LMM
Investment Controlling

LMM COMPASS

Dear readers,

In search of better returns, alternative investments are increasingly raising investors' awareness in the current environment. Especially hedge funds are considered as stabilizers of the portfolio and thus represent an alternative to bonds. Can they fulfil this function? How does that change the portfolio risk? Which additional factors have to be considered? These issues are the subject of our professional article.

Gerhard Seger
Member of the Management Board

Jelmer van der Meulen
Member of the Management Board

THEMES

Market data
- Markets and strategies

Topic
- Are hedge funds a suitable bond substitute?

LMM Inside
- Outlook 2018

MARKETS AND STRATEGIES

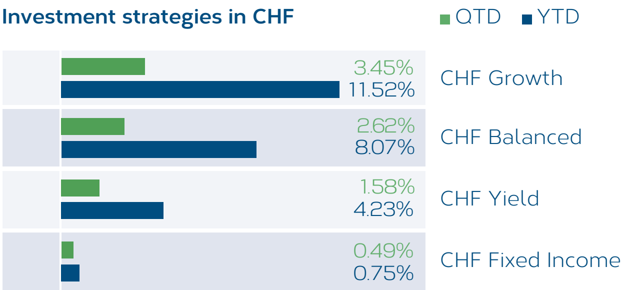
In the 4th of quarter 2017, all asset classes across the board went up and the investment year 2017 was finally successfully completed. Especially stocks continue to be supported by the low-interest rate environment and are considered by the investors as being without alternative. The stock price performance is historically unprecedented in terms of duration and the low price fluctuations. Due to positive economic figures and encouraging corporate results, investors are still confident.

		Value	% QTD	% YTD	Currency
Currencies	EUR/CHF	1.17	+2.30	+9.16	
	EUR/USD	1.20	+1.57	+13.85	
	USD/CHF	0.97	+0.72	-4.12	
	USD/JPY	112.65	+0.08	-3.42	
Bonds	Switzerland	136.41	+0.48	+0.13	CHF
	Europe	248.69	+0.55	+0.68	EUR
	USA	2046.37	+0.39	+3.54	USD
	EMMA	402.25	+0.90	+9.61	USD
	Inflation linked	343.68	+2.85	+8.67	USD
	High Yield	1309.84	+0.87	+10.43	USD
	World	484.73	+1.08	+7.39	USD
Equities	Switzerland	2696.42	+2.51	+17.47	CHF
	Europe	216.45	+0.63	+10.24	EUR
	North America	7012.17	+6.40	+21.19	USD
	Pacific	6504.67	+7.99	+24.64	USD
	EMMA	521.46	+7.44	+37.28	USD
	World	246.18	+5.73	+23.97	USD
Alternatives	Real Estate	4036.81	+3.83	+11.42	USD
	Commodities	88.17	+4.39	+0.75	USD
	Gold	1303.05	+1.79	+13.09	USD
	Private Equity	2626.63	+1.13	+25.37	USD
	Hedge Fonds	1275.6	+1.50	+5.99	USD

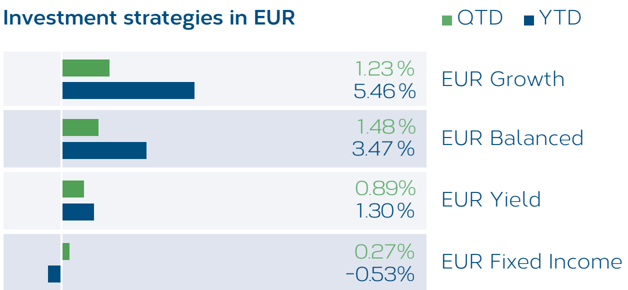
reference date 31.12.2017

2017 was a very good year for Swiss franc-based investors. The value of the Swiss franc declined vs. Euro and thus profits were generated on Euro investments. In addition, this effect supported Swiss stocks, since they generate a large part of their profits in the Eurozone. This currency effect was negative for European investors. The positive economic indicators allowed the Euro to appreciate against the US-Dollar by around 14 %. Nevertheless, the majority of the investors managed to end the year on a positive note, as the gains on the stocks compensated for the negative currency effects.

Investment strategies in CHF



Investment strategies in EUR



Calculation LMM; Period 01.01.–31.12.2017 (before costs)

Please note: Performance figures gross (Custody- and management fees not included)

ARE HEDGE FUNDS A SUITABLE BOND SUBSTITUTE?

Our analysis show growing hedge funds quotas in investment strategy portfolios. After hedge funds could not prove their "all-weather suitability" during the 2008 financial crisis they came under pressure and investors were losing their interest. However, recently we observe a renaissance. The record-low interest rates are forcing investors to consider alternatives to bonds. The question arises whether hedge funds are suitable for the job.

Reference index data does not show reality

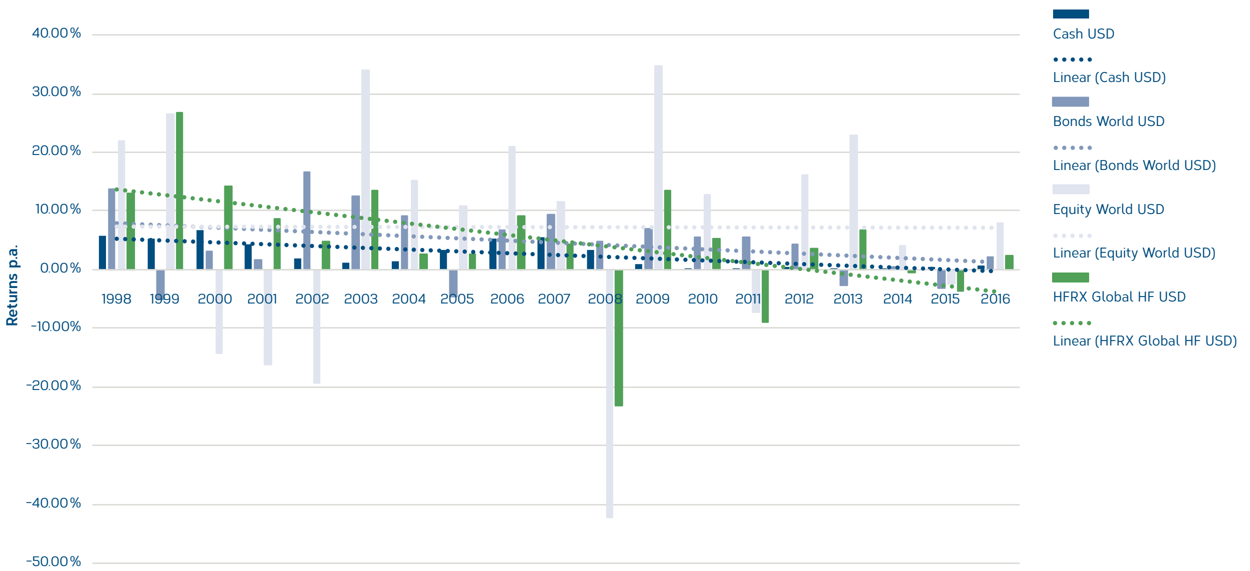
Performance data from hedge funds has to be analysed with caution, since they are not required to publish their data. Reference indexes are mostly fed by successful hedge funds. Closed funds fall out of the data series. The resulting index data shows significantly overvalued returns versus the effective returns of the whole hedge funds universe. This effect is called survivorship-bias.

Historical estimates suggest that hedge funds have been able to achieve returns that are well above an average of bond and stock market in the past. So despite the "bias-effects", they were quite attractive. However, recent studies show that hedge funds' returns were consistently lower between 2009 and 2016.

Our own analysis confirm these observations. Returns on a portfolio consisting of 45 % equities, 45 % bonds and 10 % cash have fallen from 7.36 % (in USD) between 1998 and 2007 to 4.25 % p.a. between 2007 and 2016 – mainly due to the deflationary environment and the low interest rate policy. By contrast, the average annual returns of hedge funds went back from an above average 9.96 % to a below average -0.08 % p.a. in the two comparative periods.

The lower performance of Hedge funds can only partially be explained by lower market returns, e.g. by the lack of interest on collaterals, in recent years.
The steady upswing in the financial market, stimulated by the national banks, has resulted in reduced market volatility and increased correlation between and within almost all investment categories. This environment was detrimental to most Hedge funds strategies.

Declining returns from fixed income, but especially from hedge funds



TOPIC

Diversification and optimization potential
According to our model calculations the return expectation will rise, if we gradually replace bonds by hedge funds in a model portfolio with 10% liquidity, 45% bonds and 45% shares.

However, the higher return is achieved at the expense of higher fluctuation risks. This increase in risk can be explained by the higher correlation of hedge funds with equities. This high correlation applies to the entire universe, not necessarily on individual hedge funds strategies.

Consequently, hedge funds as an investment category are not a suitable substitute for bonds from a pure risk perspective. An alternative option would be to introduce hedge funds at the expense of both bonds as well as equity. With an improved diversification, it is possible to optimize the return-risk relationship of the portfolio.

Despite these findings, when using hedge funds caution is advised. Not only a large number of providers and strategies but also their opacity and low regulations have to be considered in investment decisions. Knowledge about the hedge fund manager and his investment strategy are a premise. Not at least, the relatively high costs have to be questioned.

Author: Jelmer van der Meulen
Remark: We will be happy to send you our detailed study on demand.

LMM INSIDE

OUTLOOK 2018

The turn of the year is traditionally the time to reflect the past year and to look at the prospects for the coming year. In 2017, we were concentrating on two major internal projects, which we will present to our customers in 2018.

Within the scope of digitalisation of many processes, we have revised our standard-reporting technically and optically. Furthermore, our customers will have the possibility to have an online access to their assets.

Sustainable investments are meanwhile more than just a buzzword. Many charitable and ecclesiastical investors as well as pension funds take into account ESG-criterias in the investment process. We will be able to monitor their compliance efficiently with our Controlling and to display it comprehensively in our reports. More details on these topics will follow in the next issues.

Content:
LMM Investment Controlling Ltd. (Head office)
Zollstrasse 32 · P.O. Box 174 · LI-9490 Vaduz

www.lmm-ic.com

LMM Investment Controlling Ltd. is an independent provider of Investment Controlling services and represents the interests of private and institutional clients towards banks and asset managers. Apart from the head office in Vaduz, LMM has branches in Zurich, Dubai and Vienna.