

CONFIDENTIAL

## 2016 Year in Review

*One for the Books...*

Credit Suisse Prime Services

Capital Services, Consulting, and Risk Advisory

# Executive Summary

## 2016: Respect the Unexpected

The main lesson of 2016 may be the reminder to expect the unexpected – or at least *respect* the unexpected.

Given the numerous political changes across many jurisdictions and continued Central Bank action this year, it is a theme that may well extend into 2017 as electoral shifts prompt possible fiscal ones.

	2016 Hedge Fund Industry Themes	What could it mean for 2017?
Year of Monetary and Political Risk	<ul style="list-style-type: none"> <li>Multiple Central Bank actions (<b>PBOC, BoJ, ECB</b>)</li> <li>Unexpected political shifts: <b>Brexit, Trump</b>, Italian referendum</li> <li>Other idiosyncratic turns: India's surprise demonetization, OPEC's supply cut</li> </ul>	<ul style="list-style-type: none"> <li>On the back of numerous shock elections, 2017 could be a period of <b>fiscal shifts</b> across numerous markets</li> <li>All eyes...everywhere. Elections in France, Germany and the Netherlands</li> </ul>
Hedge Fund Shake Out?	<ul style="list-style-type: none"> <li><b>Slight increase</b> in hedge fund <b>closures</b> and returning external capital</li> <li>Challenged performance on the back of <b>sector rotation</b></li> <li><b>Investor consolidation of manager allocations</b> across some strategies</li> </ul>	<ul style="list-style-type: none"> <li>Could 2017 be a <b>more fertile landscape</b> for <b>new launches</b> as PMs feel emboldened to strike out on their own, or will the rising cost of infrastructure drive talent <b>towards platforms</b>?</li> <li>Will the <b>conversion to family office</b> theme continue?</li> </ul>
Focus on Fees	<ul style="list-style-type: none"> <li>Numerous headlines on perceived industry fee compression</li> <li>Average <b>management fee</b> remains around <b>150 bps</b></li> <li>Updating terms may bring management fees in line with average</li> </ul>	<ul style="list-style-type: none"> <li><b>Continued customization and diversification</b> of fee structures – the “new alignment” isn't one thing, aligning manager and investor interests takes many forms</li> </ul>
Rise of Passive Management	<ul style="list-style-type: none"> <li><b>ETFs reach \$3 trillion</b></li> <li>Possibly contributing to rising single stock correlations</li> <li>Hedge funds both <b>challenged by</b> and <b>taking advantage of</b> passive products</li> </ul>	<ul style="list-style-type: none"> <li>Managers may take <b>advantage of passive growth</b>, offering their own products</li> <li>Potential continued investor consolidation of Equity L/S allocations</li> </ul>
Opportunity Knocks	<ul style="list-style-type: none"> <li>Top performing funds continue to serve as <b>price setters</b></li> <li>Quant strategies power on</li> <li>Investors remain dedicated to the space by <b>rotating and reallocating</b></li> </ul>	<ul style="list-style-type: none"> <li><b>Investors remain committed</b> to the asset class</li> <li>Rising rates creates opportunities beyond potential fiscal changes mentioned above</li> </ul>

# 2016 Year in Review: Politics, Positioning, Performance<sup>1</sup>

- Hedge Fund Equity L/S Net Exposure starts year at all time highs at **62%**.
- CS Strategists: “FX the mechanism that is **most significant factor** for global markets in 2016”
- RMB devaluation, BoJ adopts **negative interest rates**

- **First Q1 hedge fund industry outflows** since 2009: **-\$15bn**
- ECB surprises: broad stimulus measures
- Avg Q1 HF performance: **-1.5%**

- **30%** of Developed Market **bonds trading below 0%**
- Record **32 straight days** of short covering

- U.S. Treasury acts to **curb corporate inversions**

- **Brexit**
- Managed Futures funds bounce back after 3 negative months, **+4.4%**

- Popular hedge fund U.S. shorts **outperformed by 350 bp** in May

- Hedge Fund **outflows continue**; 3<sup>rd</sup> straight quarter of redemptions
- Attempted Turkish coup
- **Strong hedge fund performance** +1.3%; average fund turns positive for year

- Rio Olympics
- Brazilian President Rousseff removed from office
- Emerging Markets funds lead the pack, **+6.7% YTD**
- **Gross exposure** starts to move meaningfully **higher**

- ELS managers boost net exposure again **towards all time highs**
- Diverging from Macro/CTA funds, which turned back to net short in September

- **U.S. Presidential election**
- U.S. equities rally
- OPEC agrees to output freeze
- Hedge funds retain bottom quartile exposure to energy stocks across 4y lookback

- **Sterling hits 31 year low**
- CTAs and Equity L/S funds at **opposite ends** of U.S. Equity L/S exposure ahead of U.S. election
- 3Q2016 hedge fund outflows accelerate to \$28bn; investors have **redeemed \$51.4 bn YTD**

JANUARY<sup>1</sup>      FEBRUARY<sup>2</sup>      MARCH<sup>3</sup>      APRIL      MAY<sup>4</sup>      JUNE<sup>5</sup>      JULY<sup>6</sup>      AUGUST<sup>7</sup>      SEPTEMBER<sup>8</sup>      OCTOBER<sup>9</sup>      NOVEMBER<sup>10</sup>      DECEMBER

**1Q2016**  
Central Bank Activism, short covering and currency driven deleveraging

**2Q2016**  
Trading and exposures remain muted; Equity and Event funds begin to recover from challenging Q1

**3Q2016**  
Funds re-engage post Brexit; increasing gross exposure, pre U.S. election net exposure diverging

**4Q2016**  
U.S. Equity market rally, funds maintain exposures



Source: Credit Suisse Prime Services Risk Advisory

# Performance

## Muted performance with some bright spots

After a challenging Q1, hedge funds fought back to head towards year end flat to slightly up

Prime Services **Risk Advisory team** identifies the following potential **performance headwinds**:

- **Distorted business cycle.** The unusually long (4ys) and modest (2 to 7%) corporate earnings growth rate has reduced differentiation among stocks.
  - To put this degree of flat-lined EPS growth in perspective, the previous record of single digit EPS growth was just 5 quarters ending in 1994
- **Persistent zero rate policy.** Rates, credit and currency price action is dominated by Central Bank activity

### Fortune Favors the Small?

- An internal proprietary Credit Suisse performance index reveals **half** of the top 30 performers YTD through November 2016 are **under \$1 bn in AuM**.
- ~90% of top 30 performers are under \$3 bn

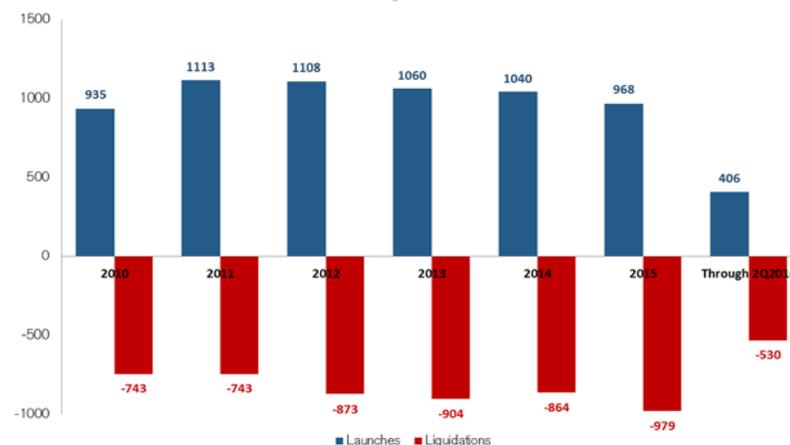
### Launches/Liquidations

- Liquidations seem to be en route to outpace launches by the widest margin since 2009
- Annualized YTD fund closures may approach 1,000
- More tepid launch landscape, with annualized launches slowing considerably year over year
- Growth of Platform organizations may in part be contributing to lower launch numbers

Source: Credit Suisse Hedge Fund Indices November 2016

Credit Suisse Hedge Fund Indices	Performance 2016 YTD through November	2015	Top Quartile YTD through OCTOBER	Bottom Quartile YTD through OCTOBER
<b>Master</b>	<b>0.08%</b>	<b>3.70%</b>	<b>5.7%</b>	<b>-4.3%</b>
Convertible Arbitrage	6.06%	0.70%	7.9%	4.3%
Emerging Markets	4.19%	-0.30%	12.7%	-1.4%
Equity Market Neutral	-3.15%	1.80%	3.4%	-4.6%
Event Driven	0.96%	-6.50%	6.8%	-0.4%
Distressed	4.87%	-5.30%	10.2%	1.4%
Merger/Risk Arbitrage	5.46%	-2.70%	4.6%	3.1%
Multi Strategy Event Driven	-0.58%	-4.00%	6.3%	-1.3%
Fixed Income Arbitrage	3.30%	0.50%	5.8%	0.1%
Global Macro	1.92%	0.10%	0.9%	-4.0%
Long Short Equity	-4.08%	3.70%	3.7%	-7.4%
Managed Futures	-7.13%	-1.50%	-0.2%	-8.1%
Multi-Strategy	2.75%	3.70%	5.5%	-1.8%

Launches and Liquidations Through 2Q2016



Source: Hedge Fund Research, 3Q2016 Industry Report

# Risk Landscape

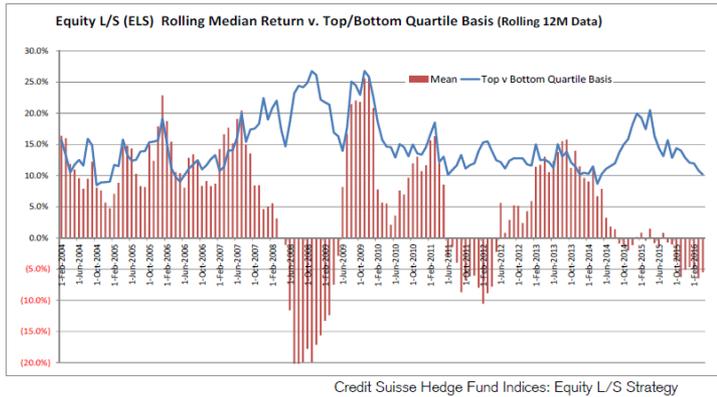
What could be impacting performance<sup>1</sup>

## Hedge Fund Returns

Equity Long/Short Strategy Rolling 12M Return vs. Dispersion

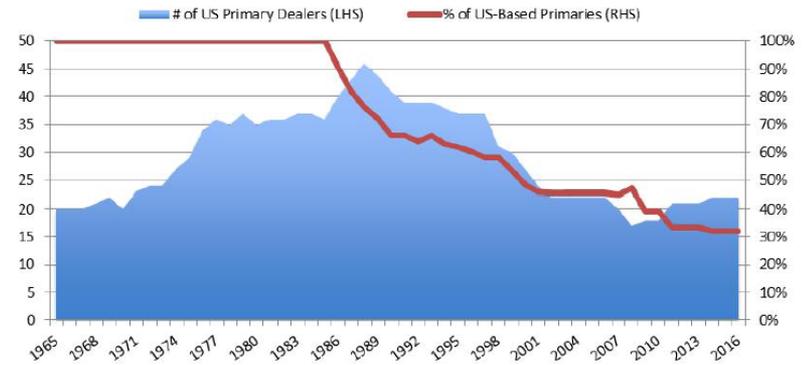
We explored the constrained market opportunity set in *This Time Is Different*<sup>1</sup>

To help explain this, we explored one potential driver of increasing cross-correlation, as global market shocks seem related to structural changes.



## # of US Primary Dealers vs. % US Institutions

(1965 thru January 2016)

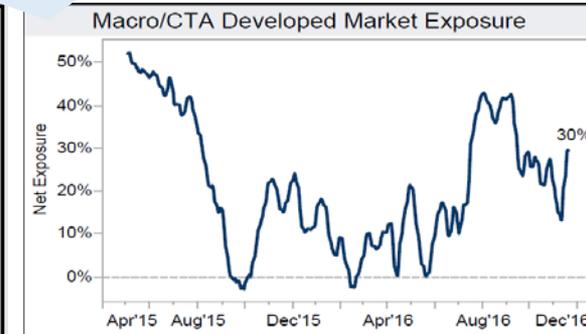
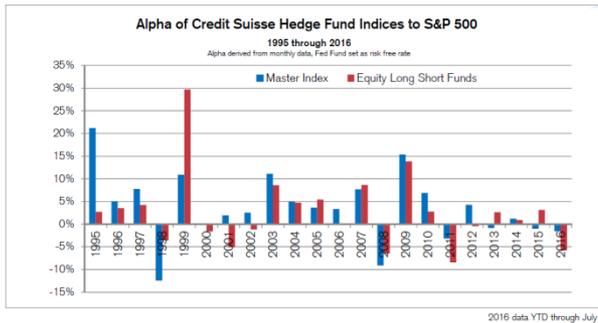


## Hedge Fund Alpha & Market Shocks

Similar to hedge fund returns, Alpha has been unusually constrained since 2012. Our analysis suggests that market risk explains a great deal of this underperformance.

And in the same piece, outlined that, like hedge fund returns have been constrained, so, too has Alpha.

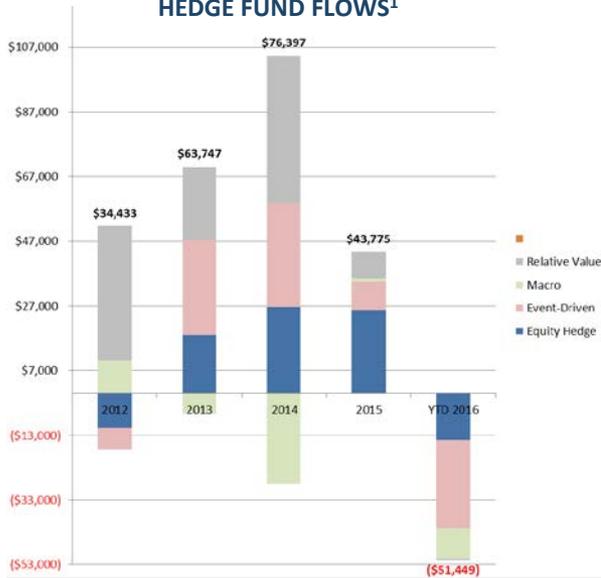
And positioning has reacted differently; Equity L/S managers started the year with net exposure towards the highs, and after a period of decline, began the march higher after Brexit, moving up since. CTAs by contrast, started 2016 towards the middle of recent historical net exposure, and post U.S. election started adding after taking exposure down<sup>2</sup>



# Capital Flows

Industry assets linger near all time highs, but lower flows for hedge funds and liquid alternatives

## HEDGE FUND FLOWS<sup>1</sup>



Despite redemptions, positive performance has left **hedge fund industry assets near all time highs**

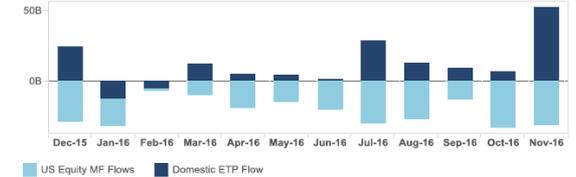
- First net outflows across three quarters since 2009
- \$51B YTD outflows relatively modest compared to post financial crisis (\$285B in outflows in '08/'09)
- Systematic strategies saw \$2B in inflows, so investors still see value in “performing” HF strategies
- Appears to be more cash on sidelines looking to come in than we have seen in quite some time
- Investors now just waiting to identify top performers before deciding where to reallocate for 2017

\*\*\*

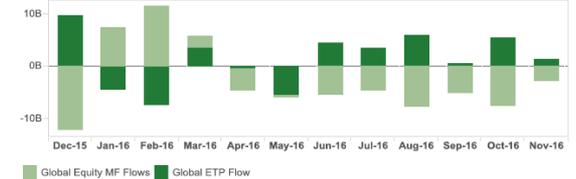
- U.S. listed Exchange Traded Products (ETPs) welcomed their 2<sup>nd</sup> greatest inflows ever (+\$52bn) in November, while Mutual Funds continued to see redemptions (-\$53bn)
- ETF trading in November averaged \$100bn per day and 32.2% of U.S. exchange trading, peaking at 37% the day after the election
- Sector focused trading continues to be a theme, accounting for 25.6% of all ETP trading in November.

## PASSIVE FLOWS TTM<sup>3</sup>

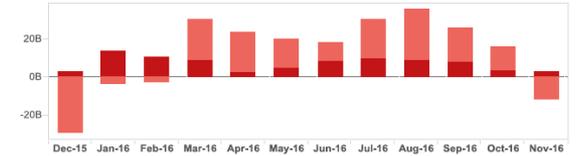
Exhibit 1: 2<sup>nd</sup> Largest ETP Inflows on Positive Post-Election Sentiment US Equity



## Global Equity

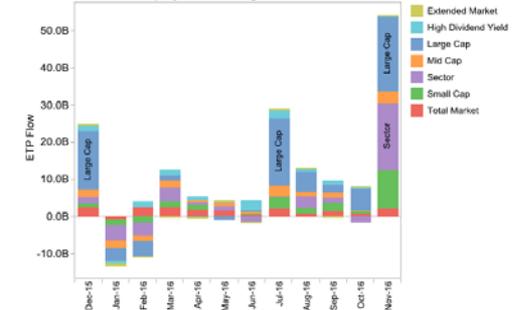


## Fixed Income



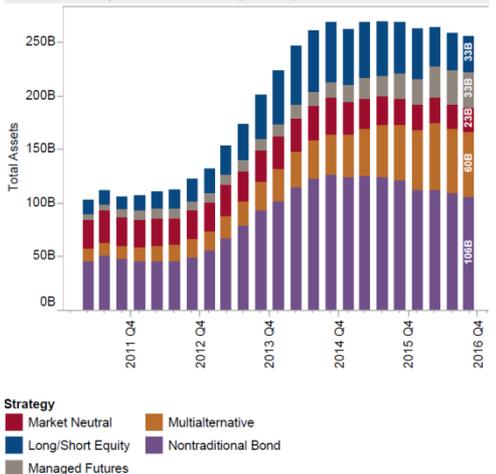
Source: Credit Suisse: Trading Strategy, Factset, ICI, Flows through Nov 30<sup>th</sup>.

Exhibit 9: Domestic Equity Inflows Surge Post-Election



Source: Credit Suisse: Trading Strategy, Factset, Excludes inverse and leveraged ETFs

## Liquid Alternatives (40 Act) - Total Assets <sup>2</sup>



# Citations

- 1 Credit Suisse Prime Services Risk Advisory Hedge Fund Bulletin 5 January, 2016, Credit Suisse Securities Research Highlights, 08 January 2016
- 2 Credit Suisse Prime Services Risk Advisory Hedge Fund Bulletin, 26 February 2016
- 3 HFR Hedge Fund Industry Report, 1Q2016 and Credit Suisse Hedge Fund Indices March 2016 returns
- 4 Credit Suisse Prime Services Risk Advisory First Look 2 June 2016
- 5 Credit Suisse Hedge Fund Indices Monthly Returns June 2016
- 6 HFR Hedge Fund Industry Report, 2Q2016 and Credit Suisse Hedge Fund Indices July 2016 returns
- 7 Credit Suisse Hedge Fund Indices Monthly Performance August 2016 and Credit Suisse Prime Services Risk Advisory First Look 11 August 2016
- 8 Credit Suisse Prime Services Risk Advisory First Look 30 September 2016
- 9 Credit Suisse Prime Services Risk Advisory First Look 31 October 2016 and HFR Hedge Fund Industry Report 3Q2016
- 10 Credit Suisse Prime Services Hedge Fund Bulletin 30 November 2016

## Disclaimer

This material has been prepared by personnel of the Prime Services Group of “Credit Suisse” and not by the Credit Suisse research department. It is not investment research or a research recommendation, as it does not constitute substantive research or analysis. It is provided solely for informational purposes, is intended for your use only and does not constitute an invitation, a personal recommendation or an offer to subscribe for or purchase any of the products or services mentioned. The information provided is not intended to provide a sufficient basis on which to make an investment decision or to adopt any investment strategy described in this material or otherwise. It is intended only to provide observations and views of Prime Services Group personnel, which may be different from, or inconsistent with, the observations and views of Credit Suisse research department analysts, other Credit Suisse traders or sales personnel, or the proprietary positions of Credit Suisse. Observations and views expressed herein reflect a judgment as of the date of publication of this material and may be changed by Prime Services Group personnel at any time without notice. Any trade report information is preliminary and subject to our formal written confirmation. This material may have previously been communicated to Credit Suisse trading desks or to other Credit Suisse clients. You should assume that the trading desk makes markets and/or currently maintains positions in any of the securities mentioned above. Any indicative price quotations, disclosure materials or analyses provided to you have been prepared on assumptions and parameters that reflect good faith determinations by us or that have been expressly specified by you. The assumptions and parameters used are not the only ones that might reasonably have been selected and therefore no guarantee is given as to the accuracy, completeness, or reasonableness of any such quotations, disclosure or analyses. Price/yield information is indicative and may change without notice.

Credit Suisse may, from time to time, participate or invest in transactions with issuers of securities that participate in the markets referred to herein, perform services for or solicit business from such issuers, and/or have a position or effect transactions in the securities or derivatives thereof.

FOR IMPORTANT DISCLOSURES on companies covered in Credit Suisse Investment Banking Division research reports, please see [www.credit-suisse.com/researchdisclosures](http://www.credit-suisse.com/researchdisclosures)

Back tested, hypothetical or simulated performance results have inherent limitations. Simulated results are achieved by the retroactive application of a back tested model itself designed with the benefit of hindsight. The back testing of performance differs from the actual account performance because the investment strategy may be adjusted at any time, for any reason and can continue to be changed until desired or better performance results are achieved. Alternative modeling techniques or assumptions might produce significantly different results and prove to be more appropriate. Past hypothetical back test results are neither an indicator nor a guarantee of future returns. Actual results will vary from the analysis.

Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, expressed or implied is made regarding future performance. The information set forth above has been obtained from or based upon sources believed by the Prime Services Group personnel to be reliable, but each of the Prime Services Group personnel and Credit Suisse does not represent or warrant its accuracy or completeness and is not responsible for losses or damages arising out of errors, omissions or changes in market factors. This material does not purport to contain all of the information that an interested party may desire and, in fact, provides only a limited view of a particular market.

## Disclaimer (continued)

Credit Suisse Hedge Index, LLC, 2016. All data was obtained from publicly available information, internally developed data and other third party sources believed to be reliable. Credit Suisse has not sought to independently verify information obtained from public and third party sources and makes no representation as to accuracy, completeness or reliability of such information.

### Options Disclaimer

Structured securities, derivatives and options are complex instruments that are not suitable for every investor, may involve a high degree of risk, and may be appropriate investments only for sophisticated investors who are capable of understanding and assuming the risks involved. Supporting documentation for any claims, comparisons, recommendations, statistics or other technical data will be supplied upon request. Any trade information is preliminary and not intended as an official transaction confirmation. Read the Options Clearing Corporation's disclosure document [www.optionsclearing.com/about/publications/character-risks.jsp](http://www.optionsclearing.com/about/publications/character-risks.jsp). Because of the importance of tax considerations to many option transactions, the investor considering options should consult with his/her tax advisor as to how taxes affect the outcome of contemplated options transactions.

### Equity Derivatives Tax Disclaimer

Credit Suisse does not provide any tax advice. Any tax statement herein regarding any US federal tax is not intended or written to be used, and cannot be used, by any taxpayer for the purpose of avoiding any penalties. Any such statement herein was written to support the marketing or promotion of the transaction(s) or matter(s) to which the statement relates. Each taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

The investments/securities described in this document are not for public offer in Luxembourg and may not be offered to the public in Luxembourg.

The investments/securities may not be offered publicly in Germany, as no prospectus has been filed with the Federal Securities Trading Supervisory Authority; The investments/securities are not registered for public distribution with the Federal Banking Supervisory Authority; The investments/securities may be treated as foreign investment units in the meaning of the Foreign Investment Act; investors are therefore advised to contact their tax advisors with respect to the tax consequences this has.

Credit Suisse has adopted policies and guidelines designed to preserve the independence of its research analysts. Credit Suisse's policies prohibit employees from directly or indirectly offering a favorable research rating or specific price target, or offering to change a research rating or price target, as consideration for or an inducement to obtain business or other compensation. Credit Suisse's policies prohibit research analysts from being compensated for their involvement in investment banking transactions except to the extent such participation is intended to benefit investor clients.

As used herein, "Credit Suisse" means Credit Suisse Securities (USA) LLC, Credit Suisse Securities (Europe) Limited and affiliates of Credit Suisse Group AG

Credit Suisse Securities Europe Limited ("CSSEL") and Credit Suisse International ("CSI") are authorized by the Prudential Regulation Authority and regulated by the Financial Conduct Authority ("FCA") and the Prudential Regulation Authority. CSSEL and CSI do not hold an Australian Financial Services License ("AFSL") and are exempt from the requirement to hold an AFSL under the Corporations Act (Cth) 2001 ("Corporations Act") under Class Order 03/1099 published by the Australian Securities and Investments Commission ("ASIC"), in respect of the financial services provided to Australian wholesale clients (within the meaning of section 761G of the Corporations Act). This material is not for distribution to retail clients and is directed exclusively at Credit Suisse's professional clients and eligible counterparties as defined by the FCA.

Credit Suisse (Hong Kong) Limited ("CSHK") is licensed and regulated by the Securities and Futures Commission of Hong Kong under the laws of Hong Kong, which differ from Australian laws. CSHK does not hold an AFSL and is exempt from the requirement to hold an AFSL under the Corporations Act in respect of providing Financial Services. Investment banking services in the United States are provided by Credit Suisse Securities (USA) LLC, an affiliate of Credit Suisse Group. CSSU is regulated by the United States Securities and Exchange Commission under United States laws, which differ from Australian laws. CSSU does not hold an AFSL and is exempt from the requirement to hold an AFSL under the Corporations Act in respect of providing Financial Services. These materials are provided solely to Institutional Investors. Credit Suisse Asset Management LLC (CSAM) is authorised by the Securities and Exchange Commission under US laws, which differ from Australian laws. CSAM does not hold an AFSL and is exempt from the requirement to hold an AFSL under the Corporations Act in respect of providing Financial Services.

Credit Suisse Equities (Australia) Limited (ABN 35 068 232 708 AFSL 237237) ("CSEAL") CSEAL is an AFSL holder in Australia (AFSL 237237). In Australia, this material may only be distributed to Wholesale investors as defined in the Corporations Act. CSEAL is not an authorized deposit taking institution and products described herein do not represent deposits or other liabilities of Credit Suisse AG, Sydney Branch. Credit Suisse AG, Sydney Branch does not guarantee any particular rate of return on, or the performance of any products described.

In Japan, this material is distributed by Credit Suisse Securities (Japan) Limited ("CSJL"), a registered Financial Instruments Firm (Director-General of Kanto Local Finance Bureau (Kinsho) No. 66). CSJL is a member of Japan Securities Dealers Association, Financial Futures Association of Japan, Japan Investment Advisers Association and Type II Financial Instruments Firms Association.

Additional information is available from us upon request.

Copyright © 2016 Credit Suisse Group AG and / or its subsidiaries and affiliates. All rights reserved.