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K2 Perspective

K2 ADVISORS®

Going Tiger

"Everybody said that tiger went crazy. That tiger didn't go crazy, that tiger went tiger! You know when that tiger was really crazy? When it was riding around on a unicycle!..."

Comedian Chris Rock in his comedy special *Never Scared* (HBO 2004), commenting on a circus tiger that attacked Las Vegas magician and entertainer Roy Horn of Siegfried & Roy fame

I am a huge fan of author Michael Lewis. Over the years he has demonstrated a remarkable ability to take complex and often dry subject matter and — through the magic of language and storytelling — craft compelling, entertaining, and above all digestible narratives perfectly suited for mass consumption — and Hollywood adaptation…*coming soon to a theater near you, Tom Cruise is Brad Katsuyama…and this time it's no more Mr. RBC nice guy*. Joking aside, the talent Lewis possesses is truly rare, and something that I can only hope to vaguely emulate even on my best days as a writer…but I digress (wistful sigh). Perhaps more than any other author of our time, Lewis' approach speaks directly to the adage that truth is indeed stranger — and quite often more entertaining — than fiction. And so the truth he communicates in his latest work, *Flash Boys: A Wall Street Revolt* (W.W. Norton & Company. 2014), about the practice of high frequency trading (HFT) and the implication that aspects of it appear to give its users an unfair, and some will argue demonstrably illegal, information advantage has certainly struck a resonant chord — with institutions, individual investors, and perhaps most surprisingly with the financial media.

So what of HFT? As we discussed in our July 2013 K2 Perspective *Ghosts in the Machine: The Potential High Cost of High Frequency Trading*, on the surface aspects of the strategy certainly appear suspect. This is not to suggest that all HFT shops are engaged in nefarious activities, and indeed many are likely using the technology to make money the 'old-fashioned' way, with quantitative statistical arbitrage models or pairs trading, strategies that do not involve any sort of front running or informational advantage. For others however, applying even the simplest of critical analysis raises some red flags. For example, the fact that the *physical length* of fiber optic cables that run from Wall Street across the Hudson River to New Jersey may mean the difference between profit or loss has got to be indicative that something is rotten in Denmark (or at least in New Amsterdam). When a prerequisite to success is the ability to transact thousands of times in fractions of milliseconds and at the speed of light…even the most progressive thinkers among us must admit it feels wrong.

That said, the media fire storm that erupted mere nanoseconds (forgive me) after Mr. Lewis' latest book hit the shelves did come as a bit of a surprise. Beginning with a Sunday night appearance on 60 Minutes – where Lewis explained to correspondent Steve Kroft that the stock market was 'rigged' in his view, and that this rigging was at the hands of a cabal of HFT firms and complicit investment banks – the hounds were released.

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Strategy Focus – March 2014

Long Short Equity

Geopolitical uncertainty related to events in the Ukraine and Syria combined with mixed macroeconomic data coming from China, Europe, and the US led to a significantly volatile month for most equity markets across the globe. While some major indices such as the S&P 500 posted modest gains, this performance masked a substantial amount of movement under the surface, marked by a swift and meaningful rotation out of momentum and secular growth holdings. As a result there were parts of the market that faced strains not evident on the surface, particularly in internet, biotechnology and housing stocks. In the absence of earnings, there was little news to put a floor under the selling and so the declines were often sharp. For example, the S&P Biotech Index was down -10.8%, the S&P Homebuilders Index was down -8.1%, and the QNET Index, a Nasdaq index of internet stocks, declined -9.2%. The consensus among managers is that the sell-off in higher momentum securities was not triggered by a change in company fundamentals but rather a change in investor sentiment. As such, many hedge funds took advantage of the volatility to reposition their portfolios in high conviction longs and shorts, with the expectation that upcoming earnings may drive a change in valuation.

Against this choppy backdrop aggregate performance for K2's long short managers in March was negative. The biggest losses were observed in Technology, Media, and Telecom (TMT) focused funds, notably those with a concentration in internet or internet dependent stocks. Exposure to Biotechnology and Specialty Pharma names was also negative; however the strategy remains a strong contributor on a YTD basis. Managers who held broad-based or index shorts did not benefit as losses were concentrated in a few sectors. On the positive side, we did see gains from cyclically oriented managers as well as from short exposure to momentum related stocks. The overall contribution from activists was roughly flat, highlighting the generally uncorrelated nature of the strategy.

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Rigged you say??? Exclaimed the CNBC and Bloomberg Television talking heads the following day, seemingly pushed into a tailspin of apoplectic shock and dismay. How could this be? Surely you must be mistaken? Are you suggesting that the playing fields of the ‘free’ market are anything but precisely and absolutely level? That all is not perfectly fair on Wall Street?

The level of outrage and righteous indignation displayed by the media over the ‘news’ that certain HFT practices appeared to be unfairly exploiting an information advantage for gain, that somehow the ‘fairness’ of the markets had suddenly been compromised by these fiendish firms, did seem a bit disingenuous to say the least, if not grossly naïve. Why would the financial media be so invested in the idea that the markets are fair anyway? In many instances it is a zero sum game, is it not? My assumption is that the visceral reaction was simply intellectual dishonesty, which at least can be understood if not defended. The need for many of these outlets to sensationalize material as often as possible in the interest of gaining viewers and hence advertising revenue (because frankly financial ‘news’ is boring, unless one has a vested interest in copper futures, in which case they will more than likely be getting their information from somewhere other than television…or at least I hope so) makes logical sense. So from the business perspective I can accept the networks ‘crisis on Wall Street’ angle in terms of the bottom line. From a journalistic quality and integrity standpoint however… not so much. It just felt forced. There are certainly many other obvious and blatant examples of the markets appearing ‘rigged’, for lack of a better description. Where is the media outrage over these indications of a system that’s broken?

Consider the perspective of the many brilliant hedge fund professionals that we work with and the decades of equity, bond, and commodity market wisdom and experience they collectively possess. I imagine they have seen enough to confirm beyond a shadow of doubt that the markets are unfair and very often appear compromised to some degree — and not simply in ways that could be attributed to HFT. For example, how many times have they witnessed a stock spike several percent (up or down) at the close, only to see ‘news’ come out shortly thereafter that coincidentally would have driven a similar movement in price? Or what of economic data releases such as Jobs Friday? How often do markets move substantially in the seconds before an important indicator is published, again in the direction that the data would suggest? Perhaps it is investors gambling one way or the other in advance of the information, but on the surface it certainly seems like these ‘gambles’ more often than not end up on the right side of the trade. The point is that these types of market oddities, some might say cheats, happen more frequently than the broader financial community — and media apparently — appear ready to admit or acknowledge. Where is the outrage, dare I suggest investigative journalism, into these type of market events? Throw the SEC a bone for goodness sake. Apparently unless it is featured on a 60 Minutes segment it is not worth attention (did I see the papers? I did not see the papers, did you see the papers? What papers!?....forgive the Martin Short/SNL reference, I could not resist. It is one of my all time favorite sketches. YouTube it).

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In response to the market moves we saw only slight reductions in gross and net exposure at the aggregate level. However, some managers, particularly in the TMT arena, made more substantial adjustments.

Looking ahead the directional outlook for equities is muted as valuations as of March-end have continued to rise. As we move through the remainder of earnings season, the expectation is for global financial markets to refocus on fundamentals, which may be favorable to long short trading strategies. In addition, earnings differentials and the potential for rising rates to create better dispersion may also be beneficial. Overall the focus will remain on identifying companies whose earnings may benefit from innovation, new product cycles, potential market share growth and smart capital allocation.

Specialist Credit

A rise in Treasury yields notwithstanding, credit markets continued to grind tighter in March. High yield bonds, leveraged loans and investment grade bonds were all modestly positive while emerging market bonds outperformed. High yield bond spreads tightened in March to a post-crisis low, while strong inflows and a lighter new-issue calendar resulted in a strong technical bid for credit.

Against this backdrop K2’s specialist credit managers captured steady gains for the month. In terms of performance drivers by sub-strategy, structured credit led the way, followed by distressed and long short trading. Drivers included allocations to non-agency RMBS, agency derivatives, distressed corporate securities, high yield corporate bonds, loan portfolios and legacy liquidations. A combination of positive investor sentiment and improving fundamentals helped to boost performance in structured credit. Detractors included short exposure to emerging market bonds and long exposure to government agency securities, which had performed well in January and February but declined in March largely due to political concerns.

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The bottom line is that I believe the anchors on Bloomberg and CNBC, the pundits posting blogs on Seeking Alpha, and the rest of the financial media aghast at the treachery of the HFTs, are all on some level — if they are intellectually honest with themselves — fully aware that markets are never truly fair or free. But in the interest of increased demographics they carry on nonetheless.

It is in the nature of any competitive landscape — whether it is the hardwood floors of an NCAA Tournament basketball game or the virtual trading floors of the world's stock exchanges — for participants to seek an advantage in any way they can. It is expected they do so with integrity, and without violating the pre-established rules of the competition. Most will comply, not just because of internal moral code but also because their wisdom allows them to recognize it is in their own best interest to consider the interests of the collective community as well. Law abiding citizens notwithstanding, there will always be those who choose to push the envelope, sometimes even stepping outside the bounds to take unfair advantage. This is the nature and byproduct of any competitive game, to seek advantage, and sometimes that advantage is sought in dishonorable ways. Is there a more competitive game in the world today than Wall Street? To borrow from the wry observations of comedian Chris Rock, the emergence of HFT firm's that appear to be pushing the boundaries of what is legal should not come as a surprise to any, it is merely the tiger going tiger. It is the nature of the beast.

Again, my intent is not to defend the HFT practitioners who appear to have crossed what for now is an imaginary line (that is until the regulators can reach warp speed….or perhaps ludicrous speed) in terms of fair access to information. That is to say the insight provided by Flash Boys into the depth and breadth of potential market manipulation being forced upon investors by a handful of HFT firms is certainly compelling, and clearly something that needs to be redressed. In fact, without having to examine any of the evidence in Lewis' book in any great detail (I'm about three quarters of the way through…deadlines however), perhaps the most glaring indication that something is awry is the fact that many HFTs pay to execute orders, often tens of millions of dollars a year. Why would someone be interested in paying for anything unless there is some financial gain to be had by doing so? What is the benefit of paying to execute another's stock market order? Certainly feels suspect does it not? Defenders of the realm will claim that HFT is beneficial to the market because it provides cheap liquidity, and that transaction costs without their services would harm small time mom and pop folks looking to trade. This argument may be valid, however there is little doubt the HFT firms have set up shop with only self-interested profits in mind, and certainly not with any enlightened or altruistic goal of bettering the marketplace for the everyman. Allow us our dignity for goodness sake. We have all seen how this so-called liquidity can evaporate faster than an ice cube in molten lava when a glitch —or dare I suggest deliberate action — causes these systems to shut down. Where's the liquidity then?

It is true, however, that twenty years ago costs for small volume trading would have been significantly higher because fees would have had to be paid to a specialist, represented by a handful of large Wall Street firms, who were privileged with a physical presence on the floor of the New York Stock Exchange — for a price of course.

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Event Driven

In aggregate, K2's event driven managers were down in March as equity market turmoil and associated portfolio de-risking created meaningful headwinds. Detractors by strategy included special situations equity, merger arbitrage and portfolio hedges. Positive drivers included special situations credit, distressed, convertible strategies and long fixed income, particularly in Greek government debt which rallied due to the successful issue of $3 billion in five-year bonds at a yield of only 4.95%.

Looking forward, the market environment continues to present attractive opportunities for the strategy. A pickup in activist activity is expected as shareholder influence continues to increase. In response, management teams and boards are becoming more engaged with said shareholders, and often may seek to pre-empt activist involvement by enacting buybacks, spin-offs, and acquisitions. Either scenario presents special situations and trading opportunities for event-driven managers, at a time when merger arbitrage spreads remain low. Special situations credit investments continue to be focused on liquidations in the US and Europe. However, managers are actively looking at the potential for European banks to begin their long-anticipated sale of securities and assets due to tighter capital requirements.

Global Macro

K2's global macro managers were meaningfully challenged in March as sharp intra-month market reversals posed challenges for both tactical systematic trading and discretionary strategies alike. Global equities experienced significant divergence as many emerging markets (EM) outperformed developed markets (DM), creating headwinds for a common discretionary strategy of long DM and short EM exposure. For systematic managers' long exposure to equities, oil, and currency positions tended to detract. On the positive side some credit positions, particularly tactical trades in emerging market sovereign bonds, were profitable for discretionary managers.

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This naturally presented a barrier to entry for many, in addition to giving these privileged floor players access to market information unavailable to many others on the outside. Was this fair? Ummmm…I would have to say not really, but it was obviously legal and the way the exchanges operated for many years.

The market has always been, for lack of a better description, 'rigged' or 'compromised' on some level…probably going all the way back to the Buttonwood Tree. I'm sure there was a guy at the turn of the 19th century whose position under the tree may have been elevated a bit on a grassy knoll, giving him the slightest hint of improved vantage point from which to trade against his fellow New Yorkers. The earliest HFT, his technology a mound of dirt. Again, it is simply in its nature; the field has never been truly level and fair and it will never be. It is a tiger after all.

Crouching from the Tiger

In summary, have markets been scalped by HFT firms — in all likelihood egregiously — over the past decade or more? Very likely. Should this be a shocking surprise to anyone? Essentially no. Will it happen again in some other form or function? Definitely. The key is to view the world with clarity, recognizing that tigers will always be tigers, regardless of the spectacle, size of the stage, or level of controls. Occasionally the animals will bite. With this knowledge we can try our best to avoid them, and take a few sanctioned bites of our own along the way.

So what to do? Ignore the noise as best one can, and look for investment opportunities where information is available that reflects an economic reality that may be contrary to public opinion and/or media pundits driving current market movements. This is where alpha will be found, where economic reality is ultimately revealed as just that – reality. As our hedge fund managers understand these opportunities tend to be discrete and occasional, as opposed to long-standing and common. Almost by definition, if the information is being generated by public voice it's probably too late to act on it, or at a minimum the risk/reward profile has been materially diluted.

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Broadly speaking we observed managers lowering their overall gross exposures heading into April, perhaps taking a moment to conduct market reconnaissance given uncertainties about Chinese growth, geopolitical risks in Ukraine and Syria, and possible action from the Bank of Japan.

Commodities

K2's commodity managers in aggregate struggled in March but remain positive YTD against what has been a challenging macroeconomic backdrop. Since the beginning of the year, transient events including cold weather, Chinese growth/credit concerns, and tensions in Crimea have driven commodity prices. While these events have had large, but offsetting impacts on overall commodity indices, the one clear net effect has been to drive correlations, both within the commodity space and between commodities and other asset classes, down to their lowest levels since the onset of the global financial crisis in 2008. Volatility levels are still relatively muted. The reduction in correlation is evidence that the macro-driven trading environment is probably behind us, which is key for discretionary commodity managers. Despite still low volatilities, commodity managers had their best first quarter in three years.

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Index Definitions

T-bills: A short-term debt obligation backed by the U.S. government with a maturity of less than one year. T-bills are sold in denominations of $1,000 up to a maximum purchase of $5 million and commonly have maturities of one month (four weeks), three months (13 weeks) or six months (26 weeks).

S&P 500 Index: Standard and Poor's 500 Index is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Swiss Re Cat Bond Index: The Swiss Re Cat Bond Total Return Index tracks the total rate of return for all outstanding USD denominated cat bonds. The index is based on Swiss Re pricing indications only.

ML High Yield BB Index: The ML benchmark index for BB-rated high yield corporate bonds.

The BofA Merrill Lynch US Floating-Rate Asset-Backed Index: is a statistical composite tracking the overall performance of the US floating-rate asset-backed securities (ABS) market over time. The index includes US dollar-denominated ABS having a floating coupon, a minimum amount outstanding of $25 million and an investment grade credit rating of BBB or higher.

BarCap U.S. Inflation Linked Bonds over 5 Year TR.: A part of the Barclays Capital family of global inflation-linked bond indices, the Barclays Capital US Government Inflation-linked bond index (US TIPS) measures the performance of the TIPS market. TIPS form the largest component of the Barclays Capital Global Inflation-Linked Bond Index. Inflation-linked indices include only capital indexed bonds with a remaining maturity of one year or more.

US Treasury Bill 90-Day On-The-Run Yield: Measured in percentage yield, this is the interest yield payable per year on the most liquid U.S. 3 month Treasury Bill.

The Dollar ("DXY") Index: indicates the general international value of the USD. The USDX does this by averaging the exchange rates between the USD and 6 major world currencies. The FINEX computes this by using the rates supplied by some 500 banks.

The Eurekahedge ILS Advisers Index: is an equally weighted index of hedge funds that explicitly allocate to insurance linked investments and have at least 70% of their portfolio invested in non-life risk.

HFRI Fund of Funds Composite Index: Funds of Funds invest with multiple managers through funds or managed accounts. The strategy designs a diversified portfolio of managers with the objective of significantly lowering the risk (volatility) of investing with an individual manager. The Fund of Funds manager has discretion in choosing which strategies to invest in for the portfolio. A manager may allocate funds to numerous managers within a single strategy, or with numerous managers in multiple strategies.

BarCap U.S. Agg TR Unhedged USD: The U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS sectors.

BarCap U.S. Long Treasury TR Index Unhedged USD: The Barclays US Treasury bond index is part of Barclays Capital global family of government bonds indices. The index measures the performance of the US Treasury bond market, one of the largest and most liquid government bond markets in the world. Using market capitalization weighting and a standard rule-based inclusion methodology; the index accurately reflects the performance and characteristics of the Treasury market and provides a basis for customized indices.

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