Being Different
and Avoiding the Crowded Trades

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In recent years, the hedge fund industry has witnessed significant concentration of assets among its largest players, with the top twenty managers accounting for nearly one-third of the total hedge fund assets under management (AUM). This concentration poses the risk that large funds with analogous business models, are pursuing similar investment ideas, leading to crowded trades. Moreover, intense competition for talent among these firms often result in the regeneration of the same ideas between them, further exacerbating the lack of uniqueness among managers. In the end, it is the investor who will pay the price for this concentration risk. However, one way to simply mitigate this is through diversification and finding managers who operate differently with success.

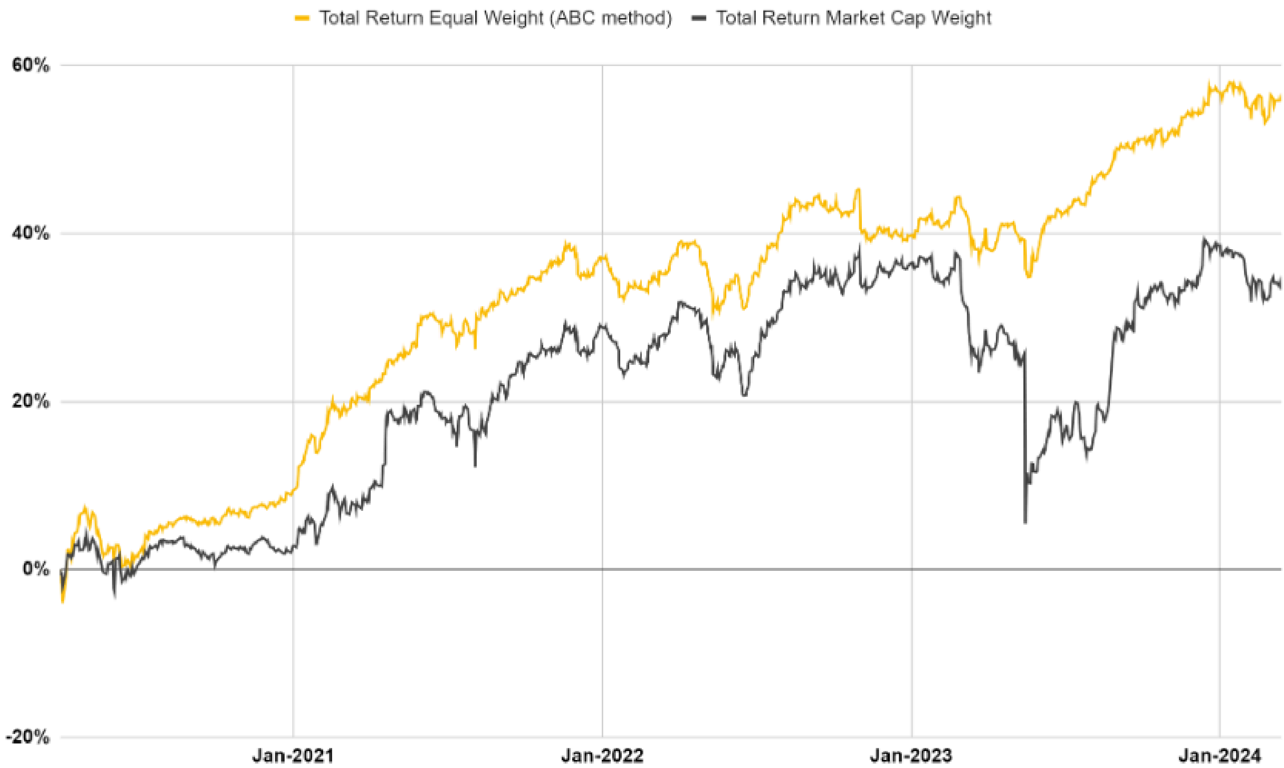
Part I: Assessing the size factor

Taking a step back, the size of a manager often determines the design of their strategy. Strategies that manage substantial capital, although well-resourced, face limitations in executing trades due to market impact considerations. Consequently, their investment universe is restricted as large funds require ample liquidity.

Why Size Isn't Always Superior?

For those not driven by size or not necessitated to trade vast amounts in a specific strategy, exploring more trading opportunities can lead to significant benefits through diversification. However, this demands both resources and expertise to adopt a broader approach. ABC arbitrage Asset Management (ABAM) is accustomed to this challenge, drawing from our extensive experience in niche strategies. By focusing on multiple smaller niche strategies rather than high-capacity ones, we aim to enhance our chances of uncovering unique or uncorrelated opportunities in the market. Consider our statistical approach to trading M&A deals as an example. Our strategy systematically selects deals globally, with the objective to optimise performance while ensuring diversification. The performance contrast between our equally dollar-weighted portfolio and an alternative market capitalization-weighted portfolio underscores the benefits of diversification, seen in figure 1.

Figure 1 - the benefits of diversification



Source: ABC arbitrage Asset Management data.

Here, we show two portfolios using the same model, differing only on their approach in weighting positions. While the market cap approach heavily weights large deals, our strategy's equal weighting fosters broader diversification across deal sizes. In terms of position concentration, for the market cap approach, on average 70% of the portfolio is invested in the top 10 biggest deals. While, when equally weighting, it's closer to 22 deals - which is meaningful in terms of additional deal exposure and diversification benefits.

Large funds would likely follow weighting schemes similar to market capitalisation ones, due to their high capacity needs. In contrast, we can hold small, mid and large cap positions in proportions that offer superior risk adjusted returns. For the largest funds, exposure to small and mid cap companies may be very light, if even present at all. Since we choose to run our strategy at a smaller size, we can be invested in all company sizes - and in fact this is true across all our strategies.

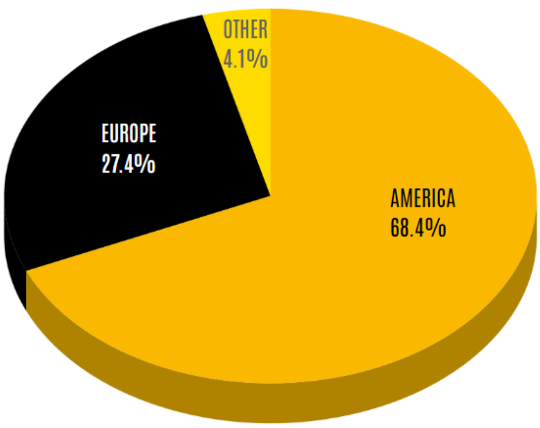
Part II: Overcoming Diversification Hurdles

How achievable is diversification in practice?

While there are attractive properties to diversification for managers, in practice it requires substantial resources and expertise. For instance, in our statistical M&A strategy, trading across various countries necessitates specialised knowledge of regulatory and legal nuances (for example knowing how a deal is approved) along with robust technological capabilities for data aggregation and modelling, especially important given the unstructured nature of this fundamental data.

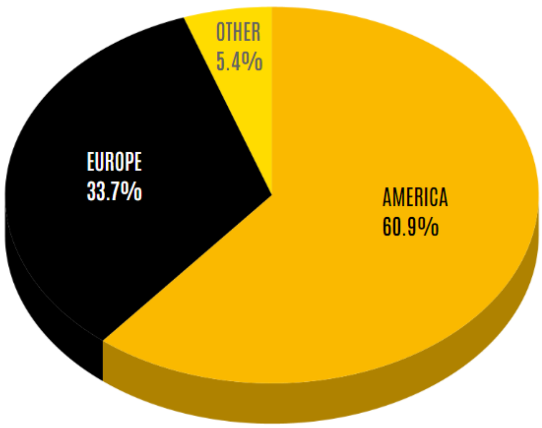
With over two decades of experience and a dedicated team of financial analysts, ABAM is well-equipped to navigate these complexities and achieve portfolio breadth and diversification through a combination of human specialists and technological resources. The type of regional exposure achievable in our M&A strategy can be observed in figure 2. On average our strategy's risk is two thirds exposed to US deals and approximately thirty percent in UK & Europe, with less than five percent in the rest of the world. While in figure 3, one can see that the returns achieved are representative of the risk taken, showing that the strategy's return contributions are aligned with the exposures taken.

Figure 2 - EXPOSURE SINCE 2021



Source: ABC arbitrage Asset Management data.

Figure 3 - RETURNS SINCE 2021



Source: ABC arbitrage Asset Management data.

In contrast, larger competitor strategies will usually be limited in their exposure to Europe mainly due to the region's lower liquidity but further hindered by the fragmentation across the continent. For example, one benefit of focusing on the US, beyond liquidity, is that you only need to know one legal and regulatory framework, versus a multitude for Europe and the UK. We believe there are benefits to undertaking this complexity risk particularly at the portfolio level. We can consider the sharpe ratio for the strategy when trading in Europe versus the US to be quite similar over the long term, with both portfolios realising around 1 to 1.2 (net). However their correlation to each other is around 0.3 which means that, at the aggregate level, combining both portfolios can achieve a sharpe ratio close to 1.5 (net), thereby improving the risk-return by at least 25%.

Our portfolio's regional exposure reflects our ability to trade across different jurisdictions effectively, leveraging our expertise and resources. While trading in Europe may present liquidity challenges and regulatory complexities, it offers diversification benefits that contribute to overall portfolio performance. Those that can support the costs of human resources and technology involved in this, stand to reap the rewards of diversification. For example, in terms of technology, there can be challenges to developing efficient and cost effective access to global markets. Over the years, we've developed these global trading capabilities and infrastructure needs for select strategies, however today they can be exploited by any strategy across the firm as we benefit from economies of scale.

Part III: "Jack of All Trades vs Master of Some"

How else are we different?

How we combine strategies is an important feature in our pursuit to find niche strategies that can truly compliment each other. For example, we trade equity stat arb as a compliment to statistical M&A given they are uncorrelated. Yet we also trade equity stat arb in a multi-signal approach, as compliments to each other. One signal was initially built to trade outside of earnings season, another was developed to trade within earnings season, and another to be agnostic on earnings season. This is just one example of many dimensions of complementarity that we strive to achieve.

The examples above are achievable based on how we organise ourselves which is in the form of business units. As all statistical equity strategies are managed together in one unit, we have great visibility on the whole portfolio. This is useful in monitoring different types of risks. However, something more subtle coming from this approach is that by sitting side by side we can understand each other's strategies more easily which has two clear advantages. Firstly, at the individual level, there are collaborative benefits that can come from working together with portfolio managers trading different strategies, for example: the statistical techniques one uses or how one handles data problems can improve any individual strategy. Secondly, at the team level, the goal of the unit is to trade a manageable number of niche strategies that are truly orthogonal to each other. While there can be a tendency to diversify as much as possible, the tradeoff is that you begin to lose knowledge acquired from specialising in any strategy. Finally, we prefer to have a focused approach and to know more about less strategies rather than being a "Jack of all trades" but ultimately a master of none.

Hypothetically, imagine there is a negative event that causes one large fund to deleverage its positions. This is realistic in liquid securities which can be highly levered by large funds. Similar strategies can be pushed to deleverage too, as 'stop loss triggers' cause a wave of risk cutting, especially automated ones.Yet, if we can be longer term in our mindset for risk, and control our stock exposure, then we can avoid cutting positions at this time, when all others are doing it - this may be more rational. It's easier for us to be rational since we are trading a reasonable number of strategies, we can see across all our sub-portfolios and therefore know why any one position is held.

Conclusion

In a landscape characterised by concentration and crowding risks, differentiation is paramount for investors seeking uncorrelated alpha. Emphasising strategies less driven by size, overcoming diversification challenges, and maintaining a focused approach to strategy combination are essential for navigating the complexities of today's investment landscape and achieving sustainable returns.

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