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Landscape and Recent Developments in Event Driven Strategies

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I. Introduction

In recent years, event driven hedge fund ('HF') strategies have been some of the most consistently in demand[1] among investors. The continued hangover of the 2008 financial crisis, combined with a buildup of cash on corporate balance sheets and cheaply available financing, created a seemingly rich opportunity set for event driven managers to capitalise upon, and we will show in this content piece that investors flocked to event driven HFs, investing record amounts over the three-year period from Q3 2012 to Q3 2015.

However, during the recent performance challenges faced by the HF industry that began in the second half of 2015, event driven managers have been among those most adversely affected, making investors' decision to pour money into the strategy look – at least at a first glance – somewhat unjustified.

It was this disconnect – between investor demand and subsequent performance – that encouraged us to look more closely at event driven strategies. We wanted to understand whether, on the basis of long-term performance, stand-alone event driven HFs merit a place in investors' portfolios – and if so, what is behind the recent underperformance: was this a blip or a sign of structural challenges faced by event driven HFs? Lastly, in light of recent developments, we wanted to see if investors are still enthused about event driven HFs – and what event driven managers should prepare themselves for in terms of asset raising in 2016.

The following are key questions that we address in this study:

1. **Event driven landscape**
   a. What is an event driven HF? Which strategies do event driven managers employ?
   b. How have assets in event driven strategies evolved? How does this growth compare with other HF strategies?
   c. How have event driven funds performed compared to the broader industry?
   d. How much 'alpha' have event driven funds generated historically? How does their typical return profile compare to other strategies?
   e. How are assets in event driven strategies divided, based on the geographical focus of investments? Has performance of event driven HFs varied by their geographical focus?
2. **Sub-strategy analysis**
   a. How has performance varied across various event driven sub-strategies (merger arbitrage, special situations, distressed, activist, and multi-strategy event) over time?
   b. What does the return profile of each of these sub-strategies look like? When do they perform well? How often do they generate significant losses?
   c. How correlated to one another are event driven HFs in each sub-strategy?
   d. What does recent performance look like for the different event driven sub-strategies? What might explain some of the recent challenges to event driven HF performance?
3. **Investor perspective and outlook**
   a. How have event driven funds performed relative to investor expectations?
   b. What factors do investors and managers attribute recent performance challenges to?
   c. In light of recent performance, what are investors most focused on when thinking about event driven manager selection?
   d. What are the expected changes to investors' HF allocations in 2016? Which sub-strategies in event driven are likely to be the winners and losers in any reallocations?

Methodology

With these questions in mind, the Strategic Consulting team sought input from 15 event driven HF managers and nearly 300 investors accounting for ~$7.5tn in total AUM. More specifically, data inputs for the study included:

- One-on-one interviews in Q1 / Q2 2016 with ~30 investors that have ~$1tn in total AUM and survey input in Q2 2016 from 258 investors with ~$6.5tn in total AUM. In aggregate, the investors we received input from account for ~$580bn in HF AUM – roughly 20% of all assets invested in HFs globally.
- One-on-one interviews with 15 HF managers with a total of $92bn in AUM, with an even split across small (<$1bn), mid-size ($1 – $5bn) and large ($5bn+) firms
- Aggregated 13F filing data compiled by Novus[2] on the long equity holdings of HFs
- External research, publications, filings, including ~2,000 data points on HF returns (Hedge Fund Intelligence (HFI), Hedge Fund Research (HFR), Barclay Hedge and Hedgefund.net / EVestment database)

Figure 1 depicts the distribution of the investors we interviewed or surveyed by investor channel, geography and size, and the profile of manager participants by size.

II. Executive summary

Event driven landscape

- Event driven HF strategies comprise five underlying sub-strategies, all focused on capitalising on opportunities in corporate events: merger arbitrage, special situations, distressed, activist and multi-strategy event driven (a combination of more than one event driven strategy sleeve).
- Event driven has been the fastest growing strategy in the HF industry since 2000, with a CAGR of 17%; it now represents over a quarter of total industry assets. Within event driven HFs, activist and multi-strategy event have been the fastest growing sub-strategies.

1. In 2015, investors surveyed in our annual outlook listed 'event driven – equity' as the most likely to see increased allocations; in 2014 it was the second most likely to attract higher allocations. Source: Barclays Strategic Consulting reports 'What Lies Beneath' and 'Waiting to Exhale'

2. Novus is a service provider (unaffiliated with Barclays) that provides industry intelligence to institutional investors and asset managers

- It has also been one of the best performing strategies on a risk-adjusted and absolute basis over the last 10 years, outperforming equity L / S and the broader industry. However, this gap has narrowed of late.
- Based on our estimates, event driven HFs have generated an average of 5% per annum of annualised 'alpha' net of their market exposure – a significant outperformance when compared to equity L / S HFs; they also have a differentiated distribution of returns versus the broader industry.
- Geographically, event driven HFs appear to be have a preference to focus on specific geographical regions (versus investing globally), and in particular have a strong skew toward the US, geographically. US-focused HFs have underperformed their peers over the past 18 months, possibly reflecting 'crowding' challenges.
- On average, event driven HFs are much larger than the average HF (more than twice as large); this is driven in particular by the size of special sits and activist HFs. Recently, the largest event driven HFs also appear to have underperformed their smaller peers.

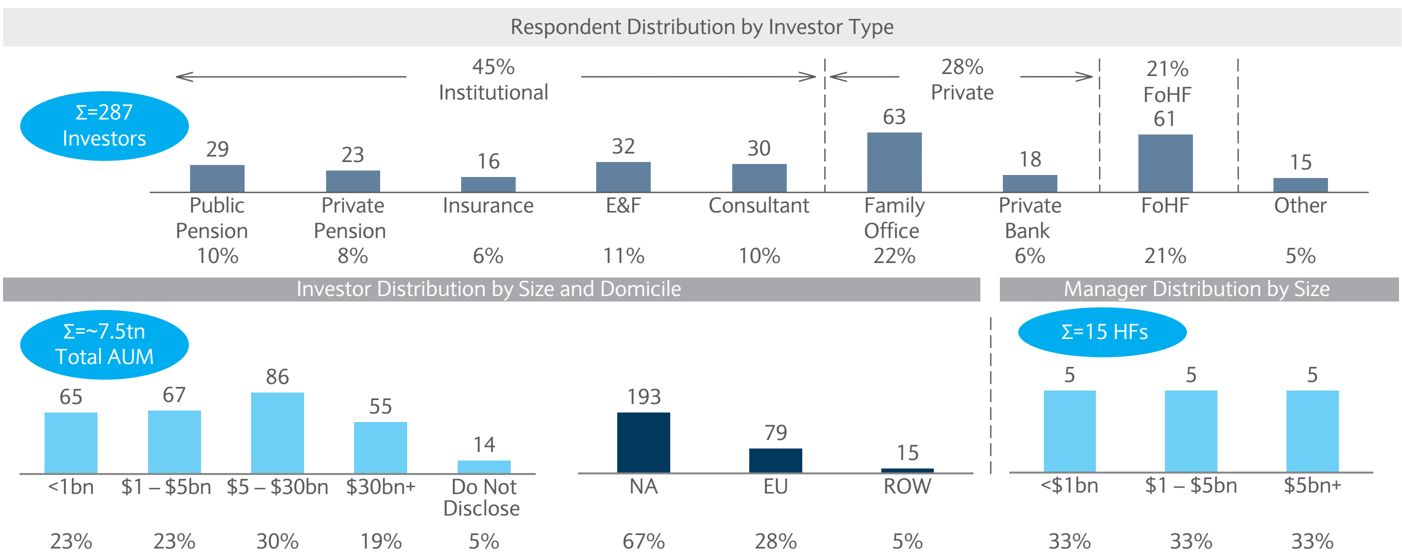
Sub-strategy analysis

- Over the last 10 years, merger arbitrage and multi-strategy event HFs have had the best risk-adjusted returns within event driven; distressed and special sits HFs have lagged the overall strategy average.
- The return profiles merger arbitrage and multi-strategy event HFs deliver are also significantly different – merger arbitrage has the lowest absolute returns but these have been generated in a much steadier fashion versus activist and special sits, which tend to have much larger drawdowns in difficult markets.
- However, on an individual HF level, it is merger arbitrage and distressed HFs which historically have been most prone to delivering '3 sigma' down months.
- The level of correlation between HFs within each sub-strategy is lower for event driven broadly than for traditional equity and credit L / S HFs; merger arbitrage and distressed HFs have the lowest level of intra-strategy correlation, suggesting these HFs capture idiosyncratic risks well.
- Recent event driven performance (since 2H 2015) has been challenged, particularly for activist, special sits and distressed HFs. It appears that much of this may have been driven by problems of crowding in US special situations names, losses in energy, and the turning of the credit cycle in distressed.

Investor perspective and outlook

- The majority (two-thirds) of investors we surveyed felt that performance of their event driven HFs has been below expectations over the last 12 months.
- Investors tended to primarily hold crowding and energy exposures responsible for performance challenges in their event driven portfolios; a bias toward value stocks and the impact of new regulations on M&A, as well as broader macro issues, shouldered the blame.
- In light of recent issues, investors are now particularly focused on identifying event driven managers that are able to identify unique ideas, have long tenure in markets and a solid pedigree, and that have demonstrated strong risk management.
- Only one-quarter of investors we surveyed plan to increase their event driven exposure over 2016, with most looking to keep their allocations unchanged and about 15% looking to reduce their exposure. Within sub-strategies, we expect distressed and merger arbitrage HFs to benefit from net inflows, while special situations and multi-strategy event HFs will likely see small outflows, and activist HFs should expect to have to deal with significant net outflows in the coming months.
- We believe that there will still be significant (~$65bn) money-in-play for event driven managers as a result of reallocations and new inflows, although event driven as a whole will likely see net outflows (~$10bn).

FIGURE 1: Participant Profile



Source: Strategic Consulting survey results only; Note: The results presented are from a relatively small number of respondents and therefore are indicative only and not meant to reflect conclusive industry trends. Data and other information presented are derived directly from respondents and we cannot confirm the accuracy of such information

III. Event driven landscape

What is event driven?

- To begin, it is worth clarifying what 'event driven' HFs are. In broad terms, event driven HFs aim to exploit opportunities around corporate events, either related to specific announced transactions or other substantial corporate changes. There are several sub-strategies that comprise the event driven universe, outlined below and in Figure 2:
  - Merger arbitrage: These HFs employ investment strategies focused on the equity instruments of companies involved in announced merger / acquisition transactions. They have little or no exposure to situations where no formal announcement is expected.
  - Special situations: These HFs invest in both announced transactions and situations with no formal announcements – for example, security issuance / repurchases, asset sales, division spin-offs – and may invest across the capital structure of these companies (not just equity).
  - Distressed: This describes HFs focused on making investments in corporate fixed income instruments, typically those of companies trading at significant discount to their face value due to financial distress or bankruptcy. They tend to be primarily credit-oriented but may also invest in equity (for example in post-reorganisation situations).
  - Activist: These funds use their shareholdings try to obtain representation in or influence over a company's board of directors in order to improve the firm's policies or strategies with the aim of driving an increase in the share price.
  - Multi-strategy: These HFs employ a combination of two or more of the strategies listed above.

Together, these strategies account for nearly 1,100 funds, which between them have ~$745bn in AUM. The largest by assets is the special situations category, which accounts for nearly half of all of the assets and a third of the funds; distressed is a reasonably distant second, with around a quarter of overall assets. These two strategies between them make up 70% of event driven AUM. The smallest strategy, with just 3% of the AUM, is pure-play merger arbitrage. While other funds in the broader event driven strategy do employ merger arbitrage, the subset of funds focused solely on these opportunities is actually fairly small.

Evolution of event driven assets

As mentioned at the outset, event driven has been one of the most popular strategies among investors lately; however, looking at the evolution of assets in event driven funds since 2000, as shown in Figure 3, it is apparent that this is not just a recent trend. Since 2000, assets in event driven funds have increased more than tenfold, from $70bn to well over $700bn. In fact, event driven has been the fastest-growing strategy in the HF industry since 2000, with a Compounded Annual Growth Rate (CAGR) of 17%, outpacing Relative Value (RV) and macro funds by a small amount, and equity hedge funds significantly.

It is also worth noting that there have only been two years in which event driven funds on aggregate have lost money: in 2008, driven by a mixture of negative performance and outflows (as was the case for the whole industry), and then again in 2015, but this time just as a function of performance – event driven still had net inflows in 2015.

FIGURE 2: What Is Event Driven?

Sub-strategy	2015 Composition: # of funds	2015 Composition: Assets	Main Attributes
	Σ 1,082	$745bn	
Merger Arbitrage	10%	3%	• Typically involves M&A transactions • 'Hard' Catalyst driven • Equity oriented
Special Situations	32%	47%	• Includes security issuance / repurchase, asset sales, division spin-off, etc. • 'Soft' or 'Hard' Catalyst driven • Equity and Credit oriented (mostly Equity)
Distressed	27%	23%	• Involves bankruptcy, reorganisations, post re-org. equity, leveraged loans, liquidations, etc. • Credit and Equity oriented (mostly Credit)
Activist	7%	17%	• Advocates division / asset sales, corporate divestiture, dividend / share buybacks, management changes, etc. • Equity oriented
Multi-Strategy	17%	9%	• Exposure to multiple event driven sub-strategies

Source: HFR, Strategic Consulting analysis. Note: Other niche strategies (Credit Arb and Reg D) account for 7% by number of funds and 1% by assets

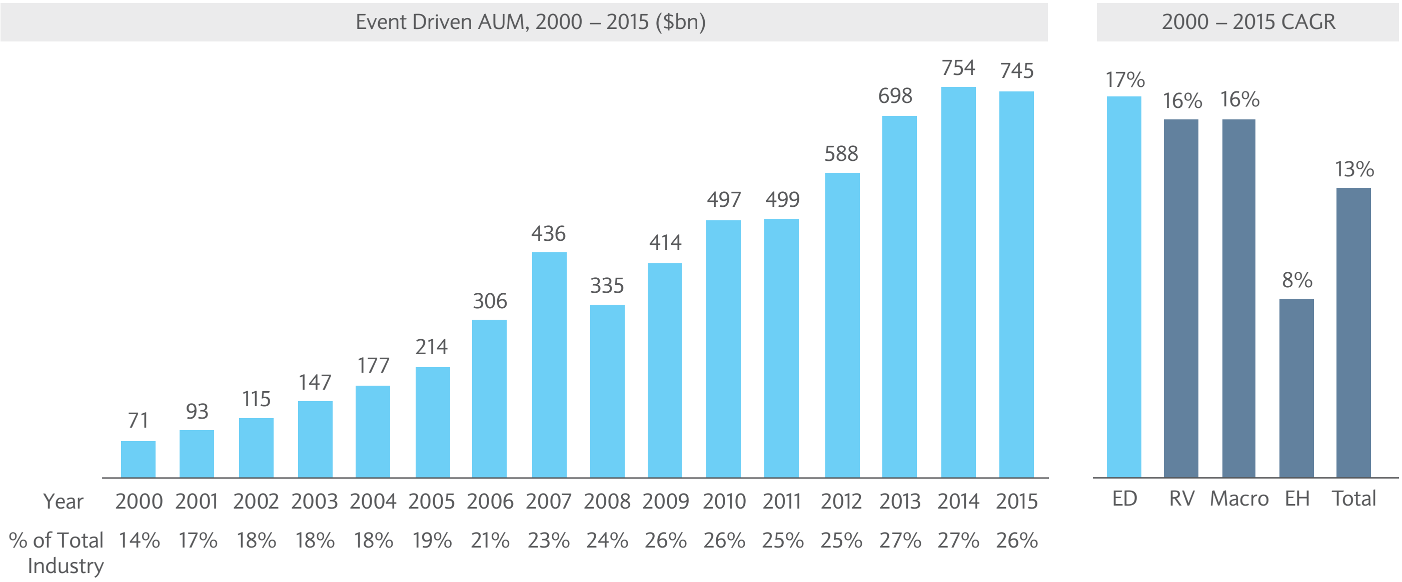
As a result of this rapid growth, event driven funds now (end of 2015) account for 26% of industry assets, up from 14% in 2000. As Figure 4 illustrates, this growth has come largely at the expense of equity hedge funds, which have seen a decline in their share of industry assets from over half to just over a quarter in the same period of time.

Within the sub-strategies of event driven, it has been activist and multi-strategy event that have seen the biggest gains, with the proportion of assets in activist funds more than quadrupling, while the assets in multi-strategy event driven funds have roughly tripled.

Event driven performance

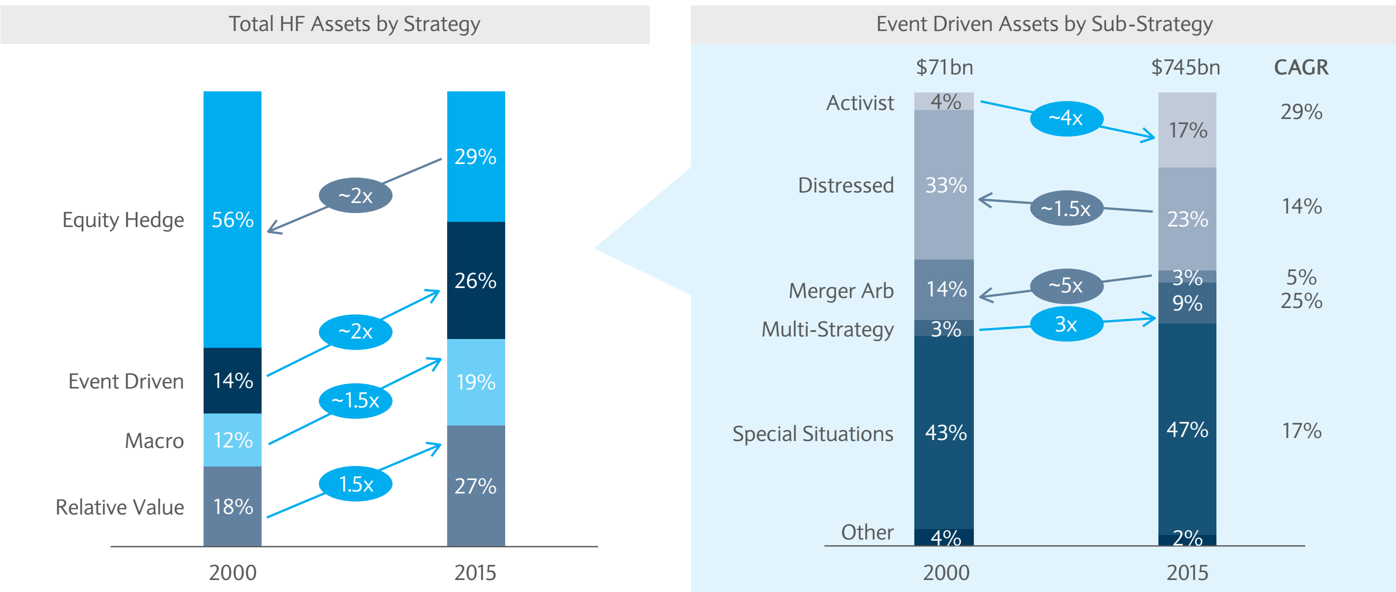
Over the last 10 years (2006 – 2015), event driven hedge funds have actually been one of the best performing hedge fund strategies, in line with their asset growth. As Figure 5 shows, event driven funds have had an annualised return of 6.7% – versus 4.1% for the broader industry and 3.5% for equity HFs – along with a lower level of volatility. Moreover, looking at the rolling annual event driven performance, it appears that the strategy has tended to do best on a relative basis in recent times of market stress – in 2008 and 2011 it appears to have weathered market turmoil relatively better than the overall HF industry.

FIGURE 3: Evolution of Event Driven Assets



Source: HFR, Strategic Consulting analysis

FIGURE 4: Share of Total Assets



Source: HFR, Strategic Consulting analysis

Given that a not insignificant component of HF returns can be explained by their market exposure, we also looked to isolate the component of returns not attributable to their market exposure – a rough proxy for 'alpha'. To do this, we first estimated the average market exposure using both equities and high yield bonds[3] and then adjusted returns lower based on this exposure; the residual return is a reasonably good indicator of the performance not explained by market exposure. The evolution of this excess return or 'alpha' in the last 10 years (2006 – 2015) is shown in Figure 6, where it is compared to the returns of equity HFs, also net of their market exposure. On this measure, too, event driven funds seem to compare favourably to equity HFs, generating 4.6% annualised net of their market exposure, versus 2.8% for equity HFs. There are also some notable periods of differentiation between the excess returns of the two: for example, in the 2008 crisis when the rolling 12-month 'alpha' of equity HFs turned significantly negative, event driven funds turned in only one negative month.

However, event driven HFs have seen a similarly significant diminution of their level of returns, net of market exposure, when compared to equity HFs: over 2014 – 2015 their annualised 'alpha' has essentially been zero, and at some points has even turned negative.

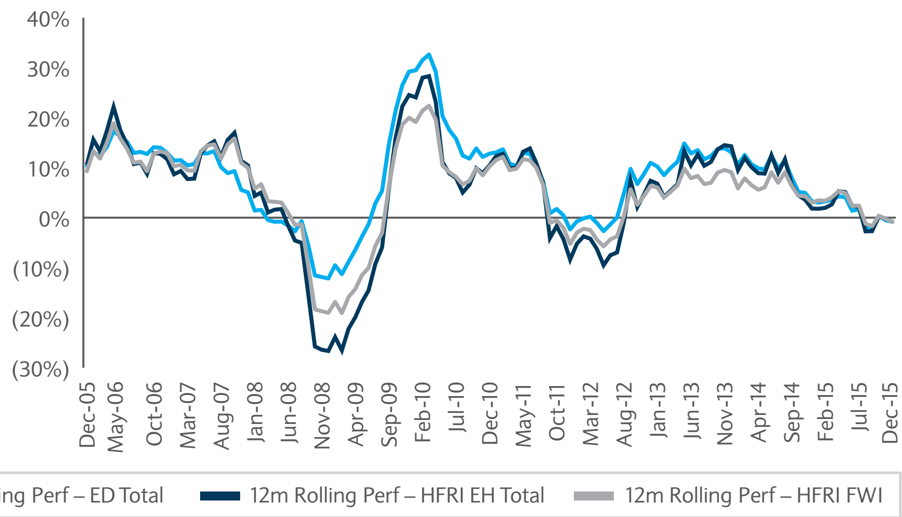
3. Exposures calculated using a multiple regression; calculated exposure of 0.19 to the Barclays HY US Corporate TR index and 0.22 to the S&P 500 (coefficients determined via regression analysis) for event driven funds, and net of a constant exposure of 0.40 to the S&P 500 for equity L / S funds.

FIGURE 5: Event Driven Performance vs. Other HF Strategies

HF Strategy Performance, Annualised, 2006 – 2015

Strategy	Return	Vol	Sharpe
Event Driven	6.7%	5.8%	0.82
Equity Hedge	3.5%	8.7%	0.18
Total Industry	4.1%	6.3%	0.33

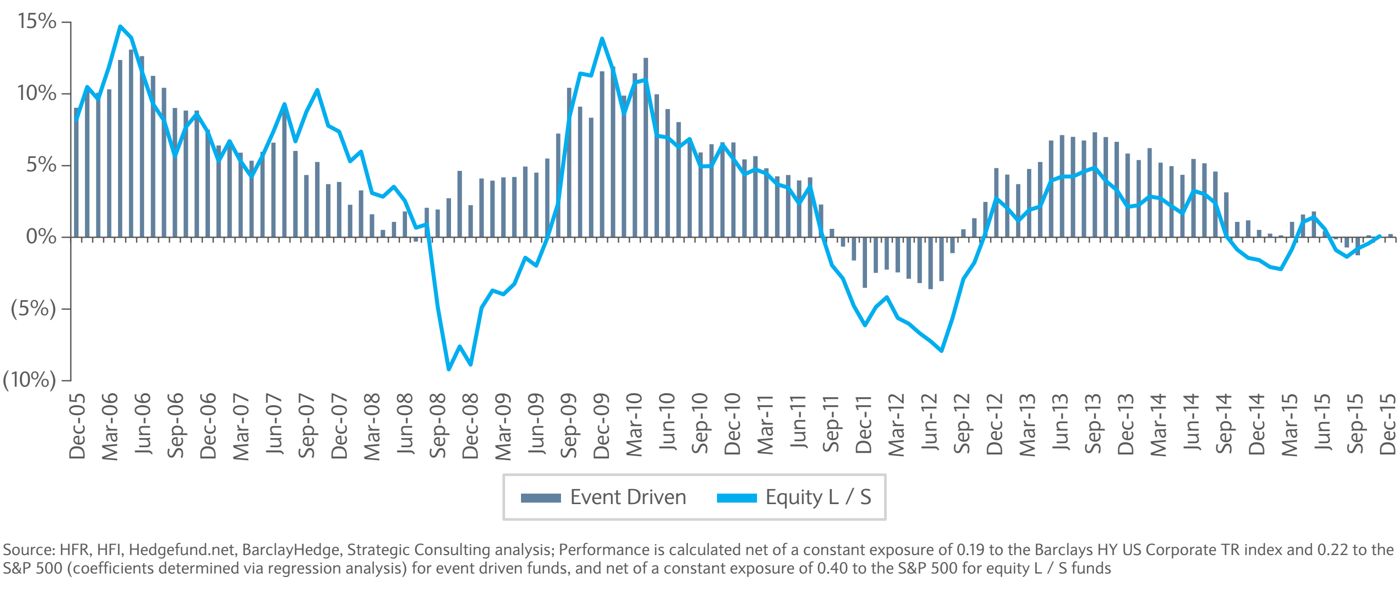
12m Rolling Event Driven Performance vs. Total and Equity HF Performance



Source: HFR, HFI, Hedgefund.net, BarclayHedge, Strategic Consulting analysis; HFRI Fund Weighted Index used for Total HFs; HFRI Equity Hedge Total Index used for Equity HFs

FIGURE 6: Event Driven 'Alpha' Generation

12m Rolling Event Driven Performance Net of Market Exposure, 2006 – 2015



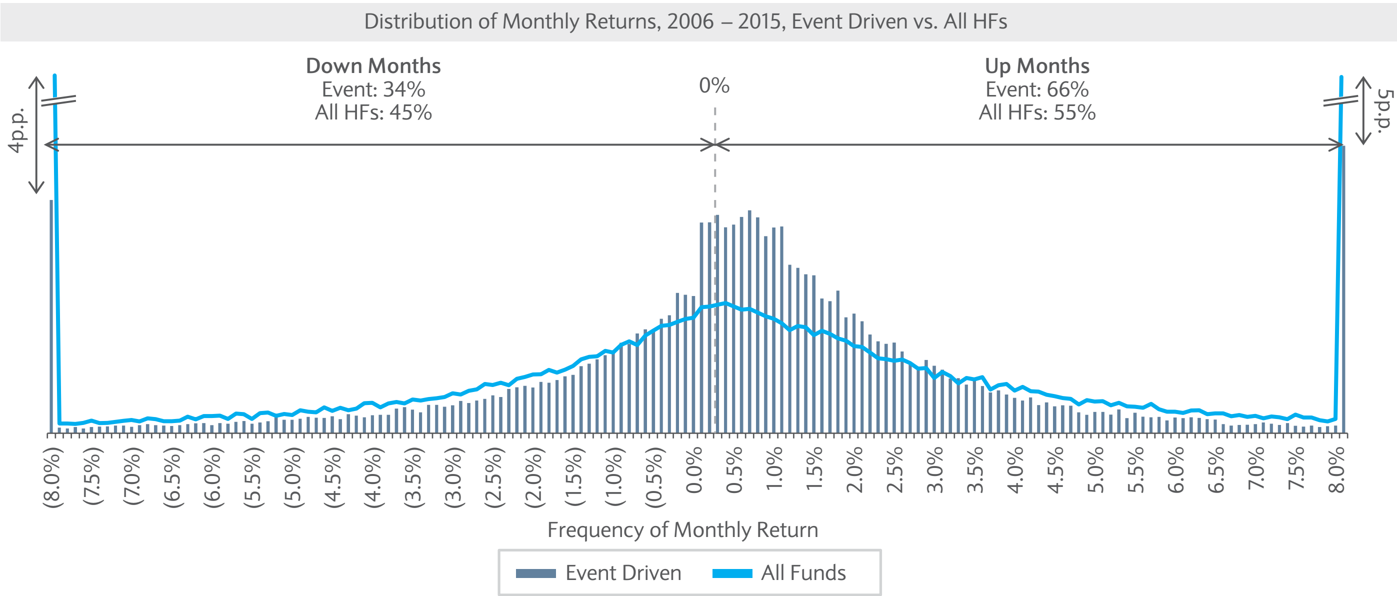
Source: HFR, HFI, Hedgefund.net, BarclayHedge, Strategic Consulting analysis; Performance is calculated net of a constant exposure of 0.19 to the Barclays HY US Corporate TR index and 0.22 to the S&P 500 (coefficients determined via regression analysis) for event driven funds, and net of a constant exposure of 0.40 to the S&P 500 for equity L / S funds

One other noteworthy difference is in the distribution of monthly returns of event driven HFs when compared to the broader industry in the last 10 years. As shown in Figure 7, there appears to be much more of a positive skew in the monthly returns of event driven HFs (with 66% of positive return months, versus 55% for the industry overall), as well as a much greater concentration of monthly returns in the 0% to +2% range. Event driven funds also have considerably smaller 'fat tails' at either end of the distribution, suggesting that they are generally less prone to generating 'outsized' monthly returns – both to the upside and downside.

Regional focus

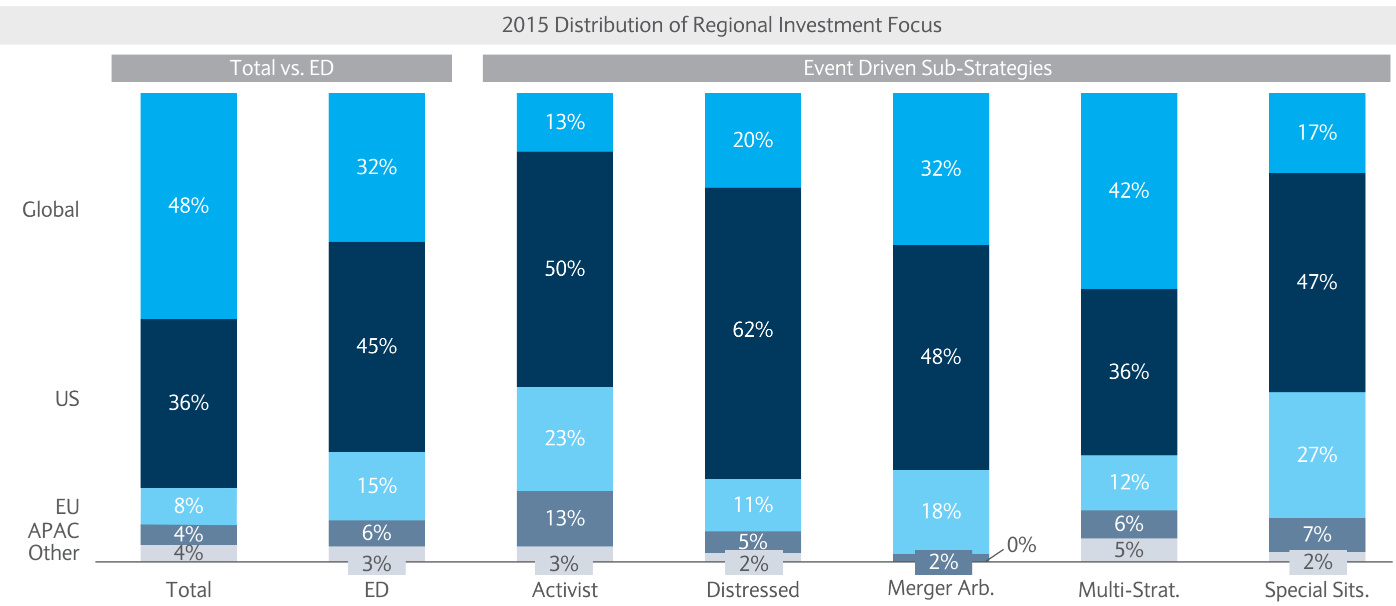
One other interesting characteristic of event driven funds is the difference in the geographic investment focus versus other strategies. As Figure 8 shows, across the overall HF industry, almost half of assets are in funds with a global investment focus (i.e., they look for investments across the entire globe), with the other half splitting their investment focus between the four main regions (US, EU, APAC, Rest of World), with the US, unsurprisingly, accounting for the largest amount of assets.

FIGURE 7: Distribution of Monthly Returns



Source: HFR, HFI, Hedgefund.net, BarclayHedge, Strategic Consulting analysis

FIGURE 8: 2015 Distribution on Regional Investment Focus



Source: HFR; Barclays Strategic Consulting Analysis

Within event driven, however, only around a third of assets are in global strategies, while 45% are focused on the US, the largest segment of all. Europe- and Asia-focused funds also account for much larger proportions of assets than in the broader HF industry.

Certain sub-strategies tend to be particularly skewed to the US – notably activist and distressed – while special situations funds have the strongest European skew. Multi-strategy funds, as one would expect, have the highest proportion of assets with a global focus – much nearer to the overall industry average.

This difference in terms of regional focus is an important one for investors in event driven to consider, because as Figure 9 shows, in the last 10 years (2006 – 2015), it actually appears to have had a noticeable effect on performance.

The difference in performance is not one that can be fully explained by the different sub-strategy splits between regions, either. Although the heavier weighting toward, for example, distressed strategies in the US probably does have a certain impact, the underperformance actually exists within the sub-strategies on a regional level. US special situations funds in particular have struggled from the second half of 2014 onward.

Given both the fact that US-focused funds are the largest component of the event driven industry and the fact that they have underperformed on a relative basis, there is much to suggest that investors in event driven may benefit from increased regional diversification in their allocations.

Fund size

Event driven also differs substantially from the rest of the industry in terms of fund size. The average event driven fund size, as shown in Figure 10, is more than twice that of the average HF, at nearly $700mn, versus ~$350mn. Much of this difference is driven by a couple of the sub-strategies in particular – namely activist and special situations, which have an average fund size of $1.5bn and $1.0bn, respectively. This means that, proportionately, investors in event driven have a greater exposure to the largest funds than is the case across the HF industry at large.

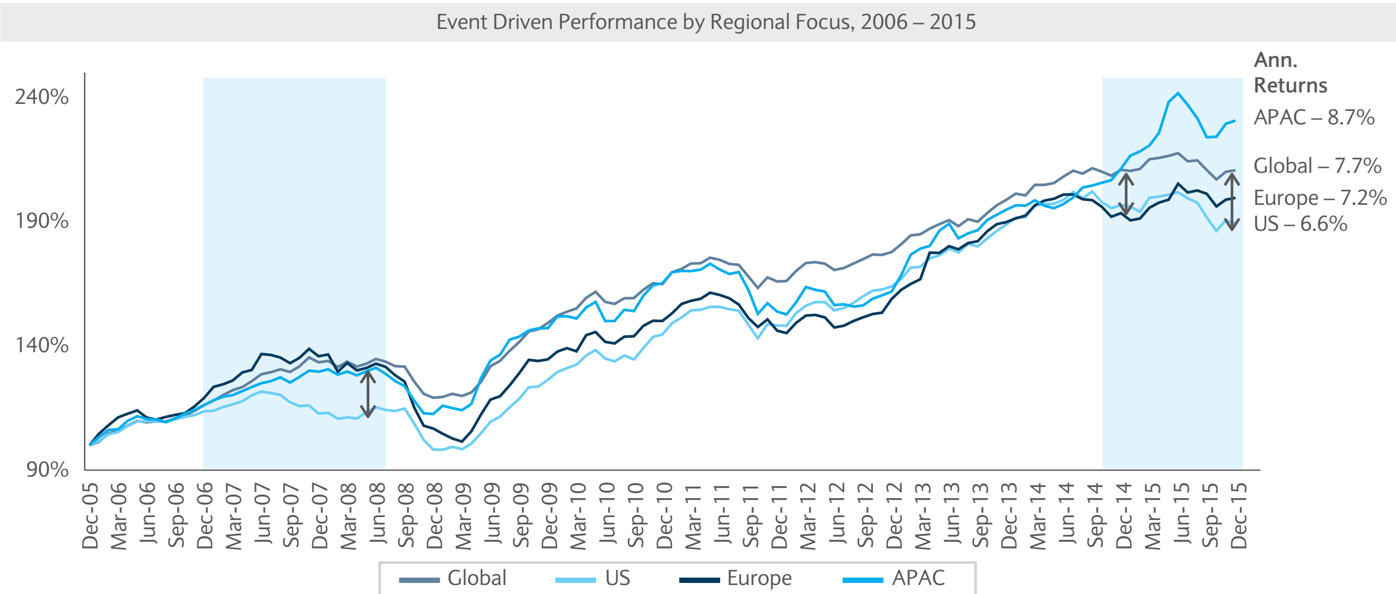
This difference is something that has become significant recently when considering performance, as Figure 11 demonstrates. While over the long run we tend to find no significant correlation between HF size and average performance, in the second half of 2015 there was a noticeable divergence, culminating in a 2 – 4p.p. difference in returns between funds with more than $1bn in assets and those with less. This is something that may help to explain some of the performance challenges of event driven HFs in 2015, as well as affecting the way that investors think about event driven manager selection going forward.

IV. Sub-strategy analysis

Performance by sub-strategy

We now turn our attention to the particular characteristics of the sub-strategies within event driven. Figure 12 outlines how the five sub-strategies that we outlined earlier compare with each other on the basis of returns and volatility. Each of these categories has somewhat different return drivers, and they have all delivered different risk / return profiles over the last 10 years (2006 – 2015). On the basis of returns alone, activist looks like the most attractive strategy – going some way in explaining its popularity among investors. However, the level of volatility that delivering these returns has entailed actually makes the strategy one of the worst on a risk-adjusted return basis. In contrast, it is interesting to note that merger arbitrage funds have had, on average, some of the best risk-adjusted returns thanks to their very low volatility.

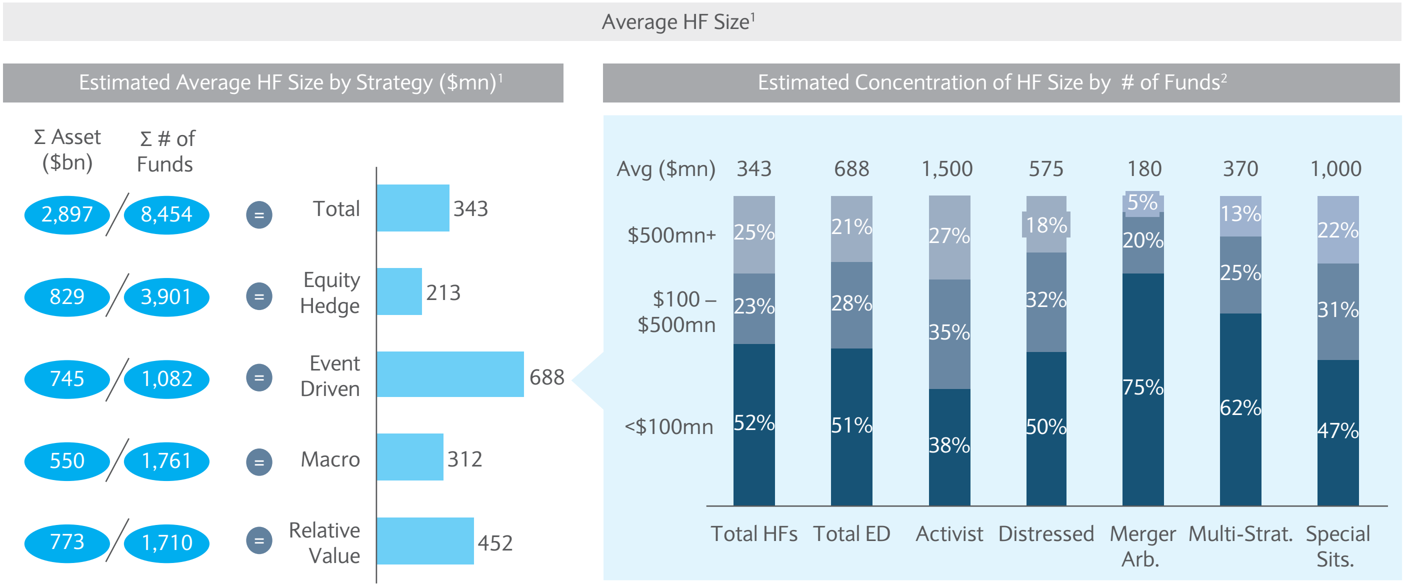
FIGURE 9: Event Driven Performance by Regional Focus



Source: HFR, HFI, Hedgefund.net, BarclayHedge, Strategic Consulting analysis

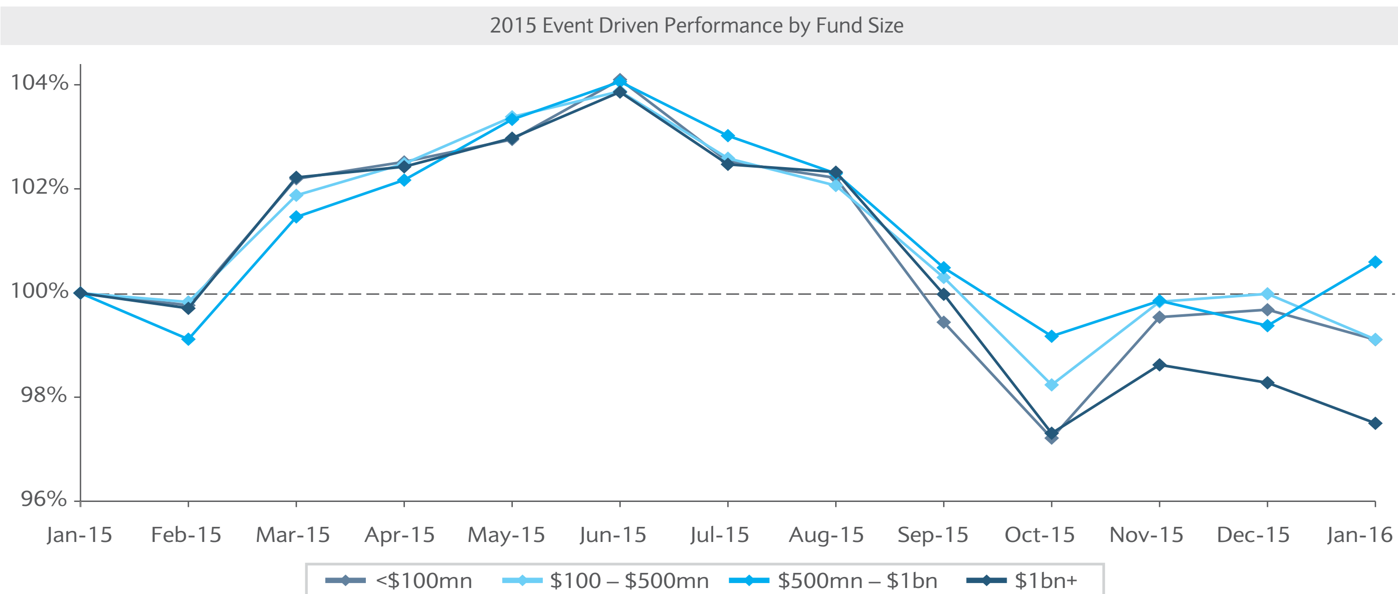
Looking at the manner in which these returns have been delivered on a month-to-month basis, shown in Figure 13, reveals more of these nuances. In the last 10 years, consistent with their low level of volatility, merger arbitrage HFs have delivered a reasonably smooth, steady return profile, with limited drawdowns, even in times of considerable market stress (2008, 2011). At the other end of the spectrum, one other issue worth noting has been the tendency of special situations HFs to underperform during these periods of market stress – this was again the case in 2014 / 2015, when special situations HFs began to significantly underperform multi-strategy event HFs, having had very similar performance over the prior four years. On balance, multi-strategy HFs appear to have one of the most appealing return profiles in terms of managing to generate somewhat higher returns while capping downside – perhaps implying that these managers add a certain amount of value through timing the sub-strategies within event driven.

FIGURE 10: Average HF Size



1. HFR, Strategic Consulting analysis; 2. HFR; Barclays Strategic Consulting Concentration Analysis Model

FIGURE 11: 2015 Performance by Hedge Fund Size



Source: HFR, HFI, Hedgefund.net, BarclayHedge, Strategic Consulting analysis

Return characteristics by sub-strategy

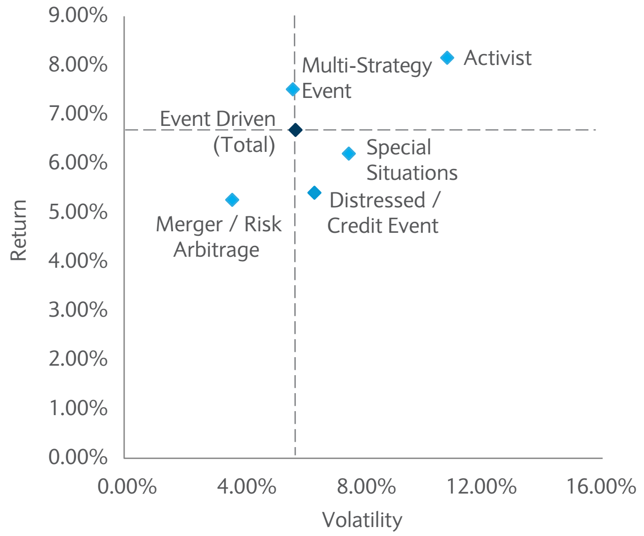
All of the analyses of event driven HF performance thus far have focused on average performance across sub-strategies; however, for many investors, average performance is not always a fair reflection of their experience of investing in event driven strategies. In order to address this, we now look at some of the characteristics of performance on a fund level.

The first of these is the incidence of '3-sigma' events on the downside in HFs' monthly returns: that is to say, how often do event driven HFs produce monthly returns that are more than 3 standard deviations away from their expected monthly return. Figure 14 shows a comparison of funds within event driven and across the industry in terms of how often they produce events that are more than 3 standard deviations below their average monthly returns in the last 10 years (2006 – 2015). We also examine this frequency relative to what could be expected assuming a normal distribution of returns – for reference, with a perfect normal distribution one would expect a '3-sigma' left tail event to occur roughly once in every 740 months, or once every 62 years.

This calculation does, of course, assume that HF returns are normally distributed which, as we showed in the first section, they do not tend to be. Nevertheless, it is interesting to examine how HF strategies compare relative to one another in this regard.

FIGURE 12: **Event Driven Sub-Strategy Performance**

Event Driven Sub-Strategy Performance – Annualised, 2006 – 2015

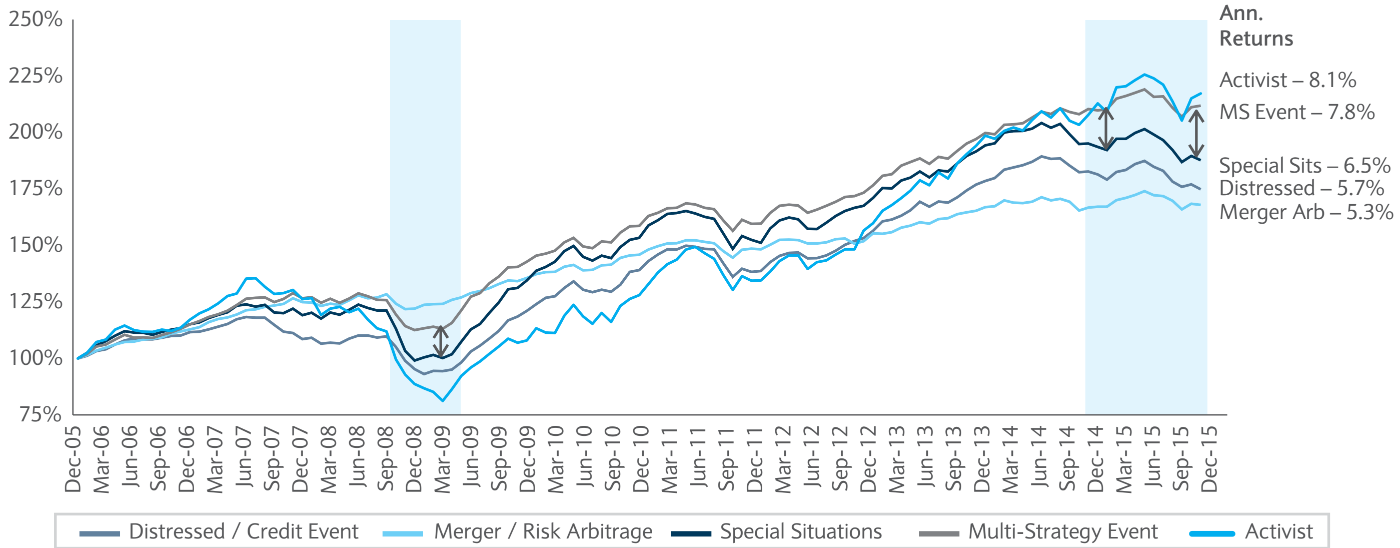


Sub-Strategies	Return	Vol	Sharpe
Distressed / Credit Event	5.8%	6.1%	0.54
Merger / Risk Arbitrage	5.4%	3.5%	0.90
Special Situations	6.6%	7.3%	0.56
Activist	8.1%	10.6%	0.54
Multi-Strategy Event	7.8%	5.5%	0.98
Event Driven (Total)	6.7%	5.7%	0.82

Source: HFR, HFI, Hedgefund.net, BarclayHedge; Sharpe Ratio calculated using risk-free rate of 2%

FIGURE 13: **Event Driven Performance by Sub-Strategy**

Event Driven Performance by Sub-Strategy, 2006 – 2015



Source: HFR, HFI, Hedgefund.net, BarclayHedge, Strategic Consulting analysis

The average hedge fund over the last 10 years has produced '3-sigma' left tail events 4.2 times more often than would be implied by a normal distribution; the comparable figure for special situations funds is 4.4x, and for multi-strategy event driven funds it is 4.8x, both of which are reasonably comparable to the average. For activist funds, it is actually only 2.8x. However, when interpreting this data it is also worth noting that strategies with higher volatility tend to be less likely to produce '3-sigma' events as to do so would be to produce significantly outsized returns.[4]

It is merger arbitrage and distressed funds that have most often produced '3-sigma' left tail events, at 6.8x and 6.9x, respectively. Interestingly, the other strategies that tend to have a similar profile in this regard are convertible arbitrage and fixed income relative value (both of which share a common characteristic of high leverage in order to capture relatively small arbitrage opportunities over time). For distressed funds, this profile is largely due to the effects of 2007 – 2008 and the significant increase in default rates over that period; for merger arbitrage funds these '3-sigma' events tend to be spread over a wider period, and many are attributable to deal breaks (Shire / Abbvie, BAE / EADS, Newscorp / BskyB, Rio Tinto / BHP to name a few prominent examples over our sample period).

In these strategies with a greater tendency toward '3-sigma' events, investors should perhaps consider holding a more diversified portfolio of these funds to insulate somewhat against these downside shocks.

Intra-strategy correlation

Another characteristic worth considering for investors is the level of intra-strategy correlation – that is to say, the extent to which funds within a certain strategy tend to be correlated to one another. The higher this number, the more idiosyncratic the risk-taking of different funds and, as such, the greater the benefit of holding a larger number of these funds should be.

As Figure 15 illustrates, from 2011 to 2015, it is equity and credit L / S funds that tend to be the most correlated to one another, suggesting that there is a fair amount of overlap between the risks these funds take. This is fairly intuitive, as these funds tend to run higher levels of beta to equity and credit, respectively. At the other end of the spectrum, macro and FIRV tend to have the least intra-strategy correlation.

Event driven HFs sit somewhere in the middle – with activist (which tends to be a high-beta strategy) quite close to equity L / S in its level of intra-strategy correlation, and merger arbitrage (which tends to be inherently more hedged) at the other end of the spectrum with reasonably low levels of intra-strategy correlation.

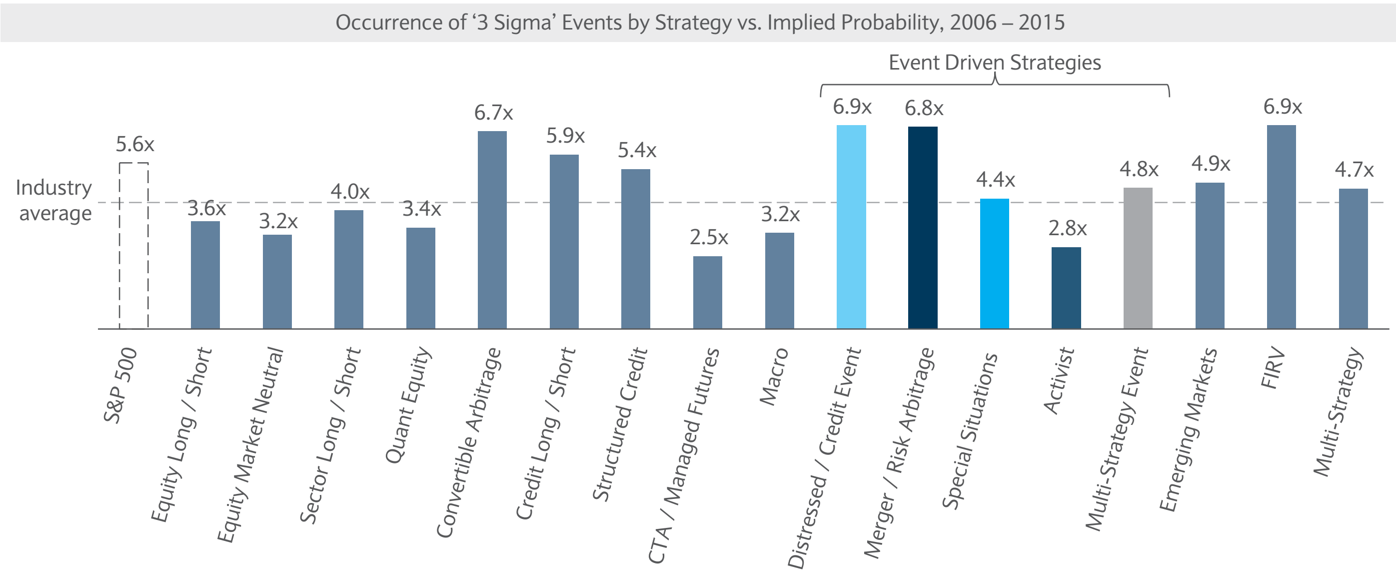
From this, we can draw two main conclusions: first, that event driven funds do indeed seem to be better at capturing idiosyncratic risk than vanilla equity and credit L / S strategies, and second, investors may find it more advantageous to hold a broader portfolio of event driven funds than is the case in other, higher-beta strategies.

Recent event driven performance

All of the analyses we have done until this point have looked at event driven strategies on a long-term basis – and on this basis, the conclusions have thus far been reasonably positive for these HFs. However, as we noted at the outset, there have clearly been some performance issues in recent times, shown in detail in Figure 16. From June through September 2015, the average event driven fund lost almost 6%, and after a brief respite in the fourth quarter the losses continued in the first three months of 2016.

4. That is to say: for a fund with 1% expected monthly returns and 8% monthly standard deviation of returns, a '3-sigma' down month would be -23%; for a fund with 1% expected monthly returns and 3% monthly standard deviation, a '3-sigma' down event would be -7%

FIGURE 14: Occurrence of '3 Sigma' Events



Source: HFR, HFI, Hedgefund.net, BarclayHedge, Strategic Consulting analysis; '3 sigma' events defined as those more than 3 standard deviations from the monthly average return for each fund within the set; An average is then taken of all funds within each strategy; The probability of such an event as implied by a normal distribution is approximately 1/740 or 0.13%

Moreover, it is clear that two sub-strategies in particular have suffered more in recent periods: special situations, and distressed. From the end of 2014 until the end of Q1 2016, these strategies lost on average 3% and 7%, respectively. We now look to understand in greater detail what went wrong in these sub-strategies.

1. Special situations

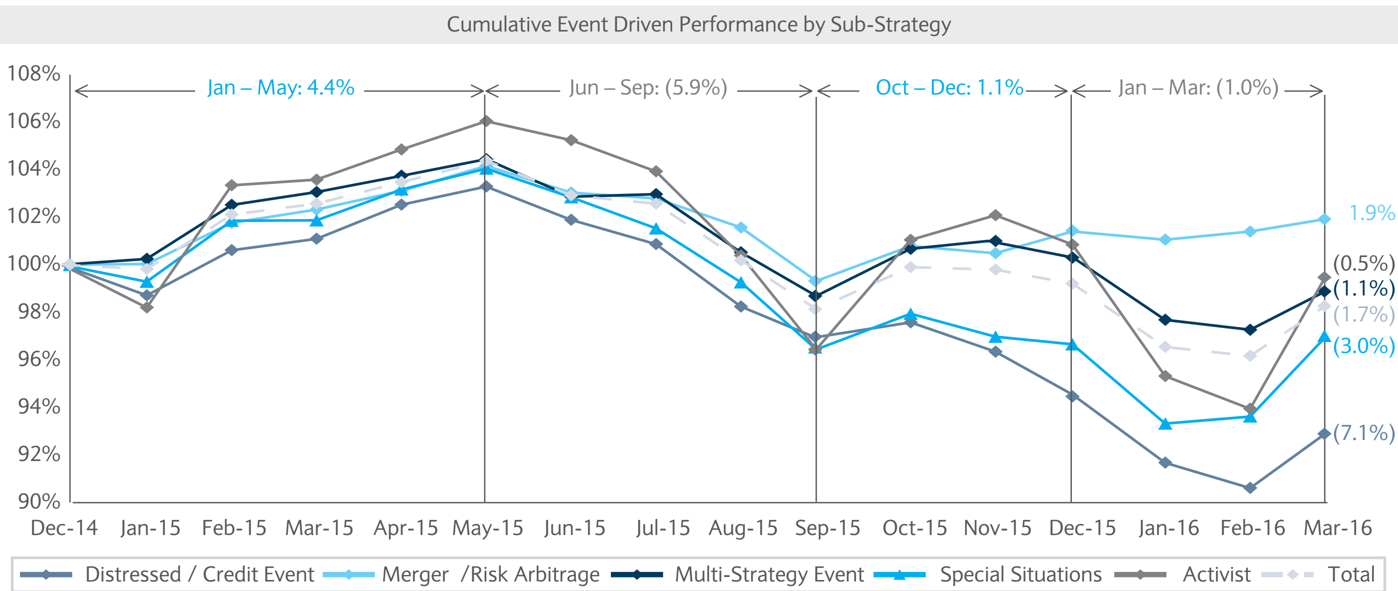
One of the consistent reasons for underperformance in special situations cited to us by both investors and managers was the issue of crowded trades, particularly in the US over much of 2013 – 2015. As such, we examined the correlation of special situations funds to crowded trades using an index provided by Novus.[5] The charts in Figure 17 illustrate the performance on a monthly basis of the HFRI Special Situations index against the performance of the Novus Crowded Portfolio, an index of the top 20 US equity longs held by HFs as defined by a blend of their popularity among HFs and illiquidity. It is evident from this that there has been a strong correlation between the returns of special situations funds and this crowded portfolio. Ordinarily, this might not have been an issue (over long periods of time, the crowded portfolio has historically tended to outperform broader indices), but 2015 saw this portfolio down 23%, with many of its losses accumulating at the same time as special situations funds entered the worst of their drawdown. As such, we believe that investors' recent concerns around the effect of crowding on special situations returns are largely justified.

5. Novus is a service provider (unaffiliated with Barclays) that provides industry intelligence to institutional investors and asset managers

FIGURE 15: Intra-Strategy Correlation

Source: HFR, HFI, Hedgefund.net, BarclayHedge, Strategic Consulting analysis; Intra-strategy correlation measured by calculating the correlation of each fund to the average return for the strategy, and then taking an average of all of these correlations for each sub-strategy

FIGURE 16: Recent Performance



Source: HFR, HFI, Hedgefund.net, BarclayHedge, Strategic Consulting analysis

2. Distressed

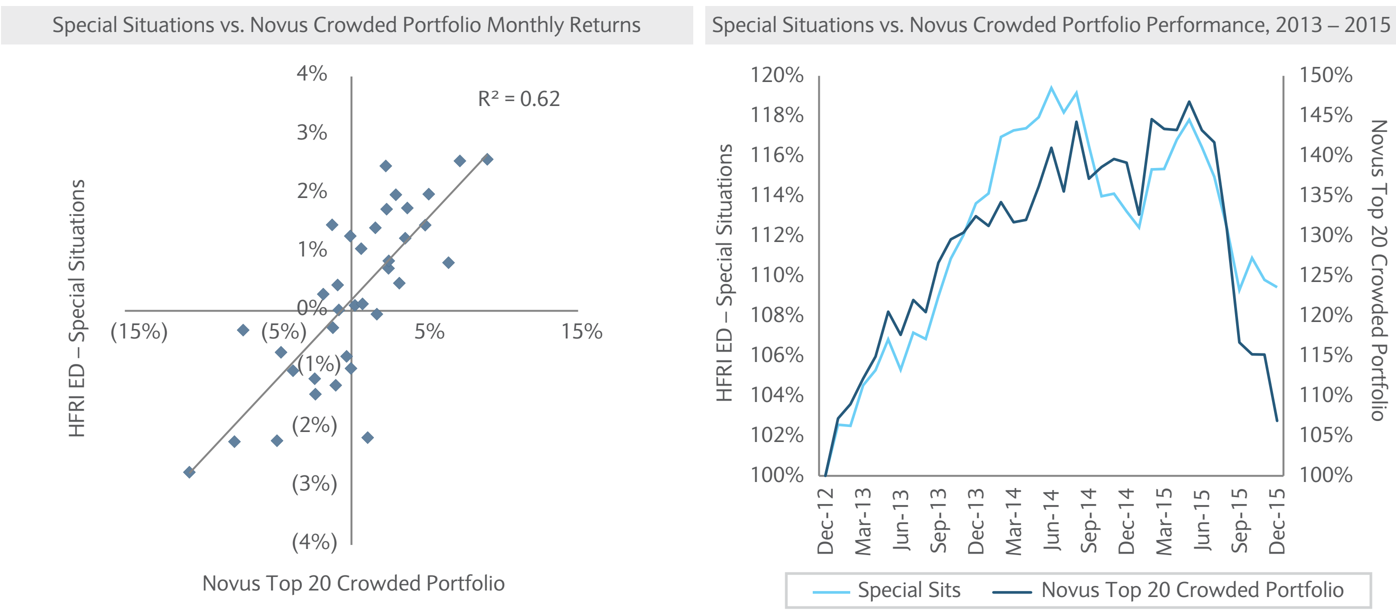
The picture for distressed funds is in many ways simpler: the 2015 underperformance was largely driven by the turn in the credit cycle and the accompanying sell-off in high yield markets. As Figure 18 shows, over 2014 – 2015, moments when high yield spreads widened coincided with drawdowns for distressed funds, in particular in the second half of 2015.

Another related issue was the exposure that some managers had in distressed positions within the energy sector: some investors expressed to us their belief that some of their managers had reentered the energy sector too early and suffered as a result. Looking at the spread of energy HY to the overall HY market shows how this occurred: after spreads in energy HY widened in late 2014, there was actually a period in early 2015 in which they narrowed again. However, the second half of 2015 saw them again widen, reaching a peak in January 2016 as oil prices fell once again.

Investors also cited to us a couple of particular distressed situations that generated losses for their managers – notably the Puerto Rico debt crisis and the TXU restructuring.

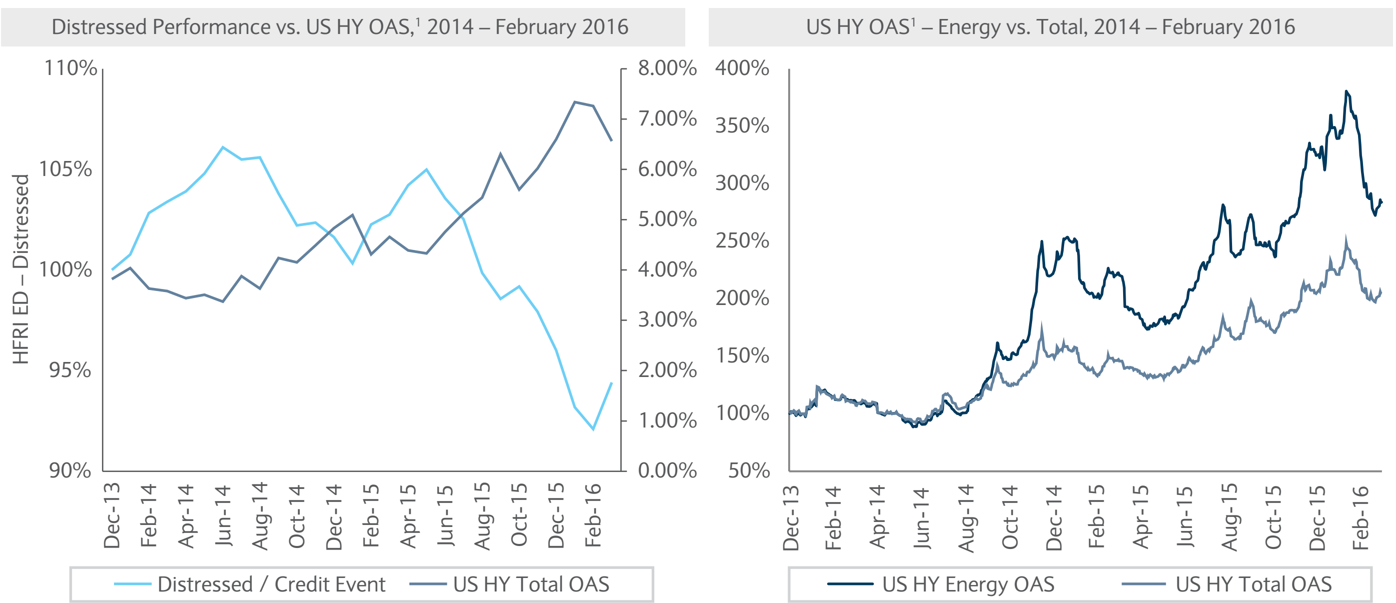
All in all, there were a number of factors that underpinned poor distressed HF performance in 2016.

FIGURE 17: Recent Performance – Special Situations



Source: Novus, HFR, HFI, Hedgefund.net, BarclayHedge, Strategic Consulting analysis

FIGURE 18: Recent Performance – Distressed



Source: Bloomberg, Barclays Research, HFR, HFI, Hedgefund.net, BarclayHedge, Strategic Consulting analysis; 1. OAS – Option-Adjusted Spread

V. Investor outlook

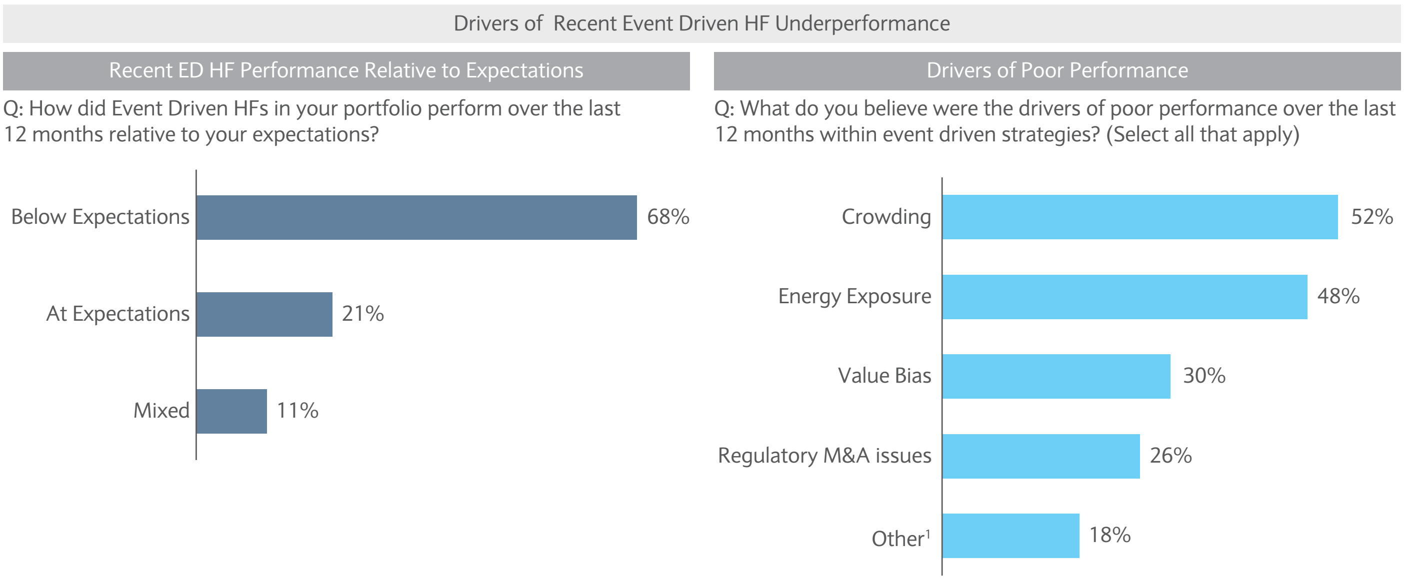
In light of the recent performance of event driven HFs, we wanted to understand how it had affected investors' perceptions of the strategy, and what their likely allocation plans were with regard to event driven strategies as a result.

Performance versus investor expectations

We began by asking investors how their event driven portfolios had performed relative to their expectations over the last 12 months, as shown in Figure 19. The overall sentiment was clearly not positive, with no investors reporting that their event driven portfolios had delivered performance above expectations. Over two-thirds perceived the performance of their event driven HFs as being below expectations, while the remainder felt performance was as expected, or mixed. Those investors who cited mixed or 'at expectation' performance from their event driven portfolios tended to have managers with exposure higher up in the cap structure, minimal exposure to energy and crowded names, and a higher allocation to hard catalyst events.

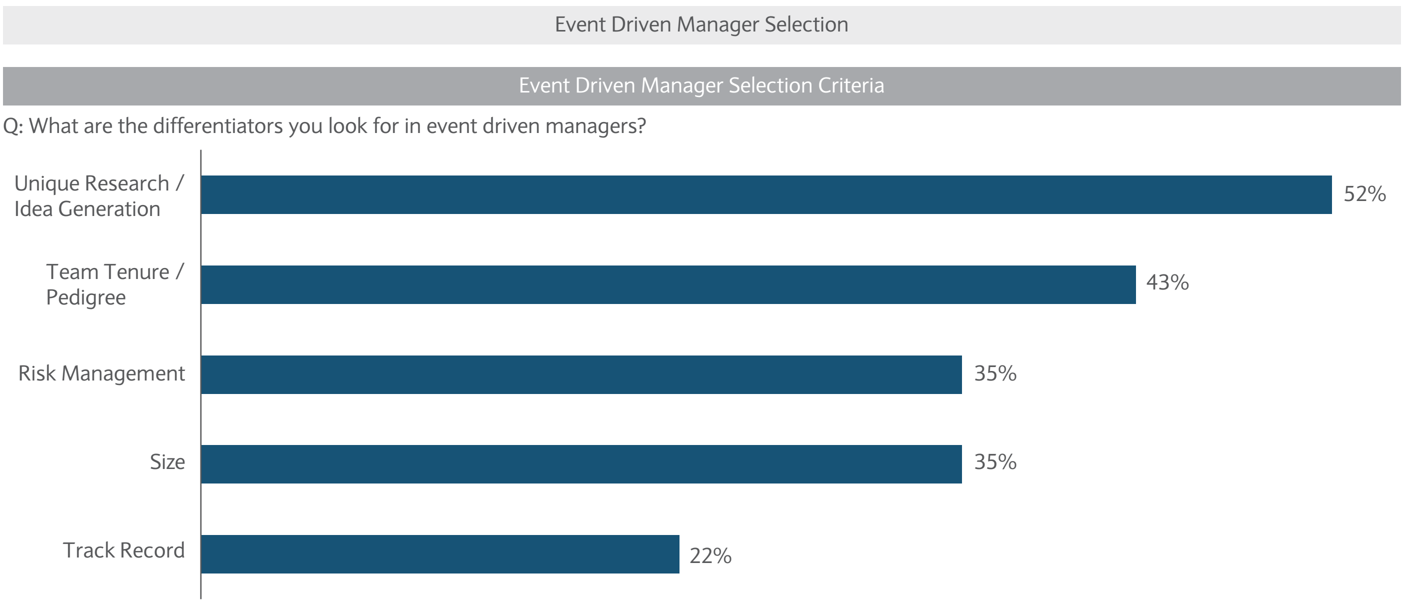
We also asked investors what they attributed underperformance in event driven strategies to. Consistent with what we noted earlier in this report, crowding and energy exposure come at the top of investors' list of concerns, for the reasons already discussed. Beyond that, a few other issues were cited:

FIGURE 19: Drivers of Recent Underperformance



Source: Barclays Strategic Consulting; 1. Poor risk management and other Macro Factors

FIGURE 20: Event Driven Manager Selection



Source: Barclays Strategic Consulting

- Value bias – Investors suggested that equity event managers tend to have a natural skew in their portfolios toward value stocks; during 2015, value as a factor underperformed the broader markets.
- Regulatory issues in M&A – The rejection of certain deals in recent years by regulatory authorities (e.g., those with a tax inversion element) was cited by some investors as having weighed on event driven performance.
- Other – Investors also cited poor risk management by certain managers (in particular a failure to hedge properly and a tendency to hold onto losing trades), as well as the broader macro backdrop, as factors that contributed to the poor performance of event driven strategies.

Manager selection

As a result of these recent performance challenges, we wanted to understand whether investors' criteria in selecting event driven managers have changed. Figure 20 outlines the criteria that investors in event driven strategies told us they value; all are common factors in manager selection, but it is the order in which they are prioritised that is quite telling at this point in time.[6]

1. Unique research / idea generation

Given the level of crowdedness of trades in 2015, investors are prioritising allocating to managers with a unique or differentiated research process and idea generation at this point in time as they look to return a level of diversification to their portfolio.

2. Team tenure / pedigree

There were certain types of event driven managers that did considerably better than others last year – for example, managers with more exposure to hard rather than soft catalyst trades tended to outperform. In light of this, investors are cognizant of the importance of finding managers who have experienced different market regimes and navigated numerous cycles and thus may be better at identifying the correct time to build exposure to different situations and strategies.

3. Risk management

As mentioned earlier, one concern in 2015 performance cited by some investors was a failure of certain managers to adequately manage the risk of their portfolios. This may have included not being properly hedged (e.g., running a book such that it had exposure to certain factors / sectors which could then hurt performance even though they may have appeared to have had relatively little market or beta exposure), or a tendency to hold onto losing trades for too long. As such, strong risk management is of increased concern at this point in time.

4. Size

While over the last few years a large majority of net inflows into the HF industry have been to $5bn+ managers,[7] investors now appear to be more focused on sourcing smaller managers in the event driven space. This is likely due to a combination of two factors: firstly, the underperformance of the largest event driven funds in the second half of 2015 as noted earlier, and secondly, as part of the desire to have greater exposure to more differentiated trades, which may be more easily found with smaller managers.

6. As an example of how this changes over time, in the immediate aftermath of the 2008 financial crisis, investors tended to value transparency in particular; since that time, its importance as a criterion has faded somewhat to the point that it no longer tends to be at the top of investors' priorities. See '28 Months Later', a Strategic Consulting publication from 2010, as a reference

FIGURE 21: Expected Changes to Event Driven HF Allocations

Next 12 Months' Planned Changes to Event Driven HF Allocations by Investor Type

	Private Bank	Family Office	Private Pension	E&F	Insurance	Public Pension	Total
Increase	33%	29%	21%	19%	17%	15%	23%
Unchanged	53%	54%	68%	62%	58%	52%	57%
Decrease	13%	18%	11%	19%	25%	33%	20%

Source: All figures refer to Barclays Strategic Consulting survey results only

5. Track record

This is a corollary to the earlier point around the tenure and pedigree of event driven managers: for similar reasons, investors are now also focused on finding HFs with a long track record and demonstrable experience of generating returns in different market environments.

Expected changes in event driven allocations

As a result of the issues discussed throughout this paper, investors in event driven do not appear to be particularly bullish on the strategy. As Figure 21 shows, only around a quarter plan to increase their allocations, while over half plan to keep the allocations stable and around 20% plan to reduce them. This is somewhat more bearish than the general sentiment toward HFs.[8] Moreover, when one accounts for the fact that these forward-looking surveys tend to display a persistent bias toward optimism, the outlook for event driven does not appear to be particularly rosy at the moment.

Across the different investor channels, it appears that private institutions are more bullish toward event driven strategies, with private banks and family offices most likely to be looking to increase allocations. Institutional investors – notably insurers and public pensions – appear to be the least interested in the strategy on the other hand, with fully one-third of public pensions looking to reduce their allocation. This is possibly due to their heavier exposure to the larger funds that underperformed last year.

Investors' sub-strategy preferences

Not all strategies within event driven are created equal, however. There is a wide range of levels of interest in the sub-strategies, as illustrated in Figure 22. Distressed and merger arbitrage are the most popular at this point in time. From our conversations with investors, it appears there is a degree of nuance to this – the popularity of distressed is a less immediate view, as investors are looking to increase exposure here due to a perceived possibility of greater opportunities in the US distressed space later in 2016. Merger arbitrage appears to be viewed as a more immediate opportunity set (and indeed through Q1 was the only sub-strategy within event with net inflows).[9]

Special situations, multi-strategy event and activism all appear to be out of favour at the moment, and this was confirmed in Q1 as all had outflows: within these it was special situations and activist managers that bore the brunt of outflows, seeing $3.4bn and $4.3bn of net outflows, respectively.

Projected event driven flows

Despite the expected net outflows from event driven, there is still significant 'money-in-play' within the space. In Figure 23 we estimate the total gross inflows and gross outflows in order to account for the reallocation between managers. By this measure, we believe that there will be $60 – $70bn of gross inflows as investors rotate capital out of underperforming managers and reallocate between strategies. As such, managers that belong to the more in-demand strategies and those that have differentiated their performance to the upside should still be able to find asset raising opportunities in 2016, although it will be a challenge.

7. See 2016 Strategic Consulting publication 'Bracing for Impact'
8. Ibid; the findings in that paper suggest that 33% plan to increase vs. 15% decrease
9. Source: HFR

FIGURE 22: Investors' Sub-Strategy Preference for 2016

Interest in Event Driven Sub-Strategies (%)				Most / Least Interest by Investor Type			
Sub-Strategy	Decrease	Increase	Net Diff	Most Interest	Net Diff	Least Interest	Net Diff
Distressed	(14%)	44%	30%	Private Bank	56%	Private Pensions	5%
Merger Arbitrage	(19%)	38%	19%	Private Bank	44%	Public Pensions	(21%)
Special Situations	(24%)	26%	2%	E&F	22%	Private Pensions	(26%)
Multi-Strategy	(28%)	25%	(3%)	E&F	11%	FoHF	(17%)
Activism	(36%)	9%	(27%)	Public Pension	(11%)	FoHF	(42%)

Source: All figures refer to Barclays Strategic Consulting survey results only

VI. Conclusions

In summary, we present our main conclusions from this paper:

1. On a 10-year basis, event driven actually appears to be one of the better performing strategies across the HF industry.

- Event driven strategies appear to have delivered strong returns compared to the broader industry and equity long / short HFs in particular, providing more than adequate justification for the inflows that have driven its growth within the industry.
- Moreover, in terms of the 'alpha' that it has generated and the characteristics of the return profile that it tends to demonstrate, there is much to suggest that event driven merits inclusion in investors' portfolios.

2. Event driven encompasses a wide range of sub-strategies which offer a fascinating array of differentiated return profiles.

- The differences in terms of return profiles between, at one extreme, activist HFs, and at the other, merger arbitrage HFs is huge, suggesting that these strategies can play very different roles in investors' portfolios.
- From our analysis, multi-strategy event appears to be one strategy that is unfairly overlooked by many investors: it has delivered the best risk-adjusted returns over the last 10 years, but investors that we spoke to indicated a preference for allocating to the underlying strategies and making the timing decisions themselves.

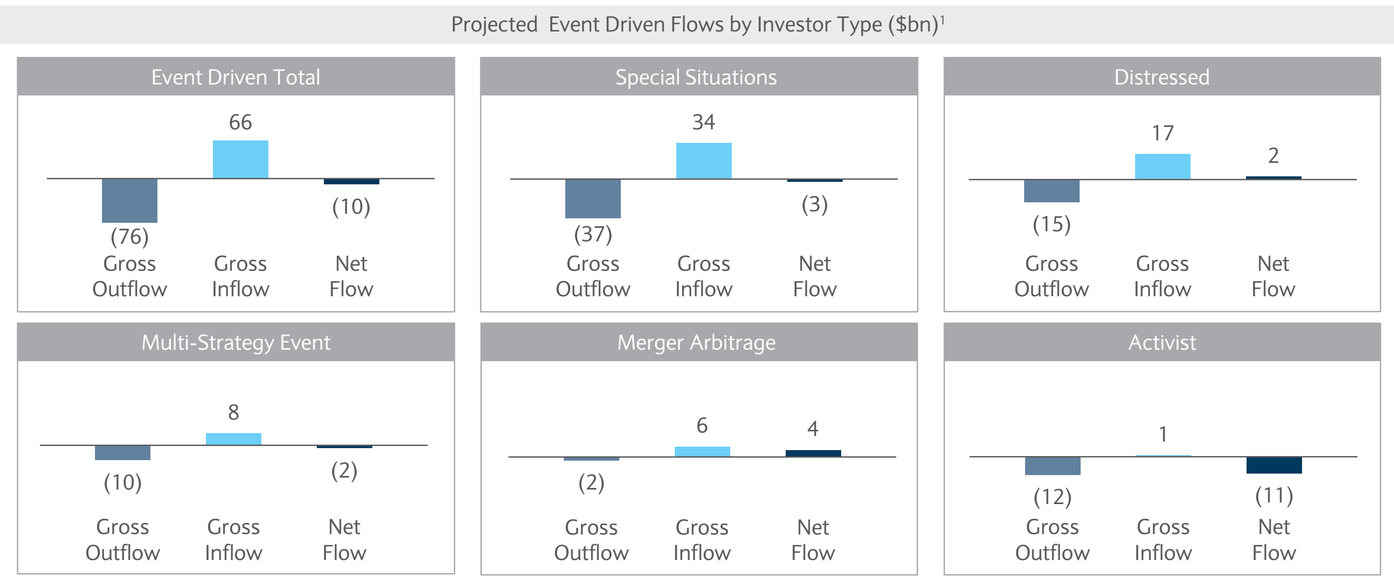
3. Recent performance seems mainly to have been driven by crowding in US special situations and the credit cycle in distressed.

- Investors and managers that we spoke to believe that recent underperformance has largely been driven by problems associated with crowding, especially in US special situations trades, and widening distressed spreads in the energy space in particular.
- Building a diversified event driven portfolio in terms of both manager size and regional focus may have helped some investors to alleviate some of these challenges.

4. Asset raising in 2016 is likely to be a challenge for event driven managers in general, but there is still significant 'money-in-play'.

- We expect a total of $10bn of net outflows from event driven managers this year, although some strategies will likely fare better than others:
  - Activist, in particular, is likely to see significant outflows, with special situations and multi-strategy event also likely to suffer outflows, albeit to a lesser extent – these managers should plan to play defence with regard to trying to retain assets.
  - Distressed and merger arbitrage, we expect, should see inflows, with investors seemingly bullish on the opportunity set for both.
- Even for those strategies that we believe will have net outflows this year, there will still be significant 'money-in-play' as investors look to reallocate, so managers that have distinguished themselves lately should aim to capitalise on this.

FIGURE 23: Projected 2016 Flows by Event Driven Sub-Strategy



Source: Barclays Strategic Consulting 2016 ED Market Sizing Model; 1. The strategy flow projection model was based on variables the team took into account including the sample's responses toward 2016 allocation / strategy preferences, estimated turnover, overall strategy breakdown and total HF industry Assets

VII. Capital Solutions

The Capital Solutions team within Prime Services offers a unique blend of industry insights and tailored client solutions for a broad range of issues.

Capital Introductions

- Maintenance of ongoing investor dialogue to provide valuable feedback to HF managers.
- Introducing HF managers to a select number of interested investors.
- Hosting events that provide a forum for knowledge transfer and discussion / debate on industry issues that helps educate and inform both clients and investors.

Strategic Consulting

- Development of industry-leading content, driven by primary analysis, on the HF industry and its participants (e.g., HF and FoHF managers, institutional investors, investment consultants).
- Provision of management consulting services to HFs and asset managers on business topics such as the launch of a new strategy, marketing effectiveness, product development and organisational efficiency.
- Acting as an HF competence center internally for Barclays.

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