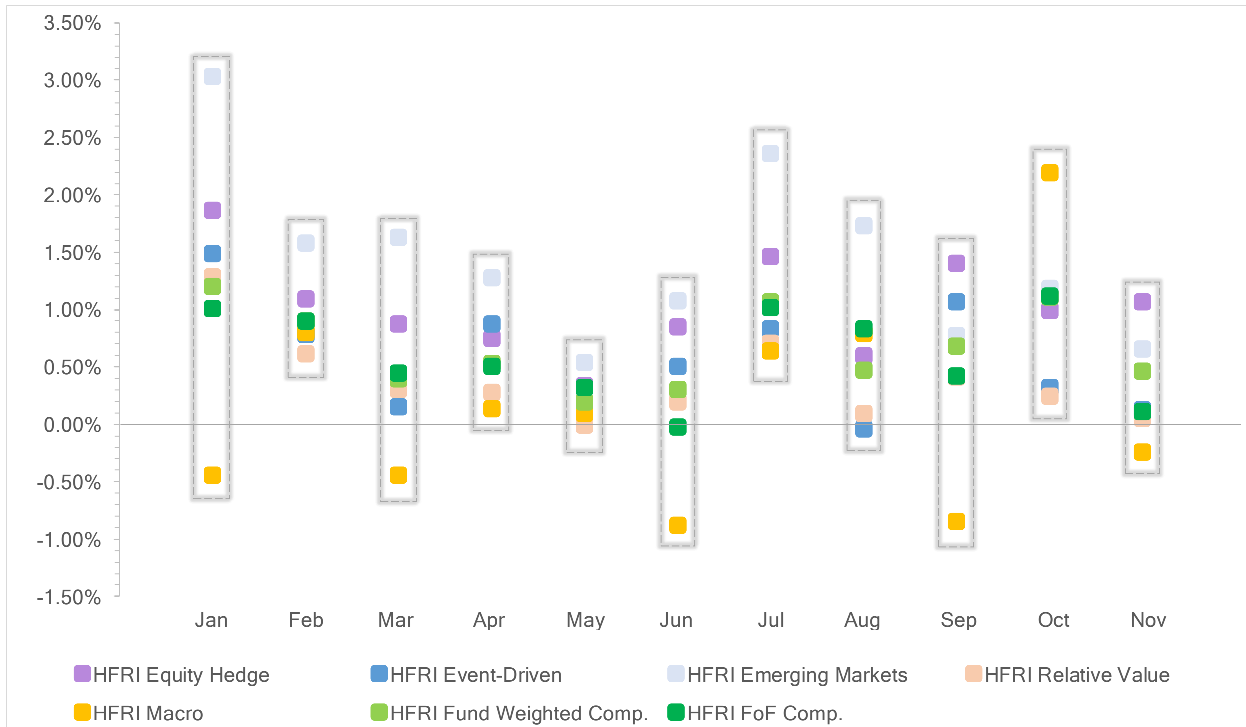
HFRI Macro 1.60%	HFRI Relative Value 4.42%	HFRI Event-Driven 6.10%	HFRI FoF Comp. 6.98%	HFRI Fund Weighted Comp. 7.55%	HFRI Equity Hedge 12.06%	HFRI Emerging Markets 17.55%

Source: Ayaltis Proprietary Database

Additionally, it is interesting to notice that emerging markets has been the most constant strategy for the first 8 months of the year, always topping the other strategies in each month from January to August, while losing some momentum in the latest months. Global Macro has been the most

volatile strategy in the second part of the year, being the least performing strategy in September and November but the best in October. Equity Hedge has almost always stayed in the top quartile, while Relative Value, although experiencing no negative months, struggled a bit due to the bull equity market driving valuations through the roof.

Chart 4: Hedge Fund Strategies - Performance Dispersion 2017



Siemens' IPO Latest Example of an Attractive Trading Space for Event Driven Managers

Siemens recently announced the plan to list its medical solution division, valued at €40 billion, in Frankfurt. This listing, which should take place in the first half of 2018, would represent the biggest IPO in the Deutsche Börse for many years.

This corporate event will be the latest of a long series, which represented a fruitful opportunity set for Event Driven managers, with the average hedge fund being up 6.10% so far in 2017. Moreover, several studies predict M&A and IPO activity to further gain momentum in 2018. Baker & McKenzie forecast the former to reach $3.2 trillion, surging 23% from 2017, while the latter should top $290 billion, up nearly 55% from the previous year. Pharma & Healthcare and Tech & Telecom are predicted to be the key drivers of this growth.

Read on at

https://www.ft.com/content/57ffd408-d521-11e7-a303-9060cb1e5f44

http://www.bakermckenzie.com/-/media/files/insight/publications/gtf/global_transactions_forecast_2018.pdf?la=en

https://www.financierworldwide.com/fw-news/2017/11/23/global-deal-activity-set-to-increase-in-2018

Veolia Issues First BBB-Rated Negative Yielding Bond

Veolia, the France-headquartered global leader in optimized resource management (dealing with water, waste and energy management solutions) has recently issued a €500 million three-year bond, bearing a negative yield of -0.026%. This has marked the first time a BBB-rated bond was sold at a negative yield at issuance. Nonetheless, the demand for this bond was so high that it resulted in an oversubscription ratio of 4:1. 75% of the investors who were wishing to lose money on a YTM basis were left empty-handed. This represents another milestone in the craziness we are witnessing in the markets today.

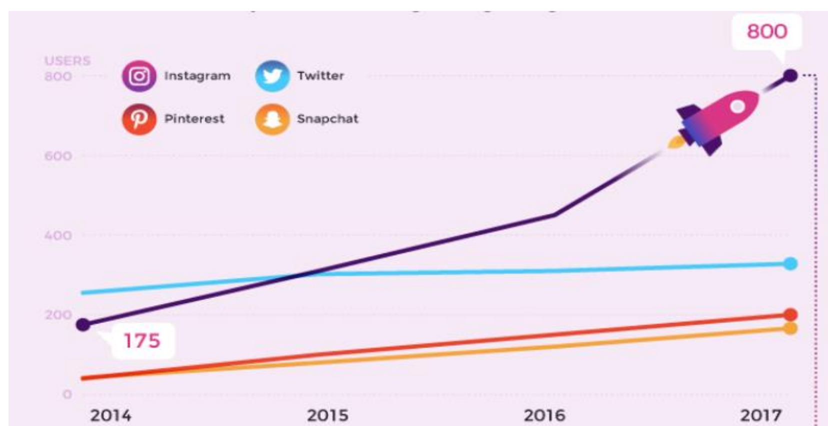
Read on at

http://markets.businessinsider.com/news/stocks/veolia-successfully-issues-a-3-year-bond-with-a-negative-yield-1008324867

Instagram Becoming Determinant in Shopping Habits

The influence of Instagram is massively growing: the social network now is considered as one of the most effective tool to reach audience. In fact, the number of its monthly users has skyrocketed in the past 36 months, surging more than 400%, much more than other giants such as Facebook, Twitter or Snapchat.

Chart 5: Growth in Social Network Monthly Users



Source: Visual Capitalist

According to surveys, Instagram is now the platform which influences shopping habits the most (51%, overtaking Facebook at 23%, with Twitter and Snapchat trailing with respectively 3% and 1%): as much as 72% of Instagram users report making purchase decisions on the basis of something they saw on the social network. Consequently, advertisement spending is exploding with the average sponsored post costing nearly $300.

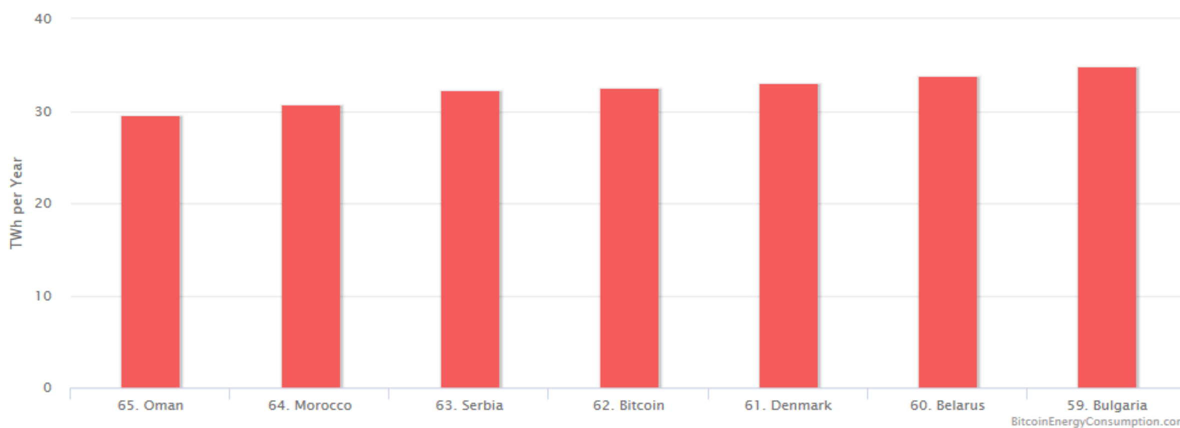
Read on at

http://www.visualcapitalist.com/influence-of-instagram/

A Glimpse Beyond Bitcoin: The Energy Issue

It makes no sense of quoting another record high of Bitcoin. It changes by the day. While the profits of Bitcoin investors remain risky, the profits of Bitcoin miners seem well locked in. “Mining” is the term related to issuing new Bitcoins as well as to verifying transactions. Apparently, the largest Bitcoin mine is situated in Inner Mongolia. There are different types of hardware systems used to mine Bitcoins. What you might not have known so far, mining Bitcoins is a highly energy-intensive process, requiring levels which make it worthwhile to be compared to some nations total usage.

Chart 6: Energy Consumption by Country



Read on at

https://digiconomist.net/bitcoin-energy-consumption

While all eyes are on Bitcoin, it is worth mentioning that overall cryptocurrencies enjoyed a great 2017. The number of initial coin offerings (=ICOs) has skyrocketed as well. The link to a short animation below illustrates this development:

http://www.visualcapitalist.com/video-ico-explosion-one-animated-timeline/

Digging Deeper:

Outlook for 2018 – Summary of Forecasts in a Nutshell

As the end of the year approaches, outlooks and forecasts pile up in front of us. Outlooks tend to be on the highly positive side and rarely touch on points of concern. While it seems to be consensus that inflation will pick up in 2018 (Hmm, we might have heard that before…), the pace of acceleration will have an impact on the markets. In general, most reports share a scenario predicting continued global growth, modest inflation and low interest rates.

Looking at the outlook for traditional asset classes, equities are the clear winner. Earnings momentum and macroeconomic data favour European and US stocks in the short-term. Opinions on emerging market stocks are more cautious based on the impact of rising US interest rates.

Bond markets are set for interesting times as 2018 will show us what it means if the Fed scales back its bond holdings. Numerous researchers see inflation numbers below central target and therefore forecast an even flatter yield curve.

Views on credit differ and analysts converge to the standpoint that it might not be the best time for credit after all. The preference within the asset class is on the European side based on stronger fundamentals and continued ECB support.

From a regional perspective, Europe emerges as the top place to be - both on the equities and the bond side.

Read further interesting outlooks for 2018 at

http://www.schroders.com/en/insights/topic-landing-page/?categoryId=537

https://www.bloomberg.com/gadfly/articles/2017-12-04/98-750-067-000-000-reasons-to-be-scared-about-2018

https://www.blackrock.com/investing/insights/blackrock-investment-institute/outlook

https://www.credit-suisse.com/media/assets/microsite/docs/investment-outlook/investment-outlook-2018/cs-investment-outlook-2018-en.pdf

https://www.gsam.com/content/gsam/global/en/market-insights/market-strategy/outlook/2018/annual-investment-outlook-2018.html#question-6

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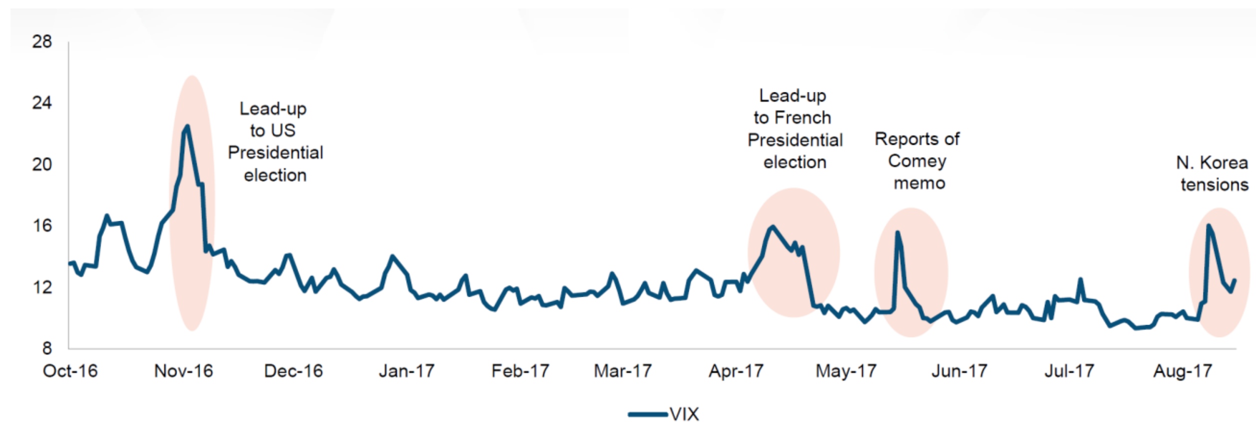
Chart 7: Recent Volatility Coincided with Political Events



Source: Bloomberg and GSAM

Despite these lines, we should keep in mind that market crashes are never well spotted in advance and you can see only in hindsight what triggered a reversal. Volatility has been low across equities and bonds and was mainly driven by political events, which are by nature hard to predict. Reasons for concern are part of the game. Which of them will emerge to a serious dark cloud for financial markets remains to be seen.

From an Ayaltis point of view, we expect more volatile and exciting financial markets in 2018.

We are looking forward to your feedback. Please feel free to share your ideas with us and continue the dialogue.

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