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Strategy snapshot

Our key forecasts for each hedge fund strategy

**EQUITY LONG/SHORT**
Trade wars take aim at markets

**EQUITY MARKET NEUTRAL**
Resilient during hard times

**MACRO**
Macro’s coming home

**CTA**
Is trend still a friend?

**CREDIT LONG/SHORT**
Into injury time?

**EVENT DRIVEN**
Puzzling number of mergers

**DISTRESSED**
Many buyers, few opportunities

**STRATEGY OUTLOOK (NEXT 12 MONTHS)**

<table>
<thead>
<tr>
<th>Positive</th>
<th>Neutral</th>
<th>Negative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Macro</td>
<td>Event Driven</td>
<td>Equity MN</td>
</tr>
<tr>
<td>CTA</td>
<td>Credit L/S</td>
<td>Equity L/S</td>
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<td></td>
<td>Distressed</td>
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**DESIRED STRATEGY ALLOCATION**

- **22.5%** Discretionary Macro
- **15%** Equity Long/Short
- **7.5%** Credit Long/Short
- **15%** CTA
- **20%** Equity Market Neutral

Disclaimer:
Past performance is not indicative of future returns. No assurance can be given that any forecast, investment objectives and/or expected returns will be achieved. Investments come with risk. Investments can fall as well as rise and investors may not get back the amount originally invested at any point in time. Investors capital may be at risk. Allocations are subject to change without notice. Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect.

Source: DWS, as of 30/06/2018.
Letter to investors

Macro’s coming home

Depending on which country you are reading this in, it is more than likely that football has not come ‘home’ yet again however for macro managers, 2018 has represented a particularly positive period for returns. The second quarter of 2018 in particular witnessed a widening of the opportunity set for the hedge fund strategy on which we have the highest conviction. One of the primary drivers behind these returns was the ongoing political situation in Italy after the elections held towards the end of the first quarter. The advent of a populist administration with anti-Euro credentials spooked the market in Italian government bonds where yields shot up while investors sought the relative “safety” of German bunds.

Taking a step back, the emergence of the new US administration 18 months ago has undeniably resulted in a new geopolitical operating environment which translates into greater uncertainty – a healthy environment for certain hedge fund strategies. For the first time ever the US, Russia and China appear to be concurrently challenging the existing order of liberal globalisation. Examples include the incipience of trade wars, the refutation of previously negotiated cross-border non-proliferation deals and opportunistic unilateral dialogue with despots. As investors wait for these challenges to the existing order to find sensible solutions we believe that the ensuing volatility across asset class pricing provides a fertile opportunity set.

Our outlook for equity long/short remains at neutral with the drivers unchanged, namely a flat outlook for market direction but a constructive outlook for stock selection. Our views on market direction are balanced by the one-off corporate tax boost to earnings growth in the US with the increasing threat of a global trade war, which would result in no obvious winners. As the Federal Reserve has become increasingly hawkish during 2018, for markets to enjoy yet another leg up we need a further surprise to the upside.

We maintain our outlook for equity market neutral at neutral/positive with equity market volatility this year trading at or near long term averages. Those approaches that are long less expensive ‘Value’ stocks and short overpriced ‘Growth’ companies have an opportunity to outperform.

As described above the opportunity set for discretionary macro appears to be supportive for returns. Normalisation of interest rates in the US, the probable end of QE in Europe and possible trade wars offer rewards for relative value positioning between developed and emerging markets, the US and Eurozone and core Europe vs periphery.

Our one change in outlook for the quarter is for CTAs where we have adjusted down from neutral/positive to neutral. This has come after a period when CTAs as a whole haven’t appeared to allocate risk optimally, with certain long term trends being monetised but short term trends being problematic.

Our views on liquid credit strategies are unchanged, namely a neutral outlook given the narrowness of current spreads and how late we are in the business cycle. Positive drivers include high corporate cash balances and continued low cost of debt. While the political environment limits some international deals, US domestic deals are getting approved.

In conclusion, we are pleased that our call on discretionary macro this year has so far proved correct and look forward to a more volatile operating environment being supportive of hedge fund returns during 2018.

Source: DWS, Bloomberg as of 30/06/2018.
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Tim Gascoigne
Global Head of Hedge Funds
DWS
A bumpy ride

Equity markets clearly got their elixir in the second quarter from earnings growth, which drove record-breaking corporate earnings. Driven by strong economic growth in the US and lower corporate tax rates, over 75% of S&P 500 companies beat their earnings in the first quarter with the index finishing up 2.9%. Despite the rally from corporate earnings; geopolitical tensions and trade war rhetoric crept back late in the quarter, negatively impacting trade-oriented companies and economies. The increased volatility resulted in wider dispersion, which is a good environment for stock selection. YTD, over 45% of the S&P 500 constituents have moved at least 10%, split evenly between positive and negative territory.

While geopolitical tensions and trade war rhetoric certainly made their mark on investors’ sentiment, they appear to make a bigger dent outside of the US. MSCI Asia ex-Japan lost -6.0% for the quarter, most of which was occurred in June and the MSCI Latin American was down -18.3%. Outside of the trade war fears, investors briefly stepped back to evaluate the elections in Europe, especially in Italy and Spain where political events are moving markets. Against this, the Eurostoxx 600 Index finished up +2.4%.

In fixed income, investors continue to pay attention to the shape of the US yield curve, which has continued to flatten. The potential inverse yield curve was a topical discussion amongst investors during the quarter with the spread between 2 year and 10 year US Treasuries now at 33bps, the tightest spread since the global financial crises. A flight to quality also led investors to other safe haven sovereign credits. For corporate bonds so far this year, higher US rates coupled with geopolitical tensions and technical supply/demand dynamic have caused spreads to unwind most of last years’ tightening. Yet, with low defaults, relatively low interest rates, and robust economic data, spreads remain well below their historical averages.

In FX, after several consecutive quarterly losses, the US dollar saw a strong rally for the quarter, driven by perceived slowing growth outside of the US, and global trade uncertainty. Meanwhile, the CNY lost -3.5% over a two weeks period at the end of the quarter, equivalent to the August 2015 shock devaluation, however this time without the same dramatic impact on the markets. JPY also lost ground against US dollar, but continues to trade in a relatively tight band. In Commodities, oil continued its impressive rally, with WTI at $74/bbl at the end of the quarter, while gold and silver fell -5.5% and -1.6%, respectively.

As we head into the summer months, with Q1 2018 being in the rear-view, the attention is now toward Q2 2018 earnings, with the markets again looking for record numbers. With our CIO forecasting a ‘peak in earnings growth, not peak in earnings’, we can perhaps see earnings delivering another dose of investor euphoria.
Our strategic views

Cautious about market direction

Neutral: We maintain our neutral outlook on equity long short strategies, as we do not believe this is the time to take directionality and market beta risk. Most equity indexes have been range-bound this year and some market commentators believe we are at an inflection point after a near decade long bull market. Our team is relatively ambivalent about market direction forecasts for the next 6-12 months, but we agree that market risk does not look very well compensated right now. As highlighted in previous outlooks, current earnings growth is strong but one should ask what room there is for further surprises to the upside at this point. A number of one-off measures, particularly in the US, have boosted earnings recently: an aggressive tax cut for US corporates supported profitability and cash flows, while capital continues flowing back to investors through a stream of share buybacks, dividends and M&A. We acknowledge that equity markets tend to ‘look in the rear-view mirror’ to extrapolate expectations, but we think right now the ratio between upside potential vs. downside risk is unfavourable and asymmetric. We believe equity market exposure, if any, should be tactical and not structural, therefore we favour managers with variable net exposure. We think this approach is particularly suitable to the current environment in which alpha generation by hedge funds is proving to be relatively strong which makes the case for taking market directionality even less compelling; as investors can turn to market neutral managers to harvest uncorrelated returns.

Neutral / Positive: We maintain our constructive view on equity market neutral as a strategy driven by what we believe is a market environment which offers compelling stock picking opportunities. Our views on market direction are uncertain and in this context equity market neutral strategies thus appear relatively attractive as stock selection continues to be a vital ingredient in order to generate interesting returns. Furthermore substantial stock dispersion can continue to prevail when both valuations and earnings forecasts remain high. On the valuation front the Shiller price earnings ratio is around 32 in the US at the time of writing which, aside from the start of the year, is the highest level since the dot com bubble in 2000. This can put pressure on company management as they seek to meet elevated earnings forecasts in order to justify
share prices. As we move into the late stage of the cycle this is becoming harder to achieve. Last quarter revealed the impact when these expectations are not met when the European Central Bank announced a more dovish than expected path on future interest rates which led to a sharp decline in European financials. At the same time in the US, the rising interest rate environment continues to put pressure on over leveraged companies’ balance sheets. With these factors in play this creates opportunities for strong managers who can identify undervalued stocks on a quality and value basis to go long. Furthermore a number of opportunities exist for managers to exploit on the short side as they identify overvalued, overleveraged companies which appear prone to a correction.

For macro managers, this could yield pockets of opportunities – from potential sources of value where we have seen stock market corrections in China as well as in other emerging market currencies. In commodities we have witnessed the price of certain metals rise which may also present knock on effects to other markets and it’s possible we will see a further liberalisation of trade barriers between countries ex US.

In Europe, we saw the fallout of the Italian election at the end of May which saw a sharp spike in the yields of BTPs. With German bunds appearing to be very overvalued, relative value trades could prove to be profitable for the more discerning managers should we see a reversion to the mean.

2018 has seen sentiment continue to shift. We believe that optimism was arguably too high at the beginning of the year and thus the risk of a market correction has greatly increased as investors realise the synchronised global growth story and goldilocks environment has failed to truly materialise. This shift may prove to be detrimental to strategies sensitive to market direction but for macro managers, we believe it may prove to be the winning goal.

Positive: We maintain our positive view on discretionary macro affirmed by continued uncertainty across trade and regulatory reforms, divergence between central banks and populist movements and what appears to be a general shift in sentiment to the downside. Is this the recipe for the perfect macro environment? While trying to not get ahead of oneself, it really is harder to imagine a more supportive backdrop for macro managers.

In the US, we’ve seen further flattening on the yield curve as the 2 year continues to rise on the back of expectations for further rate hikes however the long end displays relatively acute stubbornness. Previously a flattening yield curve has been a predictor of a recession, signalling that perhaps the FED policymakers have misjudged the extent they should tighten. We believe this creates much uncertainty to trade around, especially at a time also at the core of US is the escalating notion of protectionism. The trade war continues to have a material effect across global markets, however most notably in emerging markets where it has already significantly distorted asset prices.
Neutral: We downgrade our view on CTA strategies to Neutral. We believe that the environment for long term focused systems has been a little better in Q2 with a number of notable trends seen so far such as the rise in energy prices, strengthening dollar, rising US interest rates and falling EM equity markets. Volatility has also remained elevated which we view as a positive performance driver. However, in spite of this supportive backdrop, we have failed to see much traction for the strategy with returns generally being quite lacklustre across managers. We believe the reason for this is due to many of the longer term models generating profits while other models; shorter mean reversion ones in particular struggle. Thus, CTAs are indeed capturing trends but unfortunately, they are also generating negative alpha in other parts of their portfolio.

So will trends persist? Yes. Will all managers consistently capture them? For now, we are less certain. In light of this we have seen much diversification away from traditional trend following approaches and a move towards a more factor based multi-strategy investment framework – often employing relative value approaches vs outright directional bets. Many mangers now utilise machine learning and big data approaches as the norm. It is too early to say whether these approaches will prove to be fruitful but if pure trend strategies are struggling to generate alpha then this broader move to other systematic strategies, is in our view, welcomed. CTAs remain a vital piece of any hedge fund portfolio offering uncorrelated returns and potential downside protection in the event of a sell off but will they generate crisis alpha the way they did back in 2008 or return to delivering consistently high Sharpe ratios, this we are less certain of.

Neutral: We’re maintaining our neutral outlook on credit strategies. During the quarter, renewed trade war fears led a flight to quality to US Treasuries and German Bunds. High yield outperformed investment grade credits, as the higher yield carry offset the impact of higher rates. While corporate credit spreads have widened this year, they continue to be well below the historical averages. So far this year, the story has been one of higher energy prices, improving corporate profits, and tapering of the central bank policies globally, which has led to a higher sovereign yields and lower demand for risky credit assets. The divergence between US central bank policies and rest of the world has also increased the cost of FX hedges, reducing foreign demand for US assets. Much has been said about the shape of the yield curve, which plays a critical role in the performance of credit assets. A by-product of the flattening yield curve is that foreign investors who use short term FX hedges against longer duration USD credits are negatively impacted, further impacting demand. In lieu of the current public market conditions, we have been spending much of our time looking at private credit strategies, which we believe offer a more attractive risk/return profile. Despite the rising popularity of private credit strategies, we continue to find interesting niche private credit opportunities, alongside with managers that are acutely capturing the return premium.

All sources DWS, Bloomberg as of 30/06/2018 unless stated otherwise. Past performance is not a reliable indicator of future performance. Forecasts are based on assumptions, estimates, opinions and hypothetical models or analysis which may prove to be incorrect. Charts correspond to our outlook on each strategy over time with colour code: red = negative, light orange = neutral / negative, orange = neutral, light green = neutral / positive dark green = positive. The information herein reflects our current views only, are subject to change, and are not intended to be promissory or relied upon by the reader. There can be no certainty that events will turn out as we have opined herein.
Neutral / Positive: We maintain our neutral / positive outlook for event driven strategies even if, on the face of it, this should not be the best environment for M&A and corporate activity. With a backdrop of high equity valuations, rising rates, an uncertain regulatory environment, trade wars and political instability in the Eurozone, why should corporates embark on large transformational corporate finance transactions? We think it is a case of history repeating itself: to quote the former CEO of Citi Chuck Prince in a 2007 interview, ‘as long as the music is playing, you’ve got to get up and dance’. As the business cycle continues into a longer-than-average expansion period, corporations are looking to buy growth and unlock shareholder value through M&A, spin-offs, buyback and corporate restructurings. We see a large amount of technological disruption happening today and corporates reacting by acquiring competitors and consolidating sectors in the hope of protecting their profitability. The telecom sector is a good example of a highly profitable industry being disrupted by high-tech new entrants like Netflix and Alphabet with virtually all large incumbents in the space are engaging in some form of defensive M&A and strategic corporate finance including acquisitions, spin-offs and spin-outs. Therefore, the deal flow for event-driven investors is as good as it has ever been and global deal making has reached an all-time high in the first half of 2018, with no signs of slowing down. Having said that, we acknowledge three areas of attention in the event driven space. 1: merger spreads are quite low in absolute terms, a risk we think is mitigated by the high number of deals in the market available for diversification. 2: cross-border deals are facing headwinds from protectionist and nationalist rhetoric. 3: large deal volume in nominal terms masks an increase in average deal size, with ‘megadeals’ becoming more and more common, potentially increasing concentration risk.

Neutral / Negative: It was a muted quarter for the strategy, and we did not hear compelling arguments to change our neutral negative outlook. After an uptick in Q1 2018, the second quarter saw a meagre $1.5bln of defaults, with no defaults at all occurring in June. This is the lowest quarterly total since Q4 2013. Default activity stood at $29.7bln YTD, with the high-yield and loan default rates being 1.98% and 1.99%, respectively, well below the 3.0-3.5% long-term historical average. Despite a relatively volatile quarter in credit, the debt capital market appears to be robust and accommodative to corporate borrowers. We continue to believe that the next distressed cycle will produce plenty of opportunities, which is partly why we’re opting to stay put on the sidelines.
Equity long/short managers who as a rule tend hold portfolios net long to equity markets have had little in the way of “help” from market direction year to date. While the S&P 500 did eke out a small single digit positive return during the first half of the year, this represents a pull back from where it was by the end of the January. A relatively hawkish Fed and concerns over the impact of a trade war have impacted sentiment which has naturally been felt the most in emerging market equities where the greatest losses have been witnessed. While one can always find ways to suggest “cheapness” in equity markets for example vs current global PMI levels, the ambiguity of a possible fallout from a trade war leads us to be cautious hence we maintain market direction as neutral.

However the constructive stock picking environment in which alpha generation by hedge funds is proving relatively strong is forecast to persist. This holds true for both directional equity strategies and for equity market neutral.

Our downgrade for the driver of trending markets is predicated upon our view for very little sustainable direction in equity markets over the coming quarters. While this has led us to downgrade our views for CTAs we maintain a full positive outlook for discretionary macro for the following reasons: substantially higher rates in the US, the end of QE in Europe and possible trade wars. These dynamics offer rewards for relative value positioning between developed and emerging markets, the US and Eurozone and core Europe vs periphery. We maintain the direction of the remaining drivers which impact our views on event driven and credit strategies.

“All our downgrade for the driver of trending markets is predicated upon our view for very little sustainable direction in equity markets over the coming quarters.”

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**Key to arrows:**

- Positive: ↑
- Neutral / Positive: ↑
- Neutral: ➩
- Neutral / Negative: ➩
- Negative: ➩

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Our desired strategy allocation

Uplift in allocation to discretionary macro and tapering of equity long/short

Our starting point for a suggested balanced liquid alternative investment solution is the initial anchor portfolio which is guided by the AUM managed within each strategy across the industry. From there we move towards our suggested top down allocations driven by deliberations on the previous pages.

This quarter’s theme contrasts the elevated opportunities that appear before us for our macro managers in an increasingly uncertain world with a more uncertain outlook for equity markets. In this vein we suggest an uplift in allocation from the current 20% to 22.5% for the former strategy and taking down the allocation to equity long/short from 17.5% to 15%. The allocation to CTAs which we had already reduced last quarter remains at 15%. Our constructive view on event driven leads us to keep it at 20% allocation. EMN remains at 20% and credit long/short 7.5%.

Forecasts for the next 12 months are determined by the 12 month House View. These are anchored by the historical HFR returns over periods where related asset classes have performed in line with the house view. Data as of 30/06/2018. No assurance can be given that any forecast, target or opinion will materialise.
Team biographies

Tim Gascoigne  
Global Head of Hedge Funds  
Tim has been the Head of Hedge Fund Advisory, Alternatives in DWS since August 2013. Prior to this, excluding a year developing the alternative investment business of a UK-based consultancy firm, Tim was Managing Director, Global Head of Portfolio Management at HSBC Private Bank, where he was responsible for the management and performance of HSBC alternative investment products including Fund of Hedge Funds, institutional and private client mandates, which were a significant part of HSBC’s $38 billion alternatives business. Tim is a CFA charterholder and holds a BSc in Monetary Economics from the London School of Economics.

Lorenzo Marchioni  
Senior Research Analyst  
Lorenzo is responsible for investments research in the Hedge Fund Advisory team in London. Before joining DWS Lorenzo had a similar role at Tages, a boutique asset manager. Lorenzo was responsible for the Mergers & Acquisitions strategy of Tages Group and was formerly a private equity investor at Clayton Dubilier & Rice, researching investment opportunities in Europe. Lorenzo holds a Master Degree in Finance from Bocconi University and started his career at Credit Suisse in the European Mergers & Acquisitions team.

Ben Arnold  
Research Analyst  
Ben is an Associate in the Hedge Fund Advisory team joining the team two years ago where he now specializes in quantitative research and portfolio construction. Ben has previous experience working in Credit Trading and Equity Derivatives at Morgan Stanley. Prior to joining DWS, he completed an MSc in Finance at Imperial College London. Before that Ben gained his Masters in Aerospace Engineering from the University of Bristol specializing in trajectory optimization and mission planning for mining near earth asteroids.

Mihir Meswani  
Senior Portfolio Manager  
Mihir is a Senior Portfolio Manager in the Hedge Fund Advisory team based in New York. He has 22 years of industry experience, the vast majority in analysing and managing institutional portfolios specifically in the alternative investment segment. Prior to joining the firm in 2014, Mihir was Chief Investment Strategist at Sandalwood Securities, a credit oriented fund of funds, where he invested capital with credit and distressed funds. Mihir was a member of Investment Committee with direct responsibility for the portfolio management of Sandalwood’s fund of hedge funds and alternative mutual fund portfolios. Mihir previously held a position at the Robert Wood Johnson Foundation, a USD10 billion U.S. based foundation where he served as Director of Investments. In that capacity, Mihir had oversight over the Foundation’s allocation to hedge fund and credit strategies. Mihir has also held senior positions at Bank of America as Head of Outsourced Proprietary Trading, and J.P. Morgan as Portfolio Manager covering long/short equity strategies. Mihir holds a B.S. in Finance and a B.A. in Economics from Rutgers University.

Jack Truong  
Research Analyst  
Jack is a Research Analyst in the Hedge Fund Advisory team at DWS in New York. Prior the current role, he worked in the Global Investment Group as part of the Hedge Fund team within Deutsche Asset & Wealth Management. Previously, Jack was a Credit Analyst at Nomura Securities, covering hedge funds and mutual funds. He also has previous experience at Morgan Stanley in hedge fund administration. Jack holds a B.S. degree in Finance from Fordham University in New York.

Robert Hayward  
Research Analyst  
Robert is an Analyst in the Hedge Fund Advisory team in London. Prior to this Robert was at the University of Bath where he gained a BSc in Economics winning the Neil Farmery Prize for outstanding work in quantitative economics. Within his degree Robert spent 13 months working at the Pension Protection Fund in London within Economic Research. During this Robert assisted with economic outlooks, credit risk models, and deep dives of multiple portfolios including Hedge Fund strategies.
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Q3 2018 OUTLOOK

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