

Fixed income arbitrage, Global macro, and Equity market neutral, top strategies 2012

MondoAlternative survey on the best HF investment approaches.
Negative outlook on Short sellers and L/S Equity Europe small cap

by Research Department

HEDGE FUND STRATEGIES IN 2011	
	YTD*
Hfri Fund Weighted Composite Index	-4.45%
Hfri Equity Hedge (Total) Index	-7.15%
Hfri Eh: Equity Market Neutral Index	-2.47%
Hfri Eh: Short Bias Index	-0.02%
Hfri Event-Driven (Total) Index	-2.45%
Hfri Macro (Total) Index	-3.65%
Hfri Macro: Systematic Diversified Index	-3.78%
Hfri Relative Value (Total) Index	0.38%
Hfri Rv: Fixed Income-Asset Backed	6.15%
Hfri Rv: Fixed Income Convertible Arbitrage Index	-4.88%
Hfri Rv: Fixed Income-Corporate Index	0.20%
Hfri Rv: Multi-Strategy Index	-0.90%
Hfri Rv: Yield Alternatives Index	3.21%
Hfri Fund Of Funds Composite Index	-4.90%
Hfri Emerging Markets (Total) Index	-11.07%

Source: Hedge Fund Research, Inc.
* Data updated to November 2011.

Fixed income arbitrage, Global macro, and Equity market neutral, are the three promising winning strategies for 2012. Short seller, Long/short equity Europe small cap and Emerging markets equity should instead be reduced in the portfolios. The annual MondoAlternative survey on the outlook for any single investment approach gives an idea of what insiders expect from the upcoming year, research based on the answers by 30 international companies managing funds of HFs or funds of alternative UCITS funds. **Fixed income arbitrage** is the preferred strategy for 2012 according to managers surveyed, and it reached 64% of the preferences and is almost 67% of the asset allocations. "We have been overweight on this strategy for the last two years and remain bullish for 2012 and beyond. Fixed income arbitrage", **Ernesto Prado**, CIO Ayaltis Zurich points out, "is nothing more than the relative value subset of the Macro strategies benefiting from the volatility and dislocations generated at each volley of the sovereign deleveraging ping pong game. This game will last for a few more years as sovereign balance sheets are brought back to health or not. The main risk to watch will be surprise risk-premia widening events which will again, as in the past, blow apart generic implementations of the strategy". **Eric Debonnet**, Head of Theam Hedge Fund Solutions (BNPP IP) says that they have been overweighting this strategy since 2009: "As a matter of fact, these managers are specialized in government debt products, which are leading all other markets these days. So they are at the centre of the markets, especially in Europe, and have the expertise to understand and benefit from the much dispersion in yield curves, spreads between bonds, futures and swaps, inflation-linked products. These opportunities", he adds, "will most probably persist, if not even grow in the coming years. We favour as well experts in emerging market debt products, as they have experience in debt restructuring,

Argentina for instance, and they are very comfortable with situations like Greece". And **Roberto Giuffrida**, Co Head Global Business Development at Permal too is positive on the strategy, which "has been a good space lately, with these markets creating significant mis-pricings and therefore opportunities. We expect", the manager adds, "to see more of the same, if not more, particularly in distressed, in the coming year. You are starting to see certain asset classes where the risk has been removed: an example is Brazilian and Turkish paper which to mid December is off around 35-45% over the last 120 days". A little bit more tepid the **Credit Suisse Alternative Investment Research team**, which gives a "hold" rating. Second in ranking of the survey is **Global macro**. "In the process of adjusting to a bleak outlook for the global economy and an unstable euro zone, hedge funds seem better prepared for a crisis now than they were in 2008", Credit Suisse analysts say, therefore "diversification benefits offered by adding Macro funds to investor portfolios can bring down volatility and enhance returns considerably. Hence, we maintain our 'Top Pick' preference for this strategy". It is quite evident that investors believe in the ability of managers to spot the best opportunities and consequently 62.1% of the sample gave a positive outlook of the strategy and as much as 90% has already Global macro in the portfolio. "There are gigantic macro trends at play today and for the next three years", Prado explains, "Key macro trends today are represented by the ping pong ball bouncing between the racket held by the invisible hand of the markets and the visible hands of politicians and central bankers. The invisible hand volleys to say fundamentals are bad, while the visible hands in turn showers money to affect market pricing positively to make believe fundamentals are good". According to Prado systematic models have a very hard time understanding this illogic logic, therefore he favours "discretionary managers, experts

in understanding this smoke and mirrors game, Macro managers with sovereign balance sheet trading expertise". Giuffrida echoes him: "Discretionary macro strategies in particular look attractive, as managers seek to benefit from global imbalances, as well as political and macroeconomic uncertainties that are very difficult to quantify and model. We believe there will be plenty of investment opportunities across regions and asset classes, in interest rates, currencies, commodities, credit and equities".

And Giuffrida pours out what he believes the main macro themes in the coming months will be: in the US, the contrast between a cyclical recovery and the structural backdrop of continuing deleveraging, severe policy constraints, and the upcoming Presidential elections; in Europe, the continuing descent into recession against the structural backdrop of a potential breakup of the common currency; in China, a tight balancing act between policies aimed at a soft landing and the gathering clouds both domestically and internationally. "It will most certainly be an interesting year", he adds, "And it will pay to be nimble, flexible and tactical in one's approach".

According to the survey **Equity market neutral** is the third preferred strategy. Debonnet is positive about that, but he makes a differentiation between two types of funds: the first is about "Discretionary managers, which have low net exposure to equities. We call them "low beta" Equity L/s, as their net exposure is limited to plus or minus 20%. But performance expectations and volatility can considerably vary if they invest intra sectors or inter sectors. The dispersion amongst sectors has been very high again in 2011, so managers playing inter sectors could have nice opportunities again next year, but this approach necessitates macro expertise, in addition to micro ones, like stock picking".

The second kind is about systematic and quantitative managers, like statistical arbitrage: "They have a strict long/ short approach and do mostly pair or basket trading within the same sector. Performances have been mixed in this category, risk management and stop loss rules are a key factor. Nevertheless, those funds would benefit if the current regime of high volatility persists". The fast change of direction is of course at the centre of the debate: "Next year should be erratically volatile for all risk assets, particularly equities", the CIO at Ayaltis Zurich says, "Pure

fundamental pricing rationale will be challenged, we therefore do not believe strategies reliant on equities justify an overweight for 2012. Market neutral equities may nevertheless help preserve assets. If preservation of capital were the only focus, we would favour market neutral strategies with strong turnover which are not only based on fundamental company but on quick trading to follow risk-aversion flows". On the opposite front the Credit Suisse analysts, which "currently advise against investing in the strategy as the current environment is an unfavourable setting to deliver uncorrelated, market neutral returns". And Giuffrida too is not that confident in this investment approach: "Equity market neutral strategy, just like its directional cousin Long/short equity, assumes normally functioning markets, where fundamentals prevail and correlations are not particularly elevated. In our view, this is not the world we live in today. While it may certainly change next year, so far we see a continued and pronounced tendency for stocks to rise and fall together, almost indiscriminately, in what is come to be known as the "risk-on/risk-off" trades. As long as this is the case, we favour Global macro above all else for 2012". After the top three, the **Event driven** strategy got 57.7% of the answers, the fourth place in terms of outlook and the first along Macro about the presence in the portfolios, where it can be found in even nine out of ten allocations (90%). Event driven is a wide category which regroups many different funds and strategies, Debonnet observes, "like M&A, special situations, distressed debt. We are concerned with the market liquidity in credit products generally, which exclude a large part of the managers. The lack of cheap or available financing from banks is as well a drawback for this strategy. Nevertheless, some companies with strong balance sheets or cash rich firms will profit from low historical valuations to acquire other companies. It should be a nice environment for Risk arbitrage, or M&A specialists".

The Co Head Global Business Development at Permal is upbeat as well: "We have seen some good performances from our Event driven managers in 2011 and expect to see more of the same in 2012. Within this allocation, our managers are finding quality companies, both in Europe and the US, with cash on their balance sheets, who are looking to expand and develop their businesses through M&A

activities; just look at the US for example and the cash on balance sheets of US non-financial companies is standing at record levels. Corporate management is under pressure to look for new ways to deliver shareholder value, which could also be stock buybacks, special dividends and spin-offs".

M&A is unlikely to be isolated to purely strategic deals as significant amounts of capital remain uncalled for in private equity firms, with an estimated USD 450 billion to be invested through 2012. Despite the macroeconomic volatility, Giuffrida points out, in November there have been numerous M&A announcements, with four deals greater than USD 1 billion in North America alone. "Corporate events are going to be plentiful as companies sanitize balance sheets with free government money or expand market share through M&A in a world with no growth forecasts", Prado remarks, "Unfortunately, we expect sovereign events to partially negate the returns of corporate event trades in hedge fund portfolios through erratic volatility. Only managers who can immunize trade structures against this exogenous sovereign volatility will reap the full benefits of events sought, just as in 2011. It is harder done than said".

On the negative side, **Short seller** has the worst outlook, 40% of the answers, and that strategy is indeed chosen by only 13.3% of the funds.

Long/short equity Europe small cap has also been given a negative outlook by 37.5% of the sample, which actually has shown to get an exposure to the European larger company. These are in the 80% of the funds allocations, and the outlook in this case is steady in 60.7% of the cases.

Also **Emerging markets equity** fell in disgrace, with 28.6% negative on the matter. "Emerging economies across the board witnessed a bounce back", the Suisse analysts remark, "but impending concerns of a slowdown in growth and redemption pressures from global investors continue to pose challenges".

It is worth noticing also the mixed outlook of the **Managed future** investment approach that despite its wide use (80% of the funds) do not gather huge attention, but just a 40.7% positive and another 48.1% neutral on the strategy.

"The year 2011 witnessed extreme volatility and directionless markets, a scenario that is not particularly conducive to most managed futures strategies", the Credit

THE MAIN STRATEGIES PREFERRED BY FOHFs AND FUND OF ALTERNATIVE UCITS FUNDS MANAGERS

	Currently in portfolio		Outlook for the first half of 2012*		
	Yes	No	+	-	=
L/s equity Us large cap	60.0%	40.0%	40.0%	16.0%	44.0%
L/s equity Europe large cap	80.0%	20.0%	17.9%	21.4%	60.7%
L/s equity Japan large cap	36.7%	63.3%	20.0%	24.0%	56.0%
L/s equity Us small cap	30.0%	70.0%	21.7%	17.4%	60.9%
L/s equity Europe small cap	53.3%	46.7%	16.7%	37.5%	45.8%
L/s equity Japan small cap	10.0%	90.0%	14.3%	19.0%	66.7%
L/s technology	30.0%	70.0%	41.7%	8.3%	50.0%
L/s healthcare e biotech	33.3%	66.7%	43.5%	21.7%	34.8%
Emerging markets equity	66.7%	33.3%	28.6%	28.6%	42.9%
Emerging markets debt	43.3%	56.7%	34.8%	13.0%	52.2%
Equity market neutral	80.0%	20.0%	61.5%	3.8%	34.6%
Short seller	13.3%	86.7%	5.0%	40.0%	55.0%
Event driven	90.0%	10.0%	57.7%	11.5%	30.8%
Distressed securities	43.3%	56.7%	32.0%	32.0%	36.0%
Merger arbitrage	73.3%	26.7%	52.2%	8.7%	39.1%
Convertible arbitrage	63.3%	36.7%	41.7%	8.3%	50.0%
Multi strategy relative value	53.3%	46.7%	29.2%	16.7%	54.2%
Volatility arbitrage	30.0%	70.0%	40.9%	18.2%	40.9%
Fixed income arbitrage	66.7%	33.3%	64.0%	4.0%	32.0%
Mortgage-backed securities	26.7%	73.3%	30.4%	17.4%	52.2%
Credit long/short	75.9%	24.1%	57.7%	3.8%	38.5%
Statistical arbitrage	53.3%	46.7%	37.5%	8.3%	54.2%
Macro	90.0%	10.0%	62.1%	0.0%	37.9%
Activist	23.3%	76.7%	15.0%	25.0%	60.0%
Managed futures	80.0%	20.0%	40.7%	11.1%	48.1%

* + overweight - underweight = hold.

Percentages calculated on answers given by 30 asset management companies.

Source: MondoAlternative.

Suisse analysts explain, "As markets switched directions frequently on the back of sensitive geo-political news, fund models tried to cope by continually aligning themselves to the oscillating trends. Amidst this, beside Global macro and dedicated short, Managed futures is the only strategy capable of generating negatively correlated returns in times of market stress. Nevertheless", the analysts add, "until a solution in the European and US debt debacle is apparent, markets are unlikely to enter a defined trend. We retain our hold rating for funds within this strategy".

"Managed futures funds are mostly mid to long term trend followers", the Head of Theam Hedge Fund Solutions underlines, "They benefited mostly in 2011 from the strong established trend in short and long term rates in US and Germany, which are the most liquid futures in this asset class. This trend of lower rates may

not persist forever and most Managed futures funds are at risk of a reversal. Unless you are convinced that bull or bear long term trends will establish in the main asset classes next year, you should not invest in traditional managed futures funds. We would favour short term trend followers and managers focusing on detecting breakouts, reversals in trends, above long term trend followers, and we think that current allocation are based on past performance, which does not always make sense, especially in the case of trend followers".

"Managed futures performed fantastically in 2008 while been very liquid", Prado underlines, "As risk aversion dominates the investment landscape, investors favour this risk adverse strategy. Unfortunately, this strategy does not deliver performance during erratic volatility periods such as 2011. It generates only trading friction noise, it only delivers when there are really

long downward or upward trends". On the same page Giuffrida, who is not so keen on Managed futures: "Trends this year have been hugely unpredictable and reversals have caught many managers out, both the trend followers and non trend followers. This is why we currently put more emphasis on discretionary Macro managers. That being said, if next year sees a breakout of clear and consistent trends, we will be ready to put more money into systematic managers. We have made such re-allocations in the past, and were quite successful at it. We continue to monitor market developments for similar opportunities going forward".

Eventually the most ambiguous outlook is the one regarding **Distressed securities** (not available in UCITS format) present in the 43.3% of the portfolios, with an outlook 32% positive, 32% negative and 36% hold. A final thought by investors is about how the European sovereign debt crisis will affect their asset allocation in 2012. "We think the European crisis could impact all other regions", Debonnet predicts, "and that a geographical focus outside Europe is not the right answer. In the same vein, one should not rely too much on the Emerging markets decoupling theme. Generally, we will favour mid-sized managers who are reactive and nimble. As well, we think that a good understanding of the macroeconomic context and particularly of this European crisis is necessary for all managers, whatever their expertise. In other words, we think pure "micro" investors could struggle, as most fundamental stock or credit pickers focus too much on companies valuations without taking into account the macro factors. Finally, experts in rates and FX should have the upper hand in 2012 as it has been the case over the last 2 to 3 years". "What happens in Europe will have a huge impact on markets around the world and is one reason why the world is watching events unfold so closely", Giuffrida comments, "The European pages of the international newspapers are the ones most closely studied. From our perspective, let me give you three scenarios of how we could look to invest. In the first, Europe has a recession, the US muddles through, and China and emerging markets have a soft landing, then we see credit as a good opportunity. In the second Europe suffers a severe depression, which we believe will drag down the rest of the world into recession, and then we are likely to see plenty of distressed opportunities for us to target. And the third is more optimistic,

whereby the policy decisions turn out to be correct and risk assets rally, then our portfolios will be looking to invest in Event driven, with some sort of equity bias and catalyst orientated. But it all hinges on Europe". Three solutions for a European sovereign debt crisis, approached in a slightly different way by Prado, who concludes pointing out that there are no effects on his allocation: "We continue to take advantage of relative value trades

with managers who know how to insulate against sovereign risk overhang. In addition we continue to be constructive on binary tail events hinged on Merkel's or the Greek population's choice: if she bails out and the Greeks do not opt out of the Euro, then we rally. If she does not bail out or the Greeks opt out of the Euro, then we continue down, faster. Since no one has a crystal ball, we are positioned to benefit binary from both outcomes since 2011".

Strategy Focus

MACRO OPPORTUNITIES IN FOREIGN EXCHANGE MARKETS

We are in a very tough but interesting environment from a macroeconomic point of view and I think the best opportunities for the next months will be in the foreign exchanges. The Emerging Economies are going to reduce the interest rates and this will be supportive for the USD in the medium term.

The Euro's problems are far to be resolved and that is a further positive reason to diversify the currency allocation outside the Euro area. Other interesting trades are in the Emerging currencies and in particular in East Europe where the economic and financial situation is challenging and will suffer further due to the deleveraging of the European banking system. We like the Australian Dollar and NOK since that currencies are now more linked to the safe haven status than to the commodities trend.

The foreign exchange markets will mirror the "big shift" that is shaping the global economy and are the best "trend followers" of this extensive changes, so we will continue to allocate to these strategies an important percentage of our portfolio allocation with a long term view. The equity markets will suffer from fiscal policies aimed at supporting the government bonds and this will cap any ability to sustain important rallies for the equity markets, so we have a negative bias for the equity investments for the 2012, even if tactical rebounds are possible.

Credit and Government bonds will remain in the market's sight and further pressures in the Euro area will be still an important driver for the coming year. I think it will be difficult to assist to an Euro Area break up but the current situation in the Euro Government Bonds will persist and the current spreads between the different countries will remain at current wide levels.

Nevertheless the short term maturities of Italian and Spanish government bonds offer opportunities since, in short term, further fiscal steps will be implemented to defend the solvency of these countries. We have an important exposure to gold and I think the recent weakness is only a short term issue since the FED's monetary policy is open to further easing if the economic growth worsen and the global credit risk in the financial system will remain high for a long time.

Maurizio Novelli, CIO at Zest AM

FOCUS ON CHINA, INDIA, INDONESIA, MALAYSIA, TURKEY AND NIGERIA

Emerging market economies are neither independent nor large enough to stand alone and decouple from their ailing western counterparts. Exports make up almost 50% of GDP in Korea, just over a third of GDP in China, and around 20% of GDP in India. China, for instance, escaped recession during the financial crisis because the government increased fixed asset investment from a lofty 42% of GDP in 2008, to an extreme 60% in 2010. These numbers are staggering. In the US, the same ratio peaked at about 20% in the 1900s and immediately after the Second World War, and in Japan it peaked at just over 30% in the 1960-70s. A country that spends half its GDP on fixed assets will eventually hit a productivity wall, as excess industrial capacity generates non-performing loans in the banking sector. There is a serious risk that this process may have just started in China.

On the positive side, unlike debt constrained western economies, China has the ammunition to stimulate again and again. Even after accounting for broader debt obligations, debt/GDP is under 70%, the budget deficit is 2.5% of GDP and the country has foreign-exchange reserves of more than USD 3 trillion. However, Chinese officials know that slow growth is a more containable problem than inflation, and we therefore expect, in the short term, that the government will sacrifice growth in order to control inflation. Looking across different emerging markets regions, on a long-term structural basis we like India, Indonesia, Malaysia, Turkey and Nigeria because they currently enjoy the virtuous combination of positive demographic dynamics, high savings rates and low debt levels. We have more mixed views over the long term on China, Brazil and Russia, and these are the countries where we are just as active on the short side as we are on the long side. Short term however, we are wary of the heavy reliance for foreign capital flows in both Turkey and India, so our positioning is short bias at the moment, and we have very little exposure to either Indonesia, Malaysia and Nigeria, because these are less liquid markets which are likely to suffer most in a redemption-driven risk off scenario.

Currently our highest conviction long idea is telecoms, not so much because they are cheap and pay out high dividends but mainly because fresh signs of pricing power are beginning to emerge both within the fixed and mobile sub-segments. We also expect to see more oppor-

tunities in the equipment space as telecom operators will have to spend more in infrastructure. Our highest conviction short idea is in base metals producers, as QE2 has sparked a rally in the materials sectors. In terms of commodities, we are only bullish on food and water which are essential, non-discretionary purchases for which they are no substitutes. Summing up, it is obvious the world economy is far from being healthy and calls for austerity are a burden on growth.

However, at current valuations, stocks are already discounting a huge amount of growth. We believe that, as long as policy makers use the current low bond yields to either print more money or to inject further fiscal stimulus into the economy, there is huge potential in equities in general and emerging markets in particular.

Kristof Bulkai, co-manager of the Thames River GEM Absolute Return Fund

BACK TO STOCK FUNDAMENTALS

Seldom has writing a piece on the outlook for European equities seemed more dangerous. Currently the apparent epicentre for global risk, investors are concerned about all manner of issues neatly summarised as a 'Eurozone sovereign debt crisis'. The truth of the matter is that the problem is more complex than this, but when broken into its component parts perhaps a bit easier to understand. At the core is an unresolved banking crisis from 2008. The failure to properly recapitalise banks and reduce the leverage on their balance sheets is now causing a chronic lack of confidence in government finances. Put simply, if banks need to be saved again, can governments save them? And who will save the governments? A solution to Greece is long overdue. It is clear to us the country cannot meet its debts and a form of loss sharing needs to be found. This will be a combination of private and public sector funds. But once Greece defaults, it is done. A line will be drawn, preferably representing a deterrent to other countries of the dangers of delaying fiscal reform and providing a template for assisting other Eurozone member countries should they need it. At this point we can get back to doing what we think adds most value: Analysing stocks instead of analysing politicians. European equity markets have a clear distinction just now between financial companies and non-financials. We believe the issues facing the financial sector make it too risky to make equity investments in this area. Fortunately we don't have to and our attention turns to the rest of the market where we see many attractive opportunities. If valuation was all that mattered these equities would have stopped falling by now. On a realistic view of the profit outlook for 2012 and beyond we are more than happy to be buyers. On a short term basis the call is almost impossible. They might fall further. But while we are currently being provided with repeated chances to buy cheaply, this will not persist forever. Very few people committed to the market at the lows in March 2009, perhaps expecting an even lower price later. Investors have to make a choice between buying when fear is high or accepting meagre returns from cash and government bonds for many years as the 'reward' for 'security'. A difficult choice but lucrative for those who get it right. In the event of a recession what will happen? Well, we have had them before and the world didn't end. All recessions have winners and losers and in the short book we have the chance to capitalise on this. Companies with too much debt, pressure on operating models and high valuations are all good candidates. This is part of how we try to protect capital in weak markets. Fear and negativity is in the ascendancy to the point where good news is being ignored. Interest rates are low and staying that way. Corporates are healthy and valuations much cheaper than before the last downturn. Finally, investors are nervous, not complacent, a sign that much bad news is already in the price.

What area of the market interests you on the long side?

It is now clear that austerity and deleveraging in the Western world will act as a drag on global GDP growth for a number of years. We are also entering 2012 with most analysts now predicting a contraction in European GDP. For that reason we are avoiding those companies that are heavily geared into economic activity. Instead we are focusing on those cash generative companies that are returning capital to shareholders, either through dividends or share buybacks. Our long book is currently yielding 4.0% and on consensus numbers this will rise to 4.6% in one year. We think names such as Royal Dutch Shell look attractive. The company trades on an attractive valuation (8x P/E) and yields 4.7% which is 4x covered by the companies cash flow. However, indiscriminate buying of high yielding stocks is not a good idea. There are a number of companies in the financial sector for example that are yielding in excess of 8% where dividends will have to be reduced (one of many reasons to avoid the financial sector). Telefonica also announced a cut to its dividend last week to achieve 'greater financial flexibility', so it is prudent to understand a company's commitment to its dividend and the level of dividend cover before investment. We also hold a number of companies that are actively buying back their own shares. We didn't set out to achieve this but the qualities we are looking for in a company (undervalued, strong cash flow and solid balance sheets) has resulted in a number of them buying back their own shares. This is interesting because it is a clear expression by management that they are strong enough and that their share prices are cheap enough to want to buyback shares. These purchases are very different from those made by companies in 2007. That is when they were being urged to gear up their balance sheets and buy stocks which were expensive, with debt! What is happening at the moment is that companies which are flush with cash, which have got strong balance sheets, are buying back cheap shares with cash, completely different dynamic. I think by holding companies like that; you will do very well over the next couple of years.

What could make you go more short?

Although we are heading for (if not already in) a recession in Europe this is now in the majority of share prices and we are finding it difficult to find more short positions. In my opinion things would have to deteriorate substantially (E.g European GDP growth <-1%) for me to find a number of new short positions - we keep looking.

What could make you go more long?

The fear of a banking collapse has been the main influence on equity markets in 2011. For the market to make gains again we need some clarity and stability from the financial system. I think we will get this in 2012 when European governments follow the lead of Ireland, the UK and Denmark where the banking system is being owned by government. That is bad news for bank investors, but good for providing the stability needed for the rest of the market to make gains.

Paul Casson, fund manager of the Henderson Horizon Pan European Alpha Fund

ATTRACTIVE VALUATIONS ON CORPORATE BONDS

We believe the credit asset class currently offers attractive valuations on an outright and relative value basis. With yields on many corporate bonds currently implying high default rates we see good value, especially for investors ready to do their homework. We think detailed fundamental analysis is a key discipline in positioning to benefit from this rich opportunity set, especially in more niche and/or complicated parts of the asset class. This current market environment particularly lends itself to relative value investing given the ability to take short as well as long positions, and to benefit from volatility.

Credit spreads are proving enormously volatile. By way of example, we would highlight the sharp widening of the Markit iTraxx Europe Crossover index in recent months. This index of primarily sub-investment grade European credits, widened out from around 350bps in May 2011 to recently trade above 700bps. Close to its all-time wide, the level of this index implies a default rate well above 30% for the constituents over the next 5 years (assuming a 15% recovery rate). Although not impossible, we view such a scenario as highly unlikely, implying significant opportunity in selected high yield securities. Several factors have combined to create this more volatile credit market environment, including regulatory factors which we discuss further below.

Of note is reduced dealer appetite to provide liquidity, the continuing growth in the overall size of corporate bond markets and also the concentration of assets in less sophisticated and highly liquid UCITS retail products. Market growth has clearly added to issuer diversity but the combination of these factors is, we think, proving additive to volatility given the potential for sudden and disruptive shifts in capital flows. Regulation has clearly also become a major driver of credit market developments.

The combined effects of Basel III, Solvency II and the various moves to restrict bank proprietary trading (primarily the Volcker Rule) have been significant. Banks and Insurance companies are already positioning themselves in anticipation of higher risk weighted capital requirements and reducing exposure to what are perceived to be higher risk, less liquid and longer duration positions. We do not subscribe to the view that this is creating disruptive selling by financial entities, but we do believe it has both removed an important buyer from the market, leading to re-pricing of some assets, and has separately exacerbated volatility as trading desks withdraw liquidity. Another market-based source of credit financing has historically been the CLO (Collateralised Loan Obligation) market. Rule 122a (soon to be known as Article 394) of the Capital Requirements Directive III has effectively closed the market for European CLO issuance and is an additional example of regulation cutting off a source of market finance.

Volatile markets create opportunity and we see plenty for 2012. Investors with stable pools of capital are well placed to ride out these ongoing market moves and relative value credit market participants are particularly well positioned to benefit given their ability to take short positions and to use derivatives to actively benefit from volatility. Areas of particular current opportunity include shorter maturity high yield single B and double B names, the bonds of certain utilities in peripheral markets, US RMBS and European CMBS. Overall valuations in convertibles are also attractive and, selectively, highly compelling. Focusing on risk and liquidity management and the sizing of positions remains key. Beyond this, fundamental analysis and document review must remain at the heart of the investment process. Investors who get this right should in time be well rewarded.

Peter Warren, portfolio manager of the CQS Diversified Fund

M&A TRANSACTIONS IN HEALTHCARE, ENERGY, TECHNOLOGY AND CONSUMER GOODS

Event-driven strategies, which aim to gain from events that affect major listed companies, had a difficult year, reporting average losses of 5%, according to HFR. In fact, you needed to be responsive in order to survive the crisis unscathed, as there were so many unwelcome surprises, particularly in the hostile takeover field - like Conagra's failed takeover of Ralcorp - or from cyclicals. However, the high level of market volatility did not prevent the announcement of friendly transactions at very attractive premiums, like HP's takeover of Autonomy, or Google's takeover of Motorola Mobility. These events reminded us that major groups are always ready to launch structural transactions when they identify genuine opportunities. In 2012, mergers & acquisitions, the key driver of event-driven strategies, are therefore likely to be dominated by strategic buyers, who are willing to put their liquidity to good use in a market where valuations are attractive.

It is also interesting to note that some sellers, who are now looking to reconcile the certainty of success with rapid execution, no longer hesitate to go down other routes to maximise the value of their assets, as is shown by the sharp rise in the number of spin-offs in the United States over the year, from 46 to 64. Among event-driven funds, this new trend could therefore favour those where their strategy allows them to invest in various types of transactions. Discrepancies between sectors are also expected to remain a feature in 2012 - with high transaction volumes expected particularly in the healthcare, energy, technology and consumer goods sectors - while the geographical location of the target company remains a key selection criterion, with real differences on both side of the Atlantic.

In the US, despite a slight slowdown in the last two quarters, due primarily to funding pressure, M&A levels are expected to remain relatively high in 2012. Major groups' cash reserves are now approaching USD1.5 trillion, which gives them a real competitive advantage over private equity funds, who now have to commit more equity to each transaction. In Europe, even though merger & acquisition levels saw the sharpest slowdown since 2008 in the second half, takeovers of European targets by foreign groups - which were up 58% in 2011 - are likely to continue to accelerate in 2012, due to the depreciation of the euro and weak share prices. This will be a good opportunity for motivated buyers to buy themselves new growth engines - as J&J did with Synthes - or to use their overseas cash intelligently, like Microsoft did with Skype. In order to take advantage of these various opportunities, it will therefore be essential to choose managers who are both cautious and nimble: cautious because, before the macro-economic environment improves, priority must be given to preserving capital; and nimble because the current volatility offers entry points and arbitrage spreads that are particularly attractive. Although 2008 was a difficult year, we should remember that event-driven indices ended the following year up around 18%, their best performance of the decade.

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