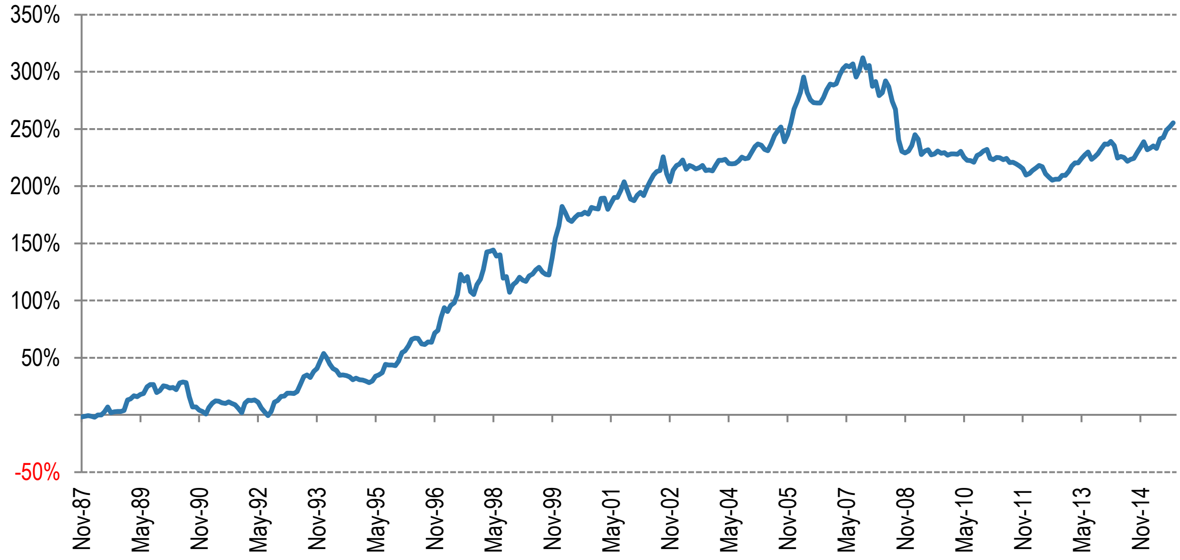
CHART OF THE MONTH

IS EUROPEAN EQUITY LONG/SHORT INVESTING BACK IN VOGUE?

Cumulative alpha versus MSCI Europe Index



Source: 1 Notz Stucki

IS EUROPEAN EQUITY LONG SHORT INVESTING BACK IN VOGUE?

With the worst quarter for equity markets since the middle of 2011 just behind us and a wipe-out of $10 trillion in global equity market cap making it the largest drop in history, are hedge funds back on the map?

Following the Global Financial Crisis (GFC) of 2008, equity markets have been in a bull market since March 2009, supported by multiple quantitative easing initiatives by the US, China, Japan and more recently Europe. This has favoured equity market “junk rallies” driven by flows into ETFs which have reached record levels and surpassed global hedge fund assets for the first time in history this summer, fuelling the debate over passive (index tracking) versus active investing. As a consequence, alpha generation was limited as correlations between equities rose sharply, causing a decline in the dispersion of returns. The net result has been that most long only active managers have underperformed their benchmark index.

With a history going back to 1949 in the US, equity long / short investing has been the most prevalent strategy amongst assets invested in the global hedge fund industry. In Europe however, the hedge fund industry has a much shorter history with the first European hedge fund dating back to 1989, launched by Tim Tacchi, followed by the likes of Crispin Odey, John Armitage and Talal Shakerchi. As a result, European long / short managers have taken a more conservative approach in terms of assets under management and risk control when building their businesses. Following the GFC, the significant shift in assets under management from L/S European strategies to systematic CTA strategies is a typical illustration of how investors are consensual in their approach, chasing past performance only to be disappointed (CTAs have been underperforming since 2008 with the exception of 2014). As a result of this shift many L/S European managers (and multimanager funds) have disappeared leaving a much smaller universe of talent to invest in.

So why invest in European long / short strategies now?

Europe has many tailwinds stock pickers can benefit from: equity valuations are reasonable, a weak Euro (beneficial to exporters), lower raw material prices (beneficial to manufacturers), low interest rates (beneficial for stock buybacks and M&A). Despite this, comments from politicians to central bankers that are not followed by concrete actions have had the power to sway markets in either direction and/or create violent sector rotations like never before. With intra-day market moves of 2-3% occurring more frequently and the sustainability of a prolonged bull market (that has over 6 years in the making) being put into question, one would be better positioned to generate consistent returns without having to stomach market volatility in European long / short strategies. In fact, European Long Short Fund indices have outperformed traditional benchmarks over the last 14 years; keep in mind that European markets have yet to recoup their August 2000 peak!