May 2015

Hedge Fund Market Intelligence: Equity Strategies and the M & A Boom Drive Returns

A monthly hedge fund performance report by the Arden Investment Research Team

ARDEN
ASSET MANAGEMENT LLC

ABOUT HEDGE FUND MARKET INTELLIGENCE

This report is based on Arden's coverage of more than a hundred hedge funds in which the firm actively invests on behalf of clients and is intended to be representative of certain trends and themes. The report is organized by strategy and is produced by Arden's Investment Research team. A leading hedge fund specialist, Arden conducts regular due diligence and monitoring on these and other funds and maintains a proprietary database with information on hundreds of fund managers. Sources of information include, but are not limited to, the fund managers themselves.

The strategy breakdown for the hedge funds covered in this report is as follows:

Strategy*	Number of Funds
Credit	23
Equity-Event	23
Global Relative Value (Discretionary and Systematic Macro)	35
Global Equities (Equity Long/Short and Equity Market Neutral)	23

**Strategies as defined by Arden. As of May 31, 2015.*

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OVERVIEW

Hedge fund strategies performed well in May, bouncing back from a lackluster April, with equities driving positive returns. Event-driven strategies in particular produced strong results, once again supported by M&A activity in the healthcare sector. Similarly, catalyst-driven events also drove positive returns for equity long/short managers. Equity market neutral strategies, however, had mixed performance throughout the month, with growth factors contributing and value factors detracting. Overall performance in the macro strategies was relatively strong, with discretionary and fixed income relative value managers producing positive returns which were partially offset by some mixed performance among systematic funds. Tactically-traded long USD exposure as well as short US and European rates biases were once again additive to returns. Finally, volatility in the credit sector was more subdued in May, allowing managers to stay largely insulated and produce carry-like returns.

Over the coming months, we expect elevated levels of M&A activity, diverging monetary policy and higher levels of market volatility to be additive for hedge fund strategies, in particular event-driven, equity market neutral and global macro.

The equity-event landscape continues to look favorable over the next few months with continuing heightened corporate activity and strong underlying fundamentals. Additionally, the opportunity set in Europe is ripening, as QE-induced improvements in economic conditions are putting pressure on corporations to make better use of their balance sheets. The strength of the US dollar also helps to support this thesis, as US companies now have financial motivation to target European peers.

Equity market neutral strategies stand to benefit from less competition and crowdedness in the markets than these funds have experienced in the past. Equity volatility is stable and positive, and fund flows into passive ETFs suggest less competition in actively managed strategies. Additionally, the current level of SPX pair-wise correlation is likely to provide managers with opportunities to generate alpha in both long and short portfolios.

Macro managers stand to benefit from the continued steady increase in implied volatility across the US treasury market. Recent moves in rates in both Europe and Germany reaffirm the trend of increasing volatility. Additionally, with the Federal Reserve expected to embark on a series of rate hikes over the coming quarters, divergence in monetary policy between different regions will become increasingly stark. We anticipate that this will create further attractive opportunities for managers to trade investment themes predicated on improving growth in the US relative to the rest of the world.

CREDIT

EXECUTIVE SUMMARY

Despite macro-related disruptions from potential interest rate shifts (10-Yr UST yields ranging from 2.03% to 2.36%) and failed negotiations between Greece and its lendors, May was the least volatile month year-to-date for credit. A lack of credit events allowed the asset class to stay largely insulated and produce carry-like returns. High yield spreads tightened a mere 0.01% to 4.58% and more rate-sensitive credits such as investment grade generally underperformed.

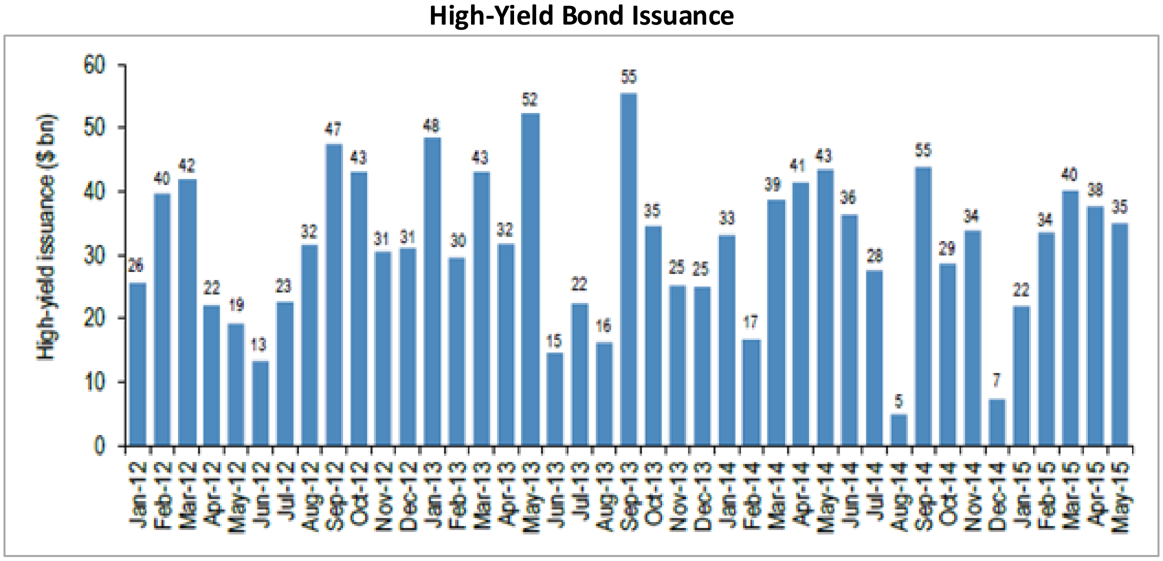
The JP Morgan Global High-Yield Index was up +0.54%; the JP Morgan Domestic High-Yield Index was up +0.37%. May performance for the other various indices was as follows: the 10-year US Treasury was down -0.32%; investment grade bonds (JP Morgan JULI Index) was down -0.56%; and emerging market bonds (JP Morgan EMBI) was down -0.54%. The S&P 500 was up +1.29%; and the Russell 2000 was up +2.28%.

New Issuance

High-yield (bond) new issuance was above average in May, totaling $35.0bn, but fell below both April and March issuances of $37.7bn and $40.1bn, respectively. Roughly $8.7bn of the new issuance this month came from energy companies looking to shore up balance sheets by extending their liquidity runways.

High-yeild loans on the other hand saw the heaviest new issue colume since November of last years, totaling $68.4 bn, though it is worth noting that an unusually high portion (54%) of the volume is attributable to re-pricing.

High-Yield Bond Issuance



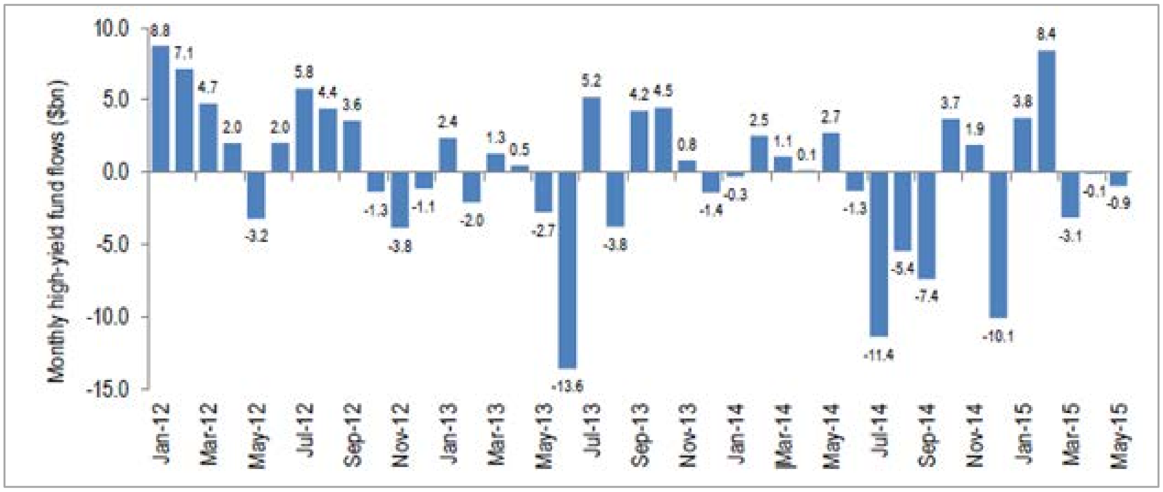
Source: JP Morgan

Inflows/Outflows

High-yield mutual funds/ETFs reported a combined outflow of -$941mn this month. This was the third consecutive month of outflows and seems to be largely driven by interest rate uncertainty. YTD inflows now stand at +$8.0bn, of which +$5.2bn is coming from high-yield mutual funds and +$2.8bn from ETFs.

Conversely, leveraged loan mutual funds posted their second consecutive month of inflows (reversing 12 previous months of outflows) given their floating rate protection and strong CLO purchasing.

Inflows/Outflows (high-yield mutual funds & ETFs)



Source: Lipper FMI

<u>Defaults</u>

Default activity remains muted. During May, four companies defaulted on $1.4bn of bonds and loans; high-yield and leveraged loan default rates are roughly half their long term averages, currently hovering at 1.58% and 1.60% respectively.

The only pockets of large cap default activity have come from either metals and mining or energy/coal companies; in fact, nine of the seventeen companies that have defaulted YTD, or 53% of total defaulted debt volume, comes from energy (43%) and coal companies (10%). Two filers of note this month were Patriot Coal ($282mn and $247mn loans) and Magnetation (metals and mining; $425mn of bonds).

ANALYSIS

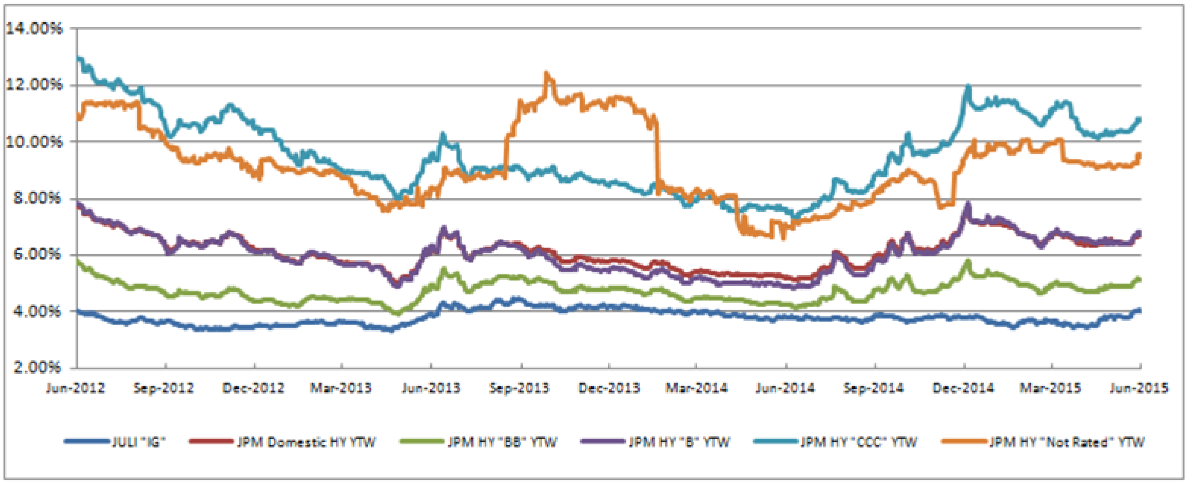
May was the least volatile month YTD for credit, which allowed most credit managers to drive positive, carry-like returns ranging from +0.25% - 0.65% for the month.

The low volatility environment allowed credit event to again produce the best overall returns. However these returns were somewhat muted by a lack of idiosyncratic events throughout month. Credit relative value returns were hampered by low volatility, a continued recovery in energy short names, minimal credit quality differentiation and a selloff in interest rate sensitive securities.

<u>Credit Relative Value</u>

“Double-B” and “single-B” rated bonds returned +0.28% and +0.44% respectively while “triple-C” credits were negative due to a higher weighting in lower-quality energy names. High grade bonds (JPM JULI Index) sold off the most, losing -0.6% this month given their magnified interest rate sensitivity.

Yield to Worst for Domestic High-Yield Bonds ("Credit Quality")



Source: Arden Research and JP Morgan

Telecom Theme:

Telecom is a thematic long/short play for many managers with many being short against U.S. wireline companies. This month shorts in Frontier (which doubled its debt to acquire landlines from Verizon) and Windstream (company separating itself into a REIT and leaving the majority of the company's debt behind at the operating company) contributed. Two positive telecom performers were Time Warner Cable which will be acquired by Charter Communications (expressed by buying equity) and Altice (management has been aggressively acquiring less-efficient European telecom competitors and improving margins).

Stressed/Distressed

The main stressed/distressed drivers this month came from Caesars, Greek debt, Puerto Rico (successful implementation of a VAT tax paving the way for a new debt issuance) and Fannie Mae/Freddie Mac securities.

Caesars:

Caesars was a material contributor to many distressed managers in May. The firm's decision, with Apollo, to strip protections on debt payments owed to holders of some Caesars bonds and loans shook up bond markets. Caesars's announcement of the maneuver spurred the sale of a record $1.2 billion of the company's bonds in a single day (May 7th) and caused maximum potential paper losses of more than $350 million that week, according to traders and data from MarketAxess. Many investors have alleged in letters to Caesars that Apollo's recent moves are fraudulent. The ruling on May 28th by U.S. District Judge Shira Scheindlin reversed Apollo's plan to separate the companies and segregate the assets. The ruling has given comfort to several of Arden's credit managers; they have rotated their holdings from the 1st lien to the 2nd lien to capture the extra yield.

Greece:

The extension of the Greek government's deadline expires at the end of June and talks appear to have broken down.

Structured Credit

Similar to the high-yield corporate market, structured products remained insulated from macro noise and returned carry-driven performance.

Agency Mortgage Derivatives:
Despite the back up in rates and curve steepening in May IOs and IIOs, agency mortgage derivatives only slightly underperformed hedge ratios.

RMBS/ABS:
GSE selling and fund/CDO liquidations continue to provide the majority of non-agency BWIC supply. STACR/CAS new issue volume remains steady, and first-loss B pieces continued to rally throughout the month.

CLO:
CLO issuance in May was $5bn, the lowest since July 2013. CLO Mezz was 0.50% tighter on the month due to the lower issuance and increased participants in the sector.

CMBS:
The CMBS market has been fairly resilient to the recent rise in rates volatility. Banks and money managers are choosing duration risk over credit risk and continue to move farther out on the yield curve to hit their yield bogeys.

OUTLOOK

The Arden credit team continues to believe performance going forward will largely be dictated by how managers have positioned their portfolios across three key exposures, specifically: (i) rates, (ii) energy, and (iii) European exposure. The credit team's view on fixed income has been reaffirmed by recent quantitative easing commentary focusing less on the timing of an interest rate move and more on the expected trajectory of rates after the first hike. The message from the last FOMC meeting was decidedly dovish and the timing for the first interest rate hike now looks to have been pushed out to Q3 2015. Meanwhile, the Bank of Japan as well as the European Central Bank look to continue easing.

Credit relative value will need a meaningful pickup in volatility, which may be difficult to sustain for an extended period in 2015 if rates continue to stay lower. In our opinion, the benign market should be beneficial to carry-oriented strategies and credit event managers should be able to generate returns by investing in idiosyncratic events. However, credit event-driven performance has been muted over the last one and a half years. Default activity remains low, making sourcing difficult for distressed managers as struggling companies continue to have easy access to raising capital. The general consensus is that overall default activity will continue to remain low with a marginal pickup in energy, coal, and metals/mining default rates.

EQUITY - EVENT

EXECUTIVE SUMMARY

The HFRI Event-Driven Index advanced +0.76% in May versus +1.29% for the S&P 500 Total Return Index and maintains a slight outperformance over the broader US equity market year-to-date (+4.01% vs. +3.23%). All HFRI event-driven sub-strategies were positive in May for the second consecutive month. Activism led the way, building on its strong YTD performance, followed by merger arbitrage. Both healthcare and energy-related positions continue to drive performance (positively and negatively) for managers, and in May, healthcare names generated strong returns while energy names were common detractors.

Activists performed well with Yum! Brands being the latest headline activist name. Dan Loeb of Third Point announced his stake in Yum! Brands on May 1. A few days later, Keith Meister of Corvex announced his stake at the Ira Sohn Conference in New York City. The managers aren't working together but both believe that the company's Chinese operations can unlock significant growth. Additionally, a broader theme is emerging among activists who are approaching companies to deploy capital by slashing long-term CAPEX spending and spending more on dividends and stock buybacks to satisfy investors.

Robust M&A activity remains the bellwether for the strategy's strong performance YTD. A handful of new deals were announced or speculated during May that drove returns, highlighted by Charter Communication/Time Warner Cable, Avago Technologies/Broadcom Corp, Intel Corp/Altera Corp, and Danaher Corp/Pall Corp. Biotech has been an active sector in the M&A boom, but now we are starting to see the trend cross over to healthcare service providers, telecommunication and cable companies, and semiconductor companies.

Industry consolidation remains a tailwind as companies in slow growth industries are consolidating in order to survive and better position themselves against competitors. Moreover, the strong dollar is another driver for M&A activity and could, in our opinion, create more cross-border activity as it has become cheaper for US companies to buy foreign ones. Gross and net exposure levels remained elevated from beginning of the year marks and managers continue to recycle capital into core investments, with many seeing an uptick in top position concentration.

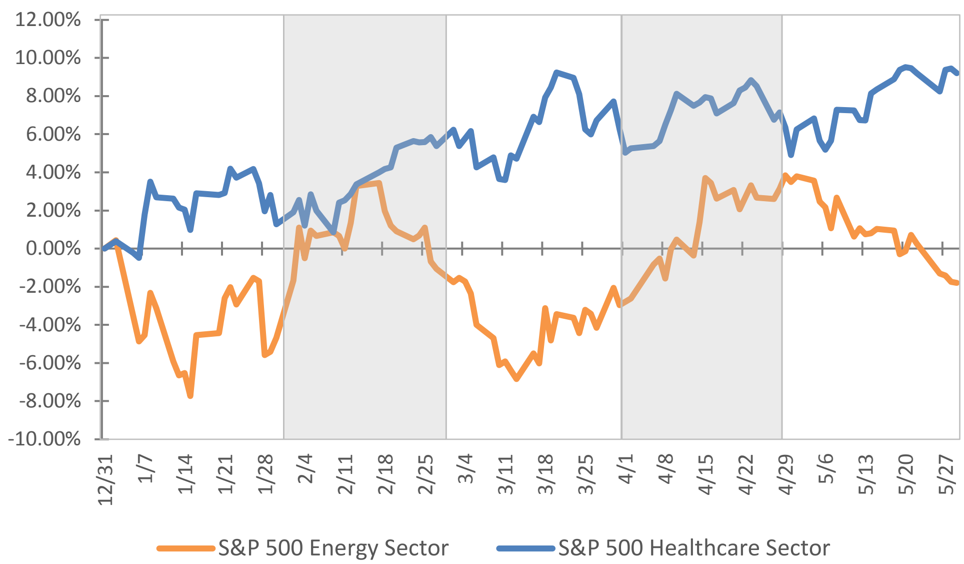
ANALYSIS

Arden's event-driven managers were up +1.91% on average in May, compared to +0.76% for the HFRI Event-Driven Index and +1.26% for the S&P 500 Total Return Index. Strong earnings announcement (inclusive of increased forward-looking guidance) and deal activity drove returns in May.

Global announced deal volume totaled approximately $464bn in May 2015 according to data from Bloomberg. More than half of that volume came from North America, where announced deal volume totaled approximately $264bn, which is 27% higher than the same period a year ago and the second highest month of announced volume in 2015.

Healthcare names rebound. After experiencing a slight selloff in April, in which some investors took profits given strong YTD performance, the healthcare sector led the way once again in May while the energy sector sold off. Event-driven managers have piled into the sector given the heightened level of corporate activity. Common names such as Actavis, Valeant Pharmaceuticals, and Zoetis all generated strong positive performance in May. Actavis traded higher following strong Q1 earnings and announcing that revenues increased 54% year-over-year. Additionally, it received FDA approval on an irritable bowel syndrome (IBS) drug. Valeant Pharmaceuticals also received FDA approval on an IBS drug that it had acquired via its acquisition of Salix Pharmaceuticals. Zoetis appreciated after the company announced a restructuring plan stating it was focused on increasing operating margins and cutting the workforce.

Healthcare and Energy Sector Cumulative Performance (12/31/2014 – 5/31/2015)

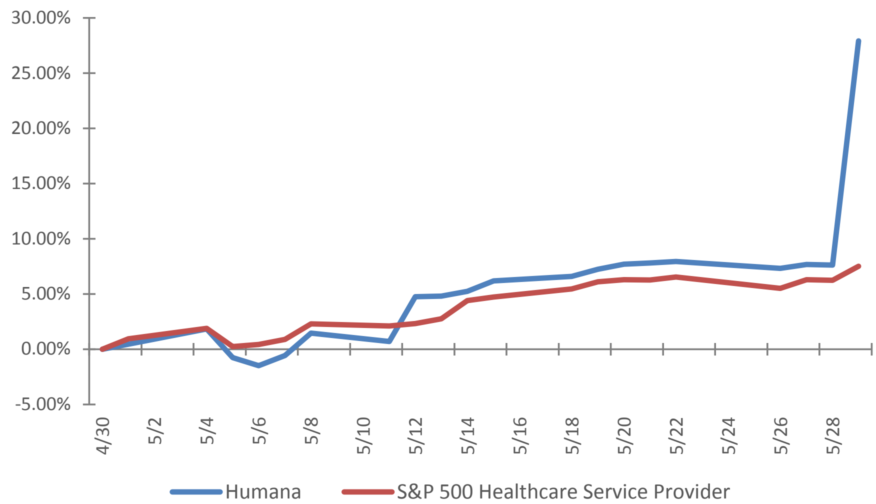


Source: Arden Research, Bloomberg

Biotech and healthcare service provider consolidation. Outside those headlines names, M&A deal activity and speculation drove additional performance. Within the biotech sector, Alexion Pharmaceuticals announced an acquisition of Synageva BioPharma Corp and Endo International agreed to buy Par Pharmaceutical Holdings, while the Pharmacyclics/AbbVie merger closed. Biotech has seen the majority of M&A activity within the healthcare sector in the recent boom, but such a trend could move over to the healthcare service provider sector as health insurers are pressured to find ways to profit from new customers the Affordable Care Act is generating.

During May, speculation arose that Humana was exploring a possible sale, with companies such as Anthem, Aetna, and Cigna as potential acquirers. UnitedHealth remains the largest health insurer by 2014 revenue metrics, according to WSJ, and such a merger could spark further consolidation in the industry. In June, the *Wall Street Journal* reported that Anthem made two takeover bids for Cigna, both of which were rejected, but speculation about the two companies remains.

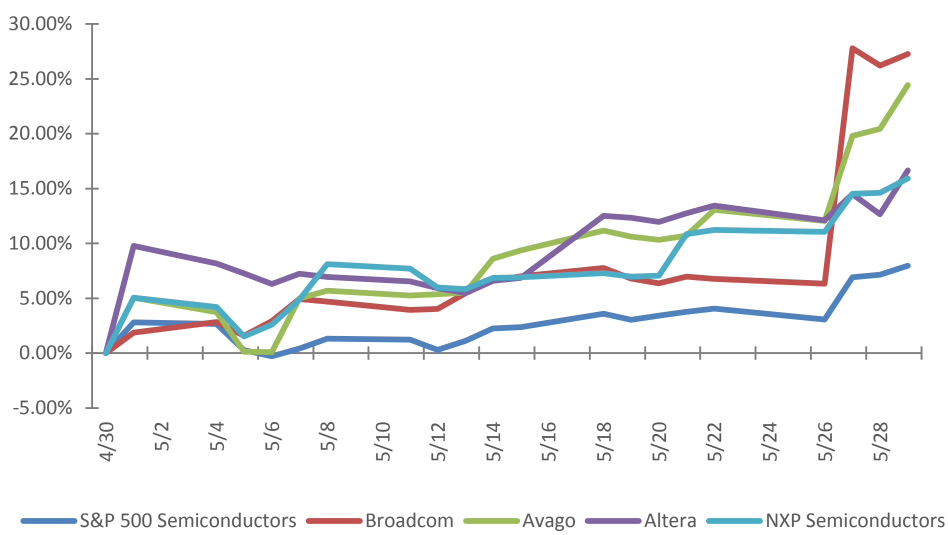
Humana Cumulative Performance (04/30/2015 – 5/31/2015)



Source: Bloomberg

Semiconductor consolidation. The semiconductor industry has been considered ripe for consolidation and May saw an increase in activity. On May 28, Avago Technologies agreed to buy Broadcom Corp for $37bn, marking the largest technology acquisition ever according to Bloomberg. Both stocks appreciated on the announcement. This deal comes after NXP Semiconductors agreed to buy Freescale Semiconductors in March. NXP Semiconductors was a positive contributor in May as the stock traded higher following positive Q1 earnings and the announced sale of its RS Power Unit to a Chinese state-owned investment company to secure approval for its acquisition of Freescale Semiconductors. Additionally, speculation emerged that Intel would attempt to acquire Altera Corp in May and the deal was subsequently announced on June 1.

Semiconductors Cumulative Performance (04/30/2015 – 5/31/2015)



Source: Bloomberg

OUTLOOK

Arden maintains its bullish view on the equity-event landscape. We believe the current market environment remains conducive for strong alpha generation by Arden's current line-up of event-driven managers.

We are mid-cycle in a wave of heightened corporate activity and investors stand to potentially benefit from valuation increases created by strategic actions such as merger and acquisitions, spinoffs, share buybacks, restructurings, recapitalizations, and shareholder activism.

We believe the opportunity set remains robust and has room to grow driven by underlying fundamentals such as high levels of cash on corporate balance sheets, low volatility, cheap financing, and increased boardroom confidence.

We feel the strategy is experiencing a positive feedback loop because management teams are eager to unlock shareholder value and accelerate business growth. Decision makers have gone from the fear of doing deals to the fear of missing out. There is a "now or never" mindset that is fueling acquisitions before interest rates rise.

Arden's conviction stems from extensive analysis on managers we believe are particularly well-positioned to capitalize on this opportunity and the underlying market conditions driving the current M&A cycle.

- Low interest rates and high levels of cash on corporate balance sheets provide cheap and easy access to capital to acquire companies and finance deals.
- Certain sectors are fragmented and ripe for consolidation. Scalability is the driving force behind consolidation as corporations continue to be strategic buyers and agree to mergers in order to better position themselves against peers and defend against increased competition.
- Activists are hungry with large war chests of capital that they are ready to put to work in order to take a large stake in a company, engage management, enact change, and increase shareholder returns.
- We believe the opportunity set in Europe is primed to take off with improving economic conditions and central bank monetary stimulus; European corporates are now under similar pressure to make efficient use of their balance sheets and embark on corporate spending plans. Additionally, with a stronger dollar and weaker euro, US companies are more likely to target European peers.

Risks to the strategy include idiosyncratic deal risk around hard catalyst events. Although we do not expect another AbbVie/Shire 'event' to occur in the near term, regulatory intervention or an idiosyncratic deal break may slow future/pending deal activity. Additional risks include macro events and sharp dislocations in equity markets, which the strategy historically has a high beta component to, especially when there is a light event calendar.

We believe that managers who have shorter duration portfolios and can identify near-term events should outperform in a muted and challenging US equity market environment.

GLOBAL RELATIVE VALUE

EXECUTIVE SUMMARY

May was a solid month for Arden's Discretionary Macro managers, with the largest driver of returns within FX trading. A long US dollar bias continued to be accretive to managers, as the Dollar Index increased +2.14% during May following weakness in April. While the US dollar has not fully recovered all of its April losses, from a technical perspective its 21-day (monthly) and 93-day (quarterly) moving averages both suggest that 2015's strengthening should continue. Arden's managers continue to express long US dollar views versus the EUR, JPY, GBP and several commodity currencies (AUD, CAD and NZD).

Arden's discretionary macro managers were also able to successfully trade interest rates during May, as short biases in the US and Europe proved profitable. Yield curves in the US and Germany both experienced bear steepening, though this was most pronounced in the long-end of the German yield curve where all points on the curve greater than 15-years saw yields rise more than 20 basis points. In the US, the interest rate moves were similar, with all points on the curve rising (or remaining flat) during May.

Trading in equities was mixed among discretionary macro managers, but in aggregate, was a positive contributor. Single name positions were responsible for the outsized equity gains, while index trading was generally the main source of losses for managers. Commodity trading was also mixed, but Arden's managers generally produced gains. Positive commodity performance was driven by shorts in natural gas as well as the agricultural sector, while metals trading was the one area of difficulty for managers.

Arden's Fixed Income Relative Value ("FIRV") managers had strong performance during May, with every Arden-owned FIRV fund producing positive performance. Performance was primarily attributed to tactical micro relative value trading around the end of the May futures contract roll. Regionally, performance was dominated by Japanese and US fixed income markets, while trading in Europe was more mixed as idiosyncratic positions in the periphery detracted. Managers were also able to take advantage of a stronger US dollar and currencies were a significant positive contributor.

Arden's Systematic Macro managers had mixed May performance. Systematic performance was driven by currencies and equities. In a reversal from April, the long US dollar bias was the single largest underlying driver of May performance as the US dollar strengthened versus every major currency during May. Rates trading was again challenging for systematic strategies as models were not able to take advantage of the global rising rate trend that has been prevalent since the end of April. Short-term models continue to underperform longer-term models, as choppy markets are preventing short-term indicators from expressing strong signals.

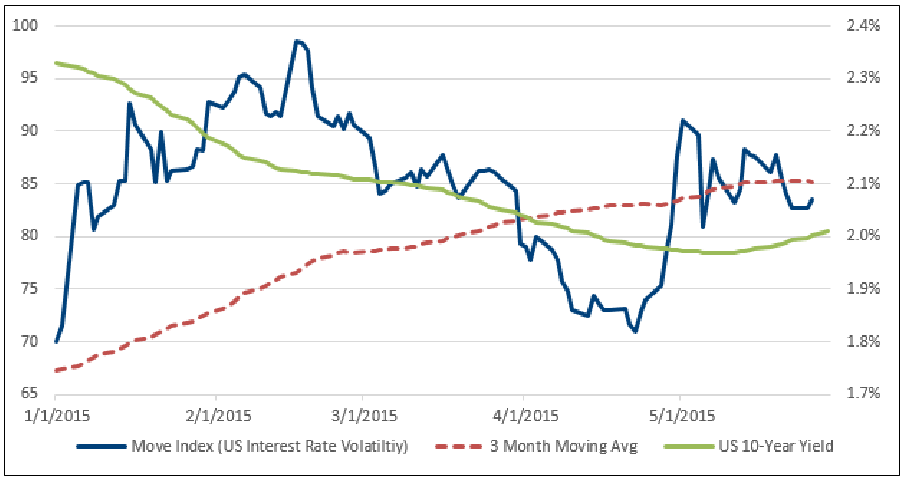
ANALYSIS

Interest rates continue to grind higher. Globally, interest rates continued their late April moves higher resulting in steeper yield curves, particularly in the US and Europe. The US 10-year yield increased approximately 9 basis points (almost 4.5% higher) during May to end the month at 2.12%. However, this was below its intra-month high of 2.29%. It appears that the trend in US rates bottomed in early May, as the three month (93-days) moving average hit a low of 1.97% during the first week and ended the month at 2.01%, signalling that the recent trend higher in US rates was set to continue. Additionally, the US yield curve, along with the European (German) yield curve, steepened furthering the expectation that rates are headed higher. However, it should be noted that the May moves in both the US and European yield curves were smaller relative to the moves that occurred during the last week of April.

Interest rate volatility increased significantly during May, in line with the move higher in US yields. Additionally, the three month (93-days) trend in interest rate volatility continues to move higher along with rates.

MOVE Index (Interest Rate Volatility) and US 10-Year Yield, YTD Performance

As US 10-year yields have increased, so has interest rate volatility and its three month trend.

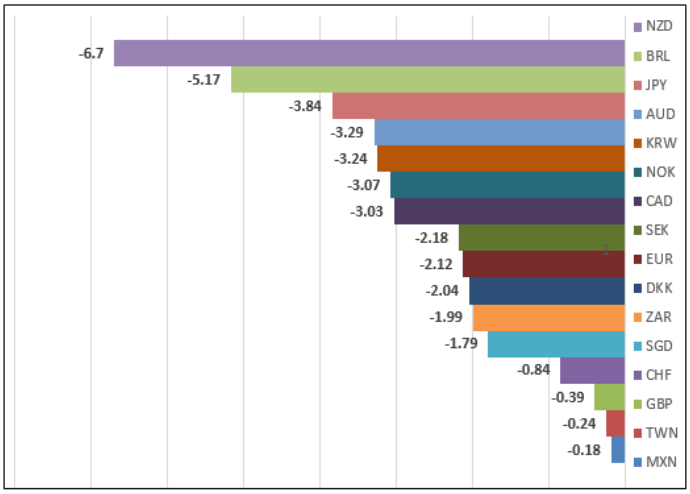


Source: Bloomberg

The reign of the long dollar play. Long positions in the US dollar remain the largest risk factor within Arden's global macro managers' portfolios; this continued to drive profits during May. The US dollar appreciated against every single other major currency during May, with the Dollar Index specifically starting to break out of its range. The dollar's largest gains came against the emerging market and commodity currencies, most notably the NZD, the BRL and the AUD. The dollar's moves against the JPY were also significant, but the majority of Arden's managers had rotated short JPY positions into long Nikkei positions, and therefore did not capture significant contributions from the outsized move.

US Dollar May Performance versus Major Currencies, Spot Returns (%), 4/30/15 – 5/29/15

The USD was stronger versus every other major currency.

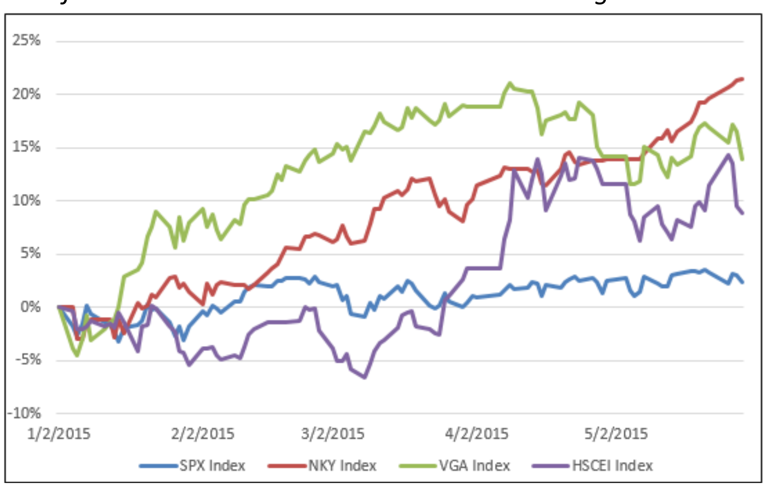


Source: Bloomberg

Globally, equity markets were higher during the month of May with the notable exception of China. The long Europe and Japan versus short US equity theme worked well during the month as the Nikkei and Eurostoxx were up 5.42% and +0.84% respectively, versus the S&P 500's +1.29%. Chinese equities contracted -0.89%, despite the HSCEI reaching an all-time high mid-month.

Global Equity (SPX, NKY, VGA, HSCEI), YTD Performance

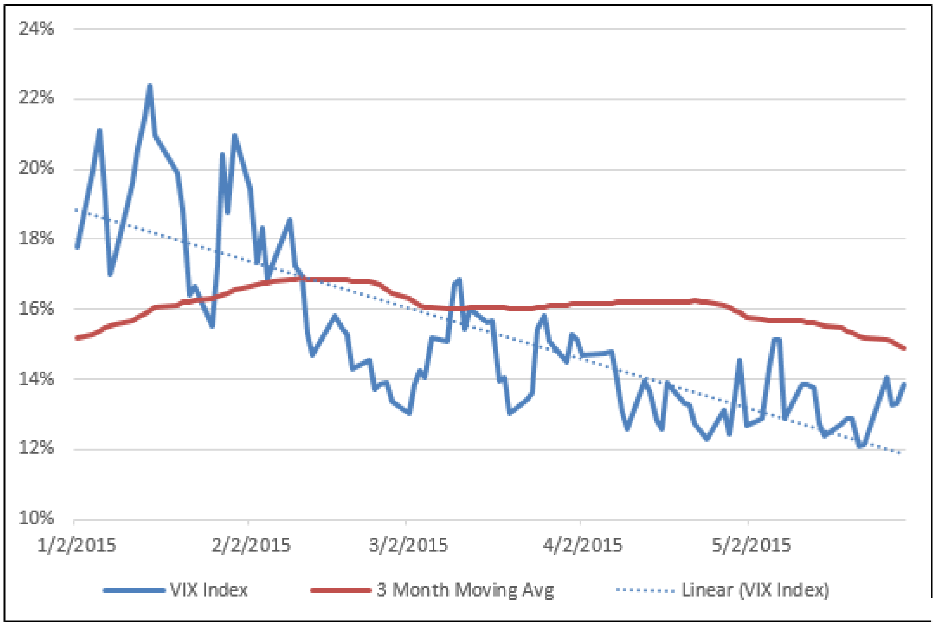
After trading in a downward sloped band since mid-March, the Dollar Index has started to break out towards the higher end of the band as the one and three month averages have exhibited bullish signals.



Source: Bloomberg

Volatility overall continues to decline, as the VIX as exhibited a clear downward trend since the October 2014 spike. Additionally, the 3 month average volatility has been declining since peaking in late February 2015. The VIX's YTD lows continue to drag lower, another negative technical signal. Despite staying elevated YTD, FX volatility is also starting to come down off of its highs. There have been a series of lower highs as well as a 3 month trend that has just begun a gradual descent.

The Volatility Index (VIX)



Source: Bloomberg

OUTLOOK

Overall the outlook for macro remains favorable, with several recent market trends validating our view. We have said for a number of quarters that one of the most dislocated financial markets was the US interest rate market, with volatility and yield suppression occurring in the form of quantitative easing over the prior several years. Over the course of the past 6-8 weeks, however, we have seen a steady increase in implied volatility across the US Treasury market. This has allowed managers to more actively trade the fixed income markets and monetize themes with greater frequency. Recent moves in European rates, Germany's in particular, also highlight the 'increasing volatility' trend. Environments that are characterized by uncertain macroeconomic developments and volatile markets have historically created a robust environment for macro managers; we feel that at this point there is increased probability that the landscape will continue in this regard.

GLOBAL EQUITIES

EXECUTIVE SUMMARY

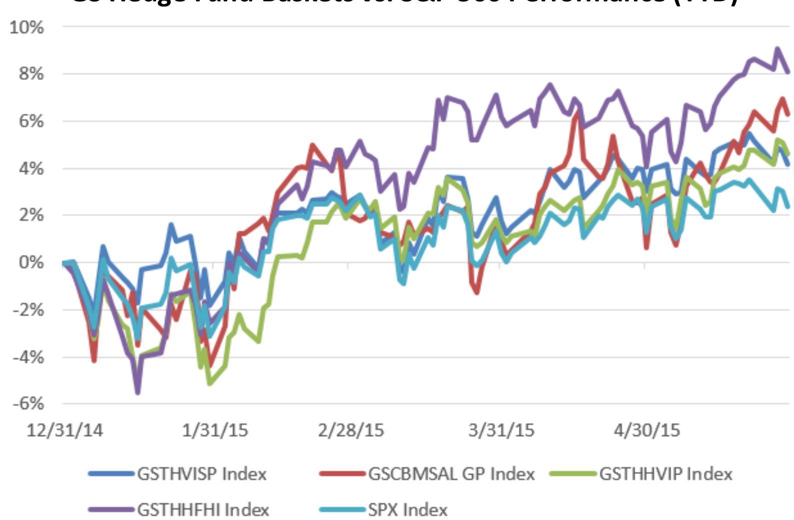
Equity long/short managers had positive performance in May. Attribution was predominately catalyst-driven, particularly in the health care services, semiconductors, and media sectors where consolidation activity caused broad industry rallies. Common individual contributors included Aetna, Avago Technologies, and SunEdison. A short position in Chinese company Hanergy Thin Film was another significant contributor. However, one manager had idiosyncratic losses on long positions in LinkedIn and Workday. Both stocks traded down on earnings, although the manager re-underwrote and continues to hold both positions. Overall, changes to gross and net exposures were negligible. Managers remain overweight sectors experiencing secular change and consolidation, such as media and telecom, and underweight commodity-sensitive industries, such as energy and materials.

Equity market neutral (fundamental and quantitative) managers had mixed performance in May. Growth factors yielded positive performance, particularly in the energy and materials sectors. However, value factors yielded negative performance driven by the health care and industrial sectors. Momentum, size, and leverage factor performance was mixed. Given the rebound in momentum stocks, 6-month momentum had a strong month, yet 1-month momentum was negative. Year-to-date, growth factors are the largest driver of strategy performance. Netflix is one of the top performing growth-oriented longs.

ANALYSIS

Hedge fund industry alpha generation was mixed based on the Goldman Sachs VIP index results in May. On the long side, companies in the S&P 500 most frequently held as a top ten holding in hedge funds as shown by the GSTHHVIP basket increased approximately 2.5% for the month as compared to the S&P 500, which also increased approximately 1.3%. The most shorted HF stocks, as shown by the GSTHVISP basket, increased 1.1%. Stocks with the highest short interest, as shown by the GSCBMSAL basket, increased 5.6%. This surpassed an index of the most concentrated HF longs (by percentage of stock owned) which rallied 3.8% (implying a negative spread of 1.8%) in May.

GS Hedge Fund Baskets vs. S&P 500 Performance (YTD)

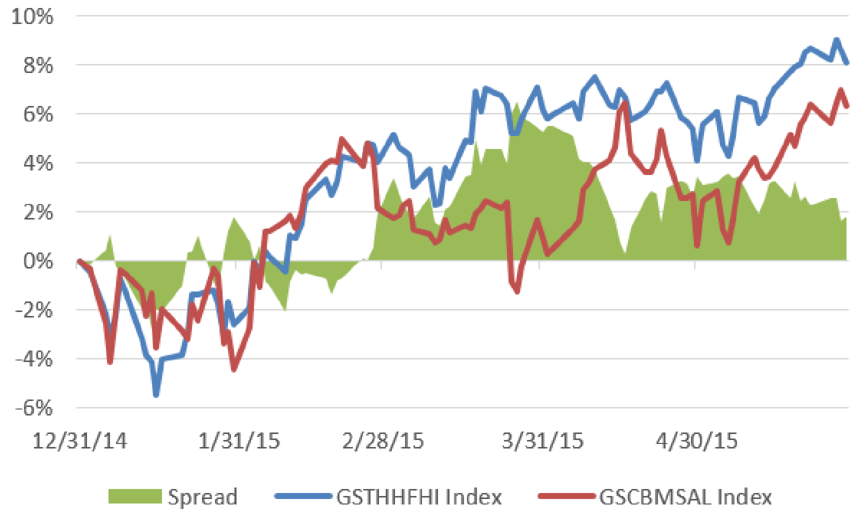


Source: Bloomberg

Notes: GSTHHVIP represents 50 stocks most commonly represented among top 10 HF holdings (based on 13-F data)
GSTHVISP represents 50 stocks with the highest dollar value of short interest outstanding.

Spread between the Most Concentrated HF Longs & Shorts (YTD)

The spread fell 1.8% in May, taking the YTD spread down to 1.7%.

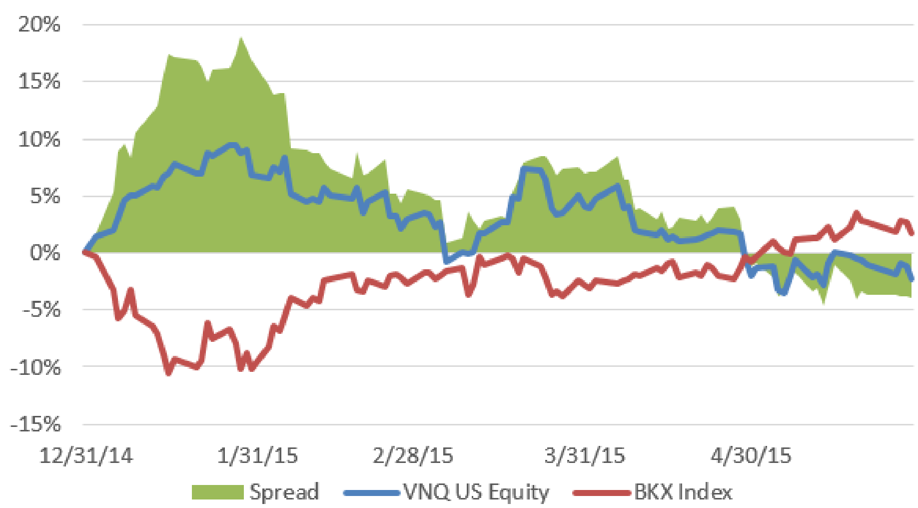


Source: Bloomberg

The financial services rate spread has turned negative as interest rates continue to rise. The spread between the Vanguard REIT Index Fund (VNQ) and the KBW Bank Index (BKX) increased nearly 20% through late January before it reversed, falling all the way to -4% by the end of May. REITs, utilities, telecommunications, and other high-dividend industries may go through a prolonged period of underperformance if interest rates continue to drift upward.

Financial Services Rate Spread (REITs minus Banks)

After increasing nearly 20% in January, the spread has turned negative YTD.



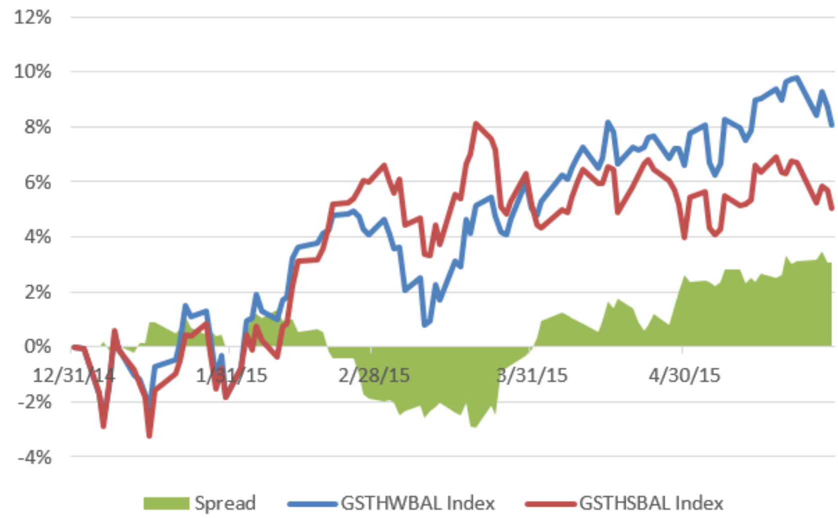
Source: Bloomberg

The New/Old Tech spread increased slightly in May. This positive performance came despite earnings misses from LinkedIn and Workday (both stocks are part of the New Tech index), and consolidation activity in the semiconductors sector. The index market neutral spread is one of 2015's top performing, up approximately 10% through May.

Weak balance sheet stocks outperformed strong balance sheet stocks in May. This trend is common in a rising market. Additionally, the choppiness and flatness of the spread this year is consistent with the choppy and flattish overall market. Quant managers with a long quality bias tend to benefit from a negative spread (i.e., quality outperforms junk).

Balance Sheet Quality Spread (Weak minus Strong)

Quality stocks underperformed in May.



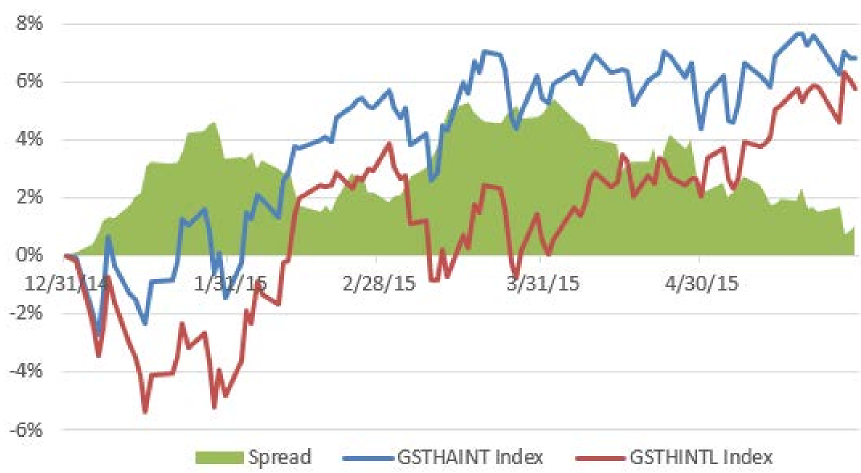
Source: Bloomberg

Note: GSTHSBAL consists of 50 S&P 500 companies across eight sectors with strong balance sheets based on Altman Z-score. GSTHWBAL is a basket of these companies from the S&P 500 which score the worst on these measures.

The sales mix spread declined in May, having decoupled from the USD. This move was somewhat counterintuitive because a strengthening US dollar should penalize multi-nationals with high dependency on foreign sales.

S&P 500 Sales Mix Spread (US minus International)

The spread narrowed further in May despite a stronger USD.



Source: Bloomberg

Note: The GSTHAINT basket contains stocks with more than 95% of revenue coming from the US. The GSTHINTL basket contains stocks with less than 30% of revenue from the US.

OUTLOOK

Equity long/short managers are finally in a fundamentally-driven trading environment where profits are attainable on both longs and shorts. Following a bull market in the U.S. where shorts were a consistent drag on performance, they may possibly now return to being a profit center. Even though macroeconomic uncertainty is a shadow of its former self, managers will need be to cognizant of letting unknowable factor risks such as interest rate sensitivity drive performance. In our opinion, managers who are agnostic to sector and region, let idiosyncratic security selection drive P&L, and have a strong risk infrastructure are poised to outperform managers who take explicit style bets.

Equity market neutral managers continue to face less competition and crowdedness that they did in the past. Multi-PM fundamental best idea products remain an attractive value proposition with leverage and professional risk management. On the quantitative side, however, managers may need to more frequently replace models that exhibit alpha decay. Quant strategies must also manage the additional complexity that comes with using a higher aggregate number of models as cross-models correlations may change over time.

Alternative risk premia managers have an ample opportunity set across asset classes. The biggest risk is the crowdedness of the strategy. The is unlikely to mimic the 2007 quant meltdown, but all of the capital inflows can alter the strategy expectations from high return and low vol, to low return and higher vol.

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