Lupus alpha

Absolute return and alternative funds in Germany

Liquid alternatives in the first half of 2024: investors drawn to specialised fixed-income strategies

When it comes to UCITS-compliant hedge fund strategies, investors focused on specialised fixed-income strategies in the first half of 2024 and raised a net EUR 2.2 billion. Overall, withdrawals from this investment segment slowed significantly, with moderate net outflows of EUR -6.4 billion. With an average performance of 4.71%, regulated hedge funds remain well positioned between equities and bonds.

About the Study

Since 2008, Lupus alpha has been evaluating the universe of absolute return and liquid alternatives funds on the basis of data from LSEG Lipper. The Study covers UCITS-compliant funds with an active management approach that are authorised for distribution in Germany. The Study focuses on market size, development and composition, performance in the investment segment and individual strategies, as well as key risk figures. It evaluates the three levels of aggregation – the overall universe, strategies within the universe, and funds within the strategies – and distinguishes between 14 strategies. The Alt. Long/Short Equity strategy, for example, includes 92 funds.

SUMMARY

The recent increased withdrawal from absolute return and liquid alternatives funds has slowed noticeably. While net outflows reached EUR 35.1 billion in 2023 as a result of the turnaround in interest rates, they were only a moderate EUR 6.37 billion in the middle of the year, with outflows decreasing from one month to the next. Fixed-income strategies were the main focus of investors in the first half of the year, recording the largest net inflows (EUR 2.2 billion). Overall, volumes in the asset class decreased by 3.1% overall to EUR 224.4 billion.

With an average fund performance of 4.71%, liquid alternative strategies outperformed unregulated hedge funds (4.08%). Liquid alternatives also significantly outperformed European corporate bonds (0.44%) and European government bonds (-2.13%), which suffered due to unfulfilled expectations that central banks would make several rate cuts.

Across all strategies, the evaluated funds kept their risks well under control in the first half of the year, with an average maximum loss of 3.6%. The longer-term view also confirms that investors in this asset class will be spared excessively painful drawdowns if they carry out careful due diligence, with nearly three-quarters of all funds successfully limiting their maximum losses to less than 20% over five years.

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IN FOCUS: SPECIALISED FIXED-INCOME STRATEGIES CONVINCE INVESTORS

The two fixed-income strategies in this asset class recorded **the biggest positive net inflows**, with EUR 1.23 billion invested in **Absolute Return Bond** and EUR 0.98 billion in **Alternative Credit Focus (p.4)**. This trend in investor preferences was already evident in 2023, when fixed income strategies accounted for almost 40% of all gross inflows despite the fact that virtually none of the strategies in the evaluated investment segment were able to raise net funds. This reflects the **reallocation of investor funds towards interest-bearing investments** that has been observed since the turnaround in interest rates. Together, fixed-income strategies account for nearly 30% of assets under management in this asset class **(p. 6).**

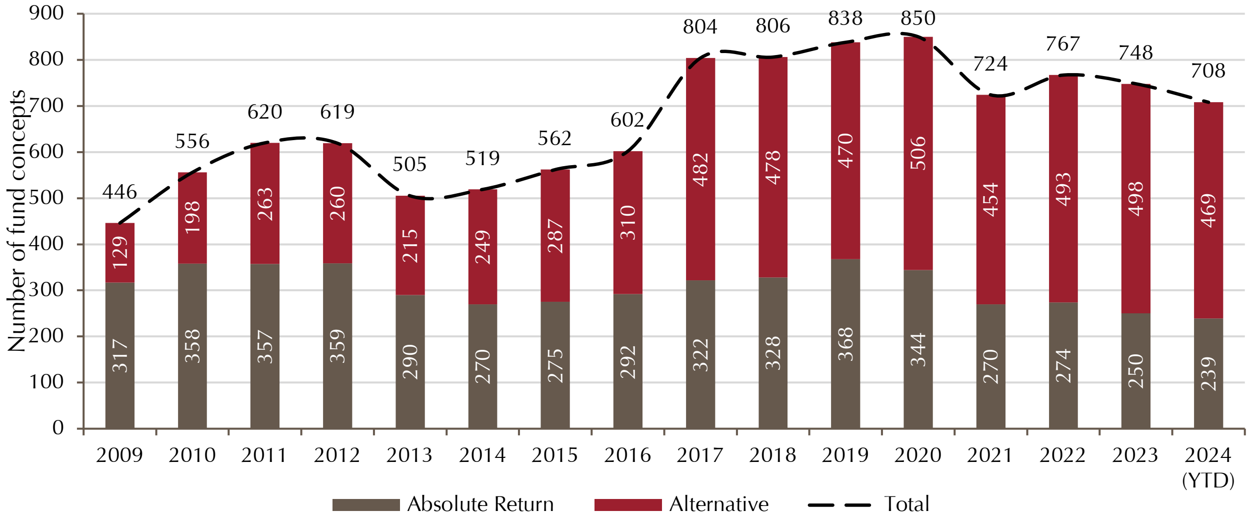
Investors who turned their attention to the two alternative fixed-income strategies were rewarded with **better performance** compared to plain vanilla fixed-income investments **(p. 8).** These strategies were also convincing in terms of risk. Fund performance within both strategies demonstrated **good downside protection** with only a very small number of funds recording moderately negative returns, while there were a number of extremely strong outliers at the upper end of the scale **(chart, p. 8)**. In addition, the ten funds with the **best Sharpe ratios** were all part of Alternative Credit Focus and Absolute Return Bond strategies **(p. 10)**. In this respect, strategies with variable interest rates such as those in the Structured Credit/CLO segment are likely to have benefited most from the rise in short-term interest rates. **Maximum drawdowns** show a similar picture, with nine of the ten funds with the lowest maximum annual losses coming from the Alternative Credit Focus and Absolute Return Bond segments – and with most taking the form of structured credit funds **(p. 9)**.

MARKET DEVELOPMENT

Number of funds declines slightly

The number of funds grouped together in the evaluated segment fell by 40 to 708 compared with the end of 2023 (-5.4%). This decline is evident among both absolute return (-4.4%) and alternative concepts (-5.8%), with the ratio of two-thirds alternatives to one-third absolute return remaining unchanged.

Number of funds declines

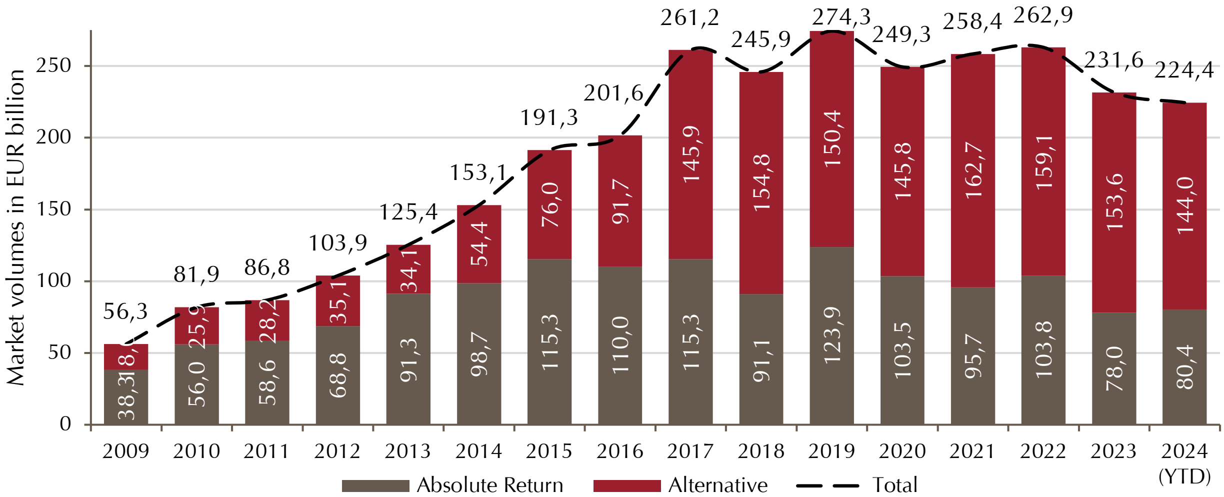


Decline in market volume flattens out

The market volume of liquid alternatives fell in the first half of 2024, with funds managing a total of EUR 224.4 billion, around EUR 7.2 billion* (3.1%) less than at the end of the previous year. This means that liquid alternative strategies have lost around 20% of their volume compared to their 2019 peak. **The growth phase for this asset class from 2009 to 2019 was mainly dominated by a low interest rate environment that prompted investors to look for alternative sources of return.** Volumes then stagnated and even declined with the turnaround in interest rates. The two fixed-income strategies alone once again recorded significant net inflows in the first half of the year (table, p. 4; chart, p. 5).

* Outflows from this asset class totalled EUR 6.4 billion (p. 4). While performance was positive at 4.72% (p. 7), the increased decline in market volume was the result of funds that were newly added to or removed from the universe.

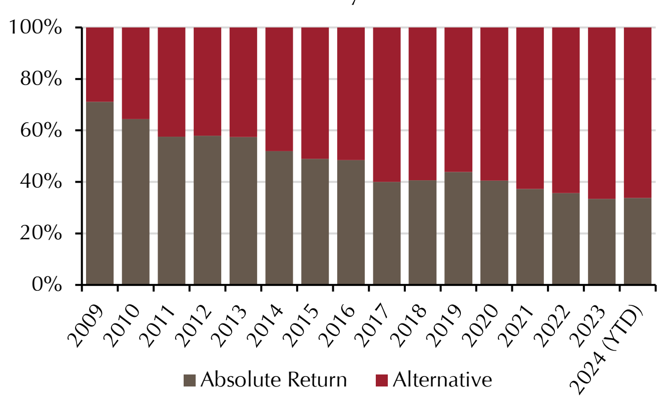
Market volumes fall further

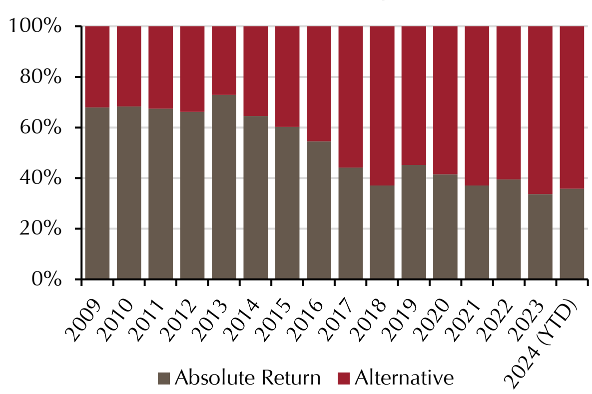


Market distribution stabilises

Market distribution between absolute return and alternatives concepts appears to have stabilised. As in previous years, absolute return concepts make up one third and alternatives concepts two thirds of all funds (left chart). This ratio also remains virtually unchanged in terms of volume (right chart), with the share of absolute return funds at around 35.8%.

Ratio of absolute return to alternatives concepts virtually unchanged

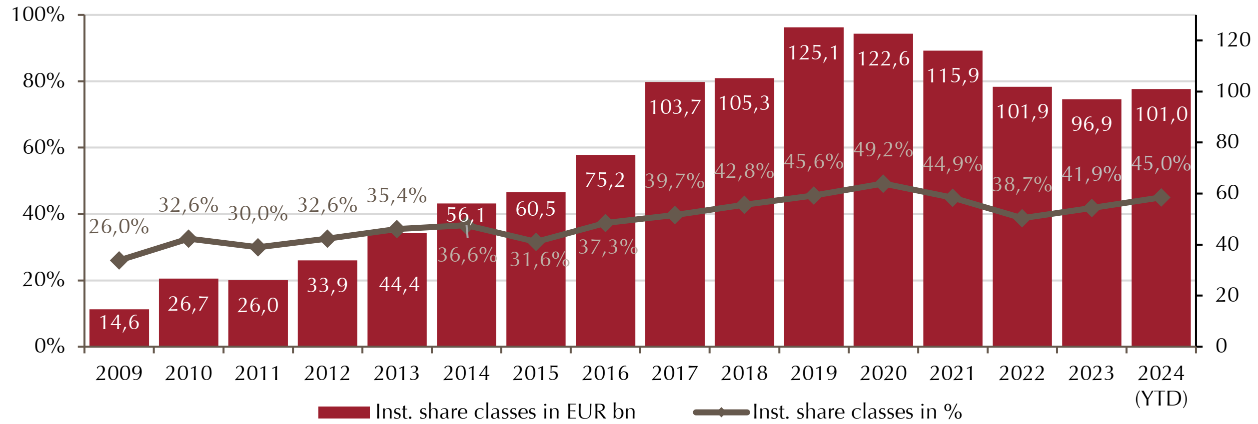




Institutional volumes gain market share

Institutional share classes could experience a reversal in trends, with market volumes increasing by 4.2% (EUR 4.1 billion) to EUR 101.0 billion between the end of 2023 and the middle of 2024, having previously declined since 2019. Institutional absolute return concepts grew to EUR 31.9 billion (+3.6%) while alternative concepts increased to EUR 69.1 billion (+4.4%). The percentage share of total volume within this asset class represented by institutional share classes has once again risen significantly to 45% since the previous year and is now approaching its 2020 peak once more.

Institutional market volumes rise again



Investors favour fixed income funds

After historically unparalleled net outflows of EUR 35.1 billion in the previous year, outflows from the evaluated fund universe slowed considerably to total EUR 6.37 billion by the middle of the year. **The two fixed-income strategies are two of the bigger outliers here,** with Absolute Return Bond attracting net inflows of EUR 1.23 billion (3.74%) while Alternative Credit Focus recorded net inflows of around EUR 0.98 billion (5.59%). The biggest loser was Alternative Multi Strategies (EUR -2.43 billion).

Net flows by strategy in the first half of 2024 (in EUR billion)

Top 5

Absolute Return Bond	1.23
Alternative Credit Focus	0.98
Alternative Relative Value	0.13
Alternative Other	0.11
Alternative Currency Strategies	0.00

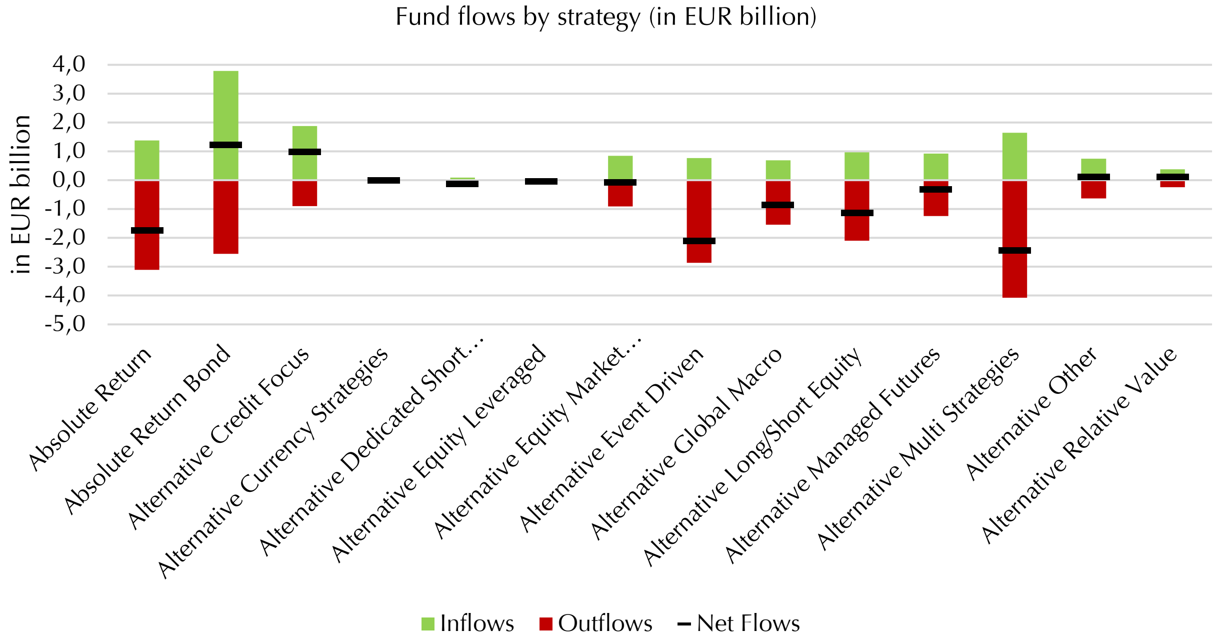
Flop 5

Alternative Multi Strategies	-2.43
Alternative Event Driven	-2.09
Absolute Return	-1.73
Alternative Long/Short Equity	-1.13
Alternative Global Macro	-0.85

Fresh capital not (yet) offsetting outflows

While most strategies recorded inflows (green bar in chart below), these were significantly outweighed by outflows (red bar), causing net flows (black line) to remain negative for almost all strategies. Investors withdrew almost EUR 6.4 billion from this asset class overall.

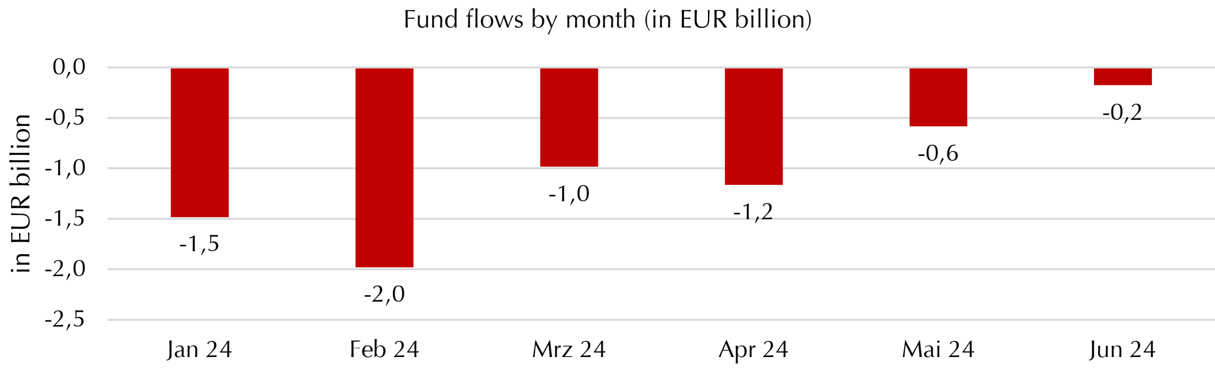
Fixed-income strategies with net inflows



Net outflows slow significantly

One striking development is how the trend of net outflows has weakened during the year. Although the segment was still burdened by higher outflows at the start of the year, these outflows fell considerably towards the end of the first half and **were almost neutral at just EUR 200 million in June**. If this trend continues, the segment could record inflows again for the first time in the second half of the year.

Net outflows slow significantly towards the middle of the year

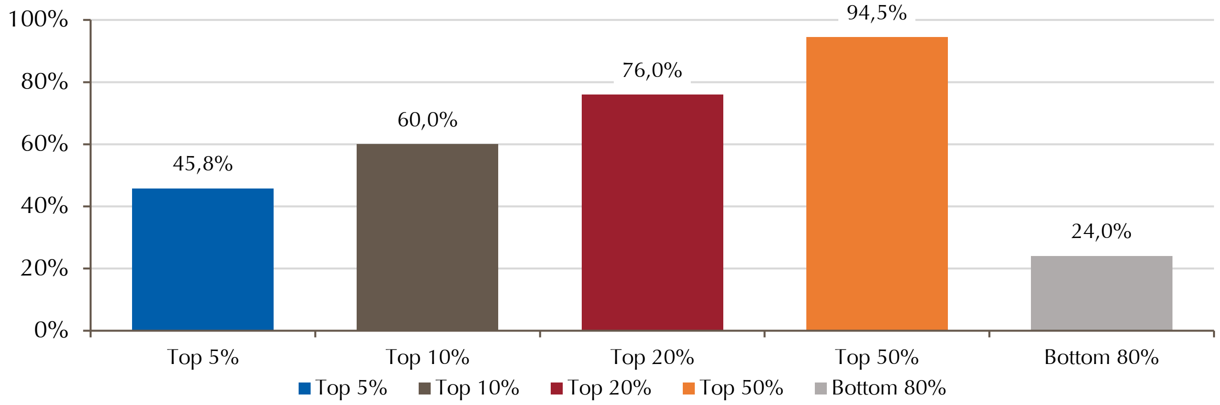


MARKET STRUCTURE

Large funds continue to dominate the market

The landscape has hardly changed compared to our previous analysis, with the top 5% of funds managing almost twice as much capital as the bottom 80%. As a result, the market continues to be dominated by a few large providers. This tendency becomes even more pronounced when dividing the market into its upper and lower halves, **with the upper half of funds accounting for 94.5% of assets in the segment,** while the lower half of funds once again manage barely 5% of all assets.

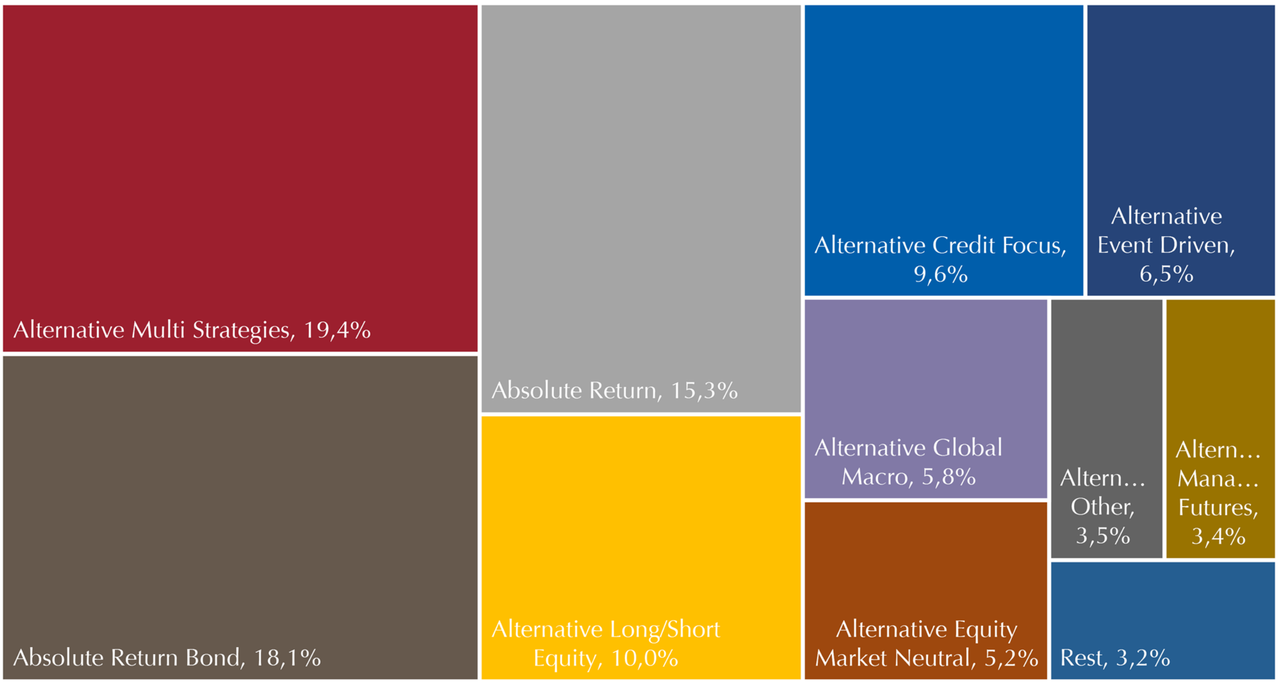
Top 5% of funds account for 45% of total market volume



Fixed-income strategies maintain their market share

The five largest strategies account for around three-quarters of the total market volume of liquid alternatives strategies, **with the two fixed-income strategies – Absolute Return Bond and Alternative Credit Focus – representing almost 30% of the entire market.** Alternative Multi Strategies extended their lead slightly once again despite recording more significant outflows (p. 4) towards the end of 2023 (18.9%) to remain the largest individual strategy at 19.4%.

The three largest strategies are responsible for half of all assets

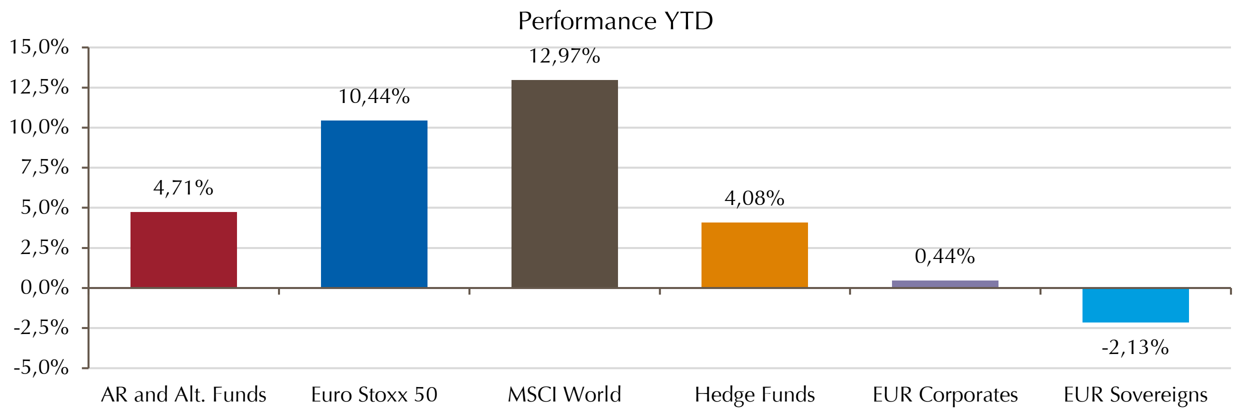


PERFORMANCE

Liquid alternatives outperforming hedge funds and bonds

Liquid alternatives recorded performance of 4.71% to position themselves between equities and bonds. While global equities in particular performed extremely well in the first half of the year, driven by the exceptional performance of US large-cap stocks, **bonds suffered from the fact that expectations of falling interest rates have repeatedly been disappointed as rate cut decisions are pushed further and further into the future.** Unregulated hedge funds were also left trailing in the wake of liquid alternatives.

Equities record above-average performance again in 2024

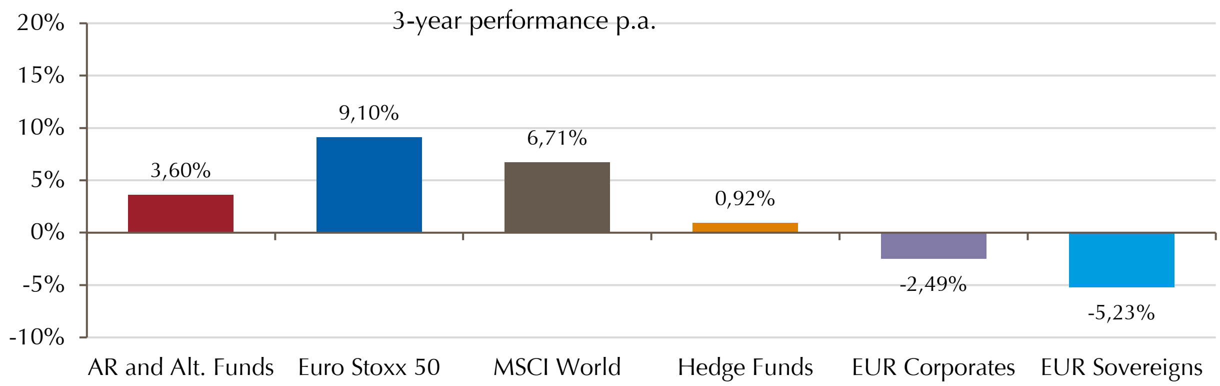


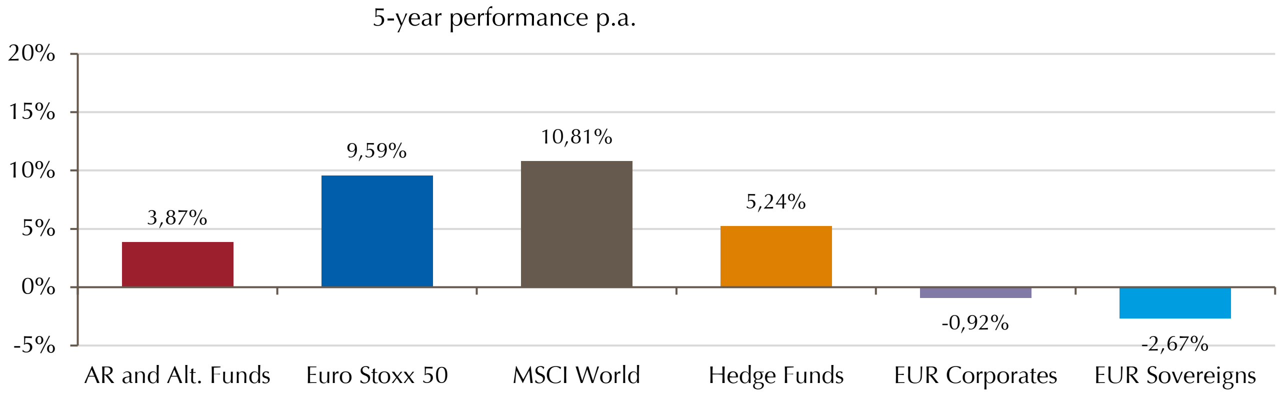
LONG-TERM PERFORMANCE

Liquid alternatives assert their position between equities and bonds

Liquid alternatives strategies are also consolidating their long-term position between equities and bonds, **underscoring their suitability as a diversifying element within a portfolio.** While many bonds have still not recovered losses that in some cases reached double digits during the turnaround in interest rates in 2022 and threaten to record another year of losses in 2024, liquid alternative strategies were able to demonstrate that they can hold their own even in a challenging market environment.

Liquid alternatives exhibit solid long-term return

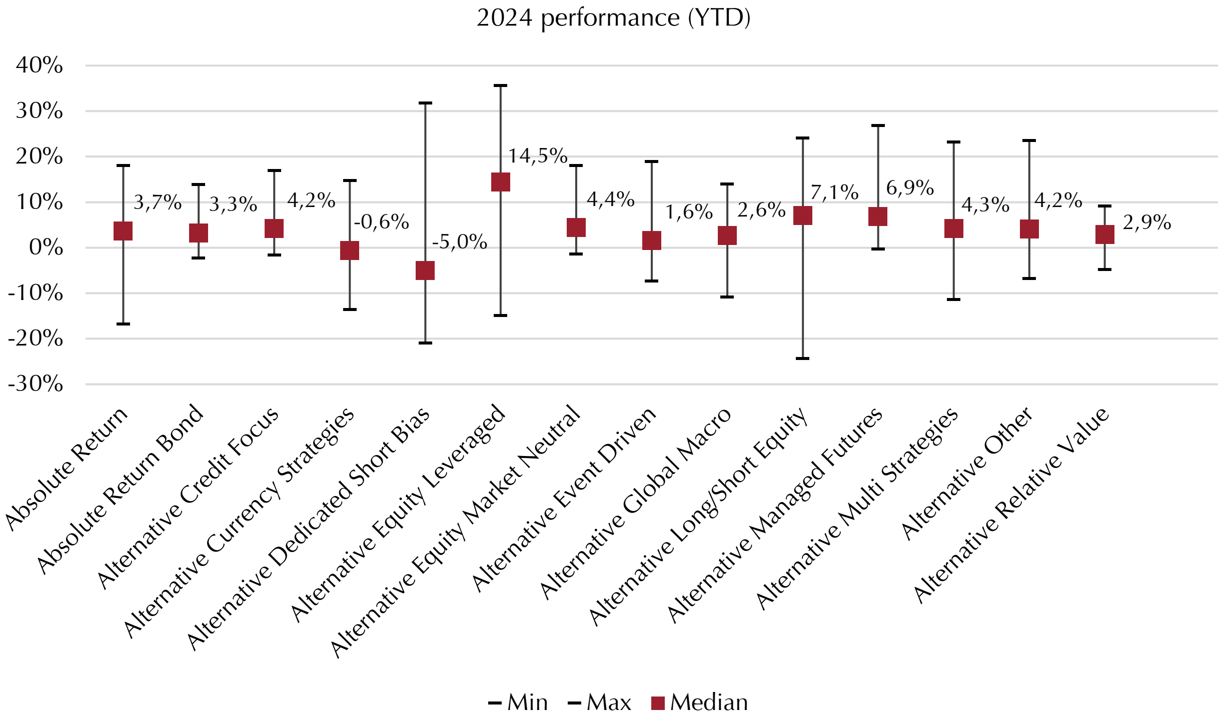




Significant differences in performance between individual funds

85% of the funds observed recorded a positive performance. Alternative Equity Leveraged delivered the best result at 14.5%, which came as little surprise given the strength of the equity market. Alternative Long/Short Equity strategies also performed well, as did Alternative Managed Futures, which often take a trend-following approach and also benefited from positive equity markets.. **Both fixed-income strategies – Absolute Return Bond (3.3%) and Alternative Credit Focus (4.2%) – recorded significantly stronger returns than euro-denominated corporate and government bonds.** Understandably, the leveraged strategies Alternative Dedicated Short Bias and Alternative Equity Leveraged recorded the greatest dispersion of returns, while returns for fixed-income strategies were significantly less scattered.

While 85% of funds in the segment recorded positive performance, there was significant dispersion across different strategies

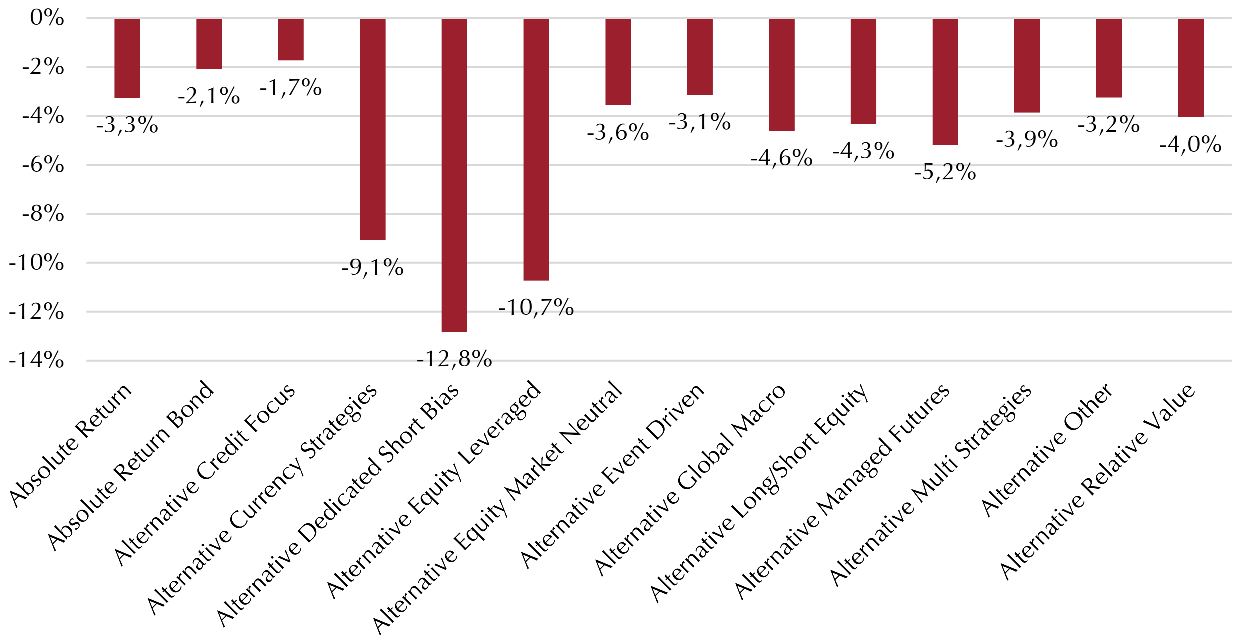


RISK ASSESSMENT

Maximum losses remain within narrow limits

The average maximum loss across all strategies was a moderate 3.6% in the first half of the year. At strategy level, both fixed-income strategies – Absolute Return Bond and Alternative Credit Focus – experienced the lowest drawdowns on an annual basis. **At fund level, nine of the ten funds with the lowest maximum losses came from fixed-income strategies, with most of these taking the form of structured credit or CLO funds.** The three strategies with the highest losses were leveraged strategies, which reported larger drawdowns per construction, as well as Alternative Currency strategies, which include crypto funds that caused major fluctuations.

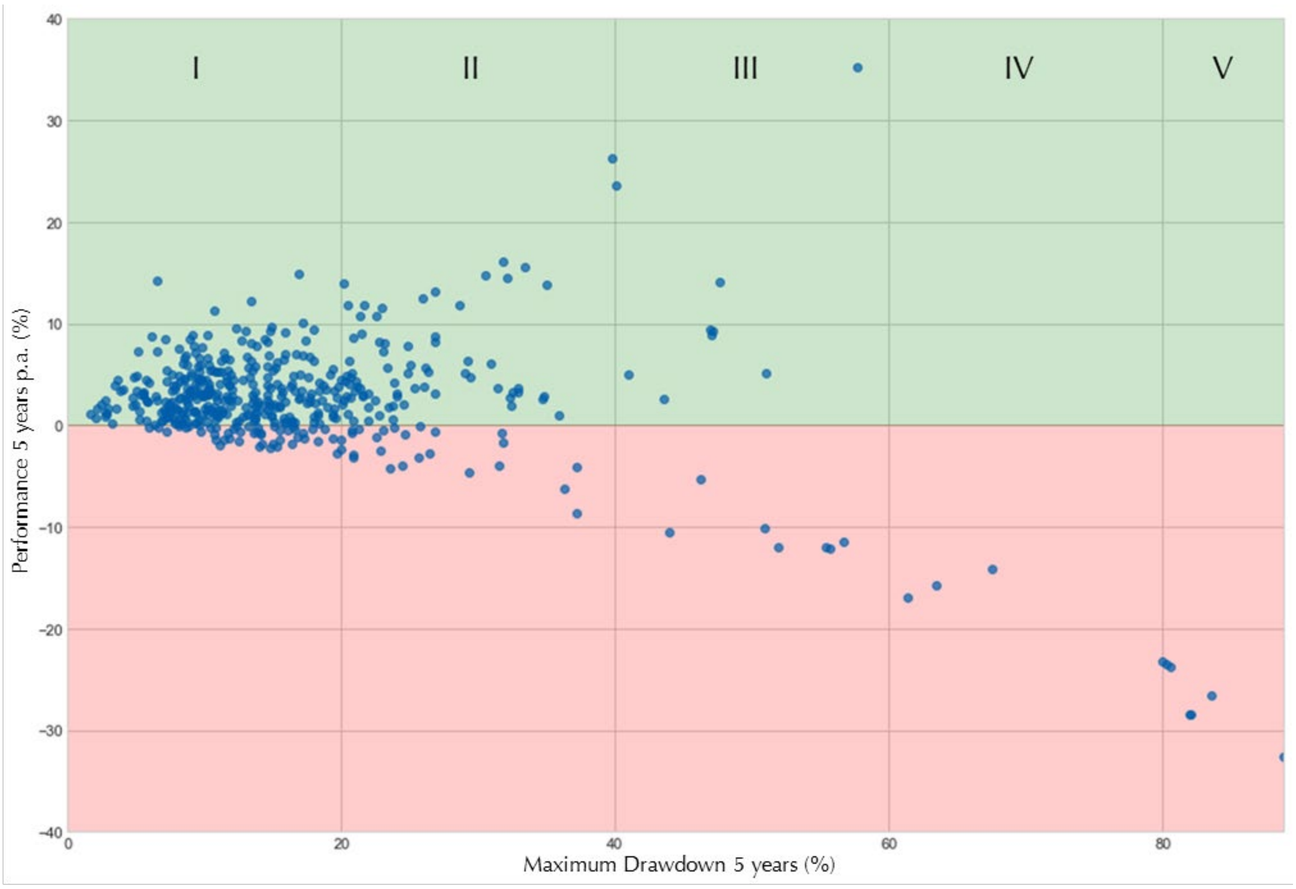
2024: Average maximum drawdown per strategy



Long-term comparison: high maximum losses jeopardise overall return

The following chart shows the returns generated by individual funds over five years in relation to their maximum losses. Each point corresponds to a fund that has already been in the segment for at least five years. **Most of these funds – more than 74% – are situated in column I on the left. They can limit their maximum losses to no more than 20%, with the vast majority recording a positive performance.** As shown in columns II to V, the higher a fund's risk tolerance is, the more pronounced the positive and negative return outliers are. However, the majority of funds in columns III, IV and V were no longer able to recover from their high maximum losses, with drawdowns of 40% or more seemingly difficult, if not impossible, to offset in this segment. **When carrying out their due diligence, investors should therefore pay particular attention to risk management and the instruments used to limit losses.** However, the aim here is not to avoid losses as far as possible, because this is expensive and eliminates not only risk but also any opportunity to generate returns.

Maximum drawdown and performance of individual funds



Sharpe ratio: variable interest rate strategies have the edge

Almost 60% of funds achieved a positive Sharpe ratio in the first half of the year, **which means the asset class is slowly but surely moving away from the low it reached during the turnaround in interest rates in 2022.** At that time, the number of funds with a positive Sharpe ratio fell to only around 25%.* This indicator highlights the extent to which investors are adequately compensated for the risk assumed for an investment. It shows the return less the risk-free interest rate relative to the fluctuation in value. The rise in interest rates over the last few years has meant that high-risk assets have to exceed the risk-free interest rate in order to achieve a positive Sharpe ratio. The ten funds with the best Sharpe ratio in the first half of 2024 come exclusively from the **Alternative Credit Focus and Absolute Return Bond strategies.** Many funds in this segment may have also benefited from the rise in short-term interest rates, which are beneficial for variable-rate strategies such as structured credit/CLOs.

* This low figure from 2022 should be considered in the context of the wider market, as equities and bonds suffered double-digit losses while liquid alternatives strategies managed to limit investors' portfolio losses with an average fund performance of -1.49%.

Costs largely unchanged

Costs have remained largely stable on average across all strategies since 2017, amounting to 1.50% in 2022 (2017: 1.62%). At around 1.52%, they are currently close to the 2022 level and also in line with the long-term average.

Glossary

Absolute Return	Funds characterised by a highly regulated market environment and an absolute return target. They aim to add value in every market environment. They are usually measured against a risk-free or cash benchmark instead of a traditional long-only benchmark.
Absolute Return Bond	Funds that pursue positive return targets in all market situations and primarily invest in debt securities. Products with the words "Absolute Return" added to their name or investment objective may be included in this category. In this case, the benchmark is usually a risk-free or cash benchmark instead of a traditional long-only market index.
Alternative Credit Focus	Funds that invest in structured credit products and whose investment process is characterised by either fundamental credit analysis, quantitative approaches or (market) opportunities.
Alternative Currency Strategies	Funds that invest in global currencies to exploit arbitrage opportunities (carry, momentum, fundamental opportunities). They use short-dated money market instruments and derivatives to achieve their objectives. Funds that invest the majority of their assets in cryptocurrencies also fall into this category.
Alternative Dedicated Short Bias	Funds that maintain a net short profile on the market on an ongoing basis. This category also includes funds that exclusively take short positions.
Alternative Equity Market Neutral	Funds seeking to generate consistent returns regardless of market phases. The portfolio is also managed with a net market exposure of zero.
Alternative Event Driven	Funds that aim to exploit price inefficiencies caused by a business transaction (e.g. insolvency, acquisition, spinoff, etc.) in accordance with their sales prospectus. Event-driven funds can invest in a variety of instruments with different risk structures (e.g. equities, credit instruments, derivatives).
Alternative Global Macro	Funds that make global investment decisions based on economic theories. These strategies typically base their decisions on interest rate expectations, expectations concerning political developments, and other macroeconomic and systemic factors. Global macro funds typically use a wide range of instruments and investment universes to implement their investment ideas.
Alternative Long/Short Equity	This strategy uses both long and short positions in equities, equity options and equity index options. The portfolio manager can decide whether the net position of their fund is positive or negative depending on their market view.
Alternative Managed Futures	Funds that primarily invest in a portfolio of futures contracts and aim to generate positive returns that are independent from the market in any situation with limited volatility. Their investment approaches consist of proprietary trading strategies that can include both long and short positions.
Alternative Multi Strategy	Funds that aim to generate an overall return by managing several different hedging strategies. These funds typically follow a quantitative approach and seek to identify opportunities where there are changes to the long-term risk-adjusted relationship between two securities.
Alternative Relative Value	They use option and arbitrage strategies on highly correlated pairs of securities to exploit price differentials. In such cases, the funds sell the more expensive security (short position) while taking a long position in the relatively cheap security.
Alternative Equity Leveraged	Funds designed to generate more than 100% of the daily performance of a benchmark index. They use a customised combination of futures contracts, derivatives and leveraged products to achieve this.

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About Lupus alpha

As an independent, owner-operated asset management company, Lupus alpha has been synonymous with innovative, specialised investment solutions for over 20 years. As one of Germany's European small and mid-cap pioneers, Lupus alpha is one of the leading providers of volatility strategies as well as collateralised loan obligations (CLOs). The specialist product range is rounded off by global convertible strategies and risk overlay solutions for institutional portfolios. The Company manages a volume of more than EUR 15 billion for institutional and wholesale investors. For further information, visit www.lupusalpha.de.

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