Hedge Fund Performance and Short Selling Bans

in Times of the COVID 19 Pandemic

The exponential spread of the COVID 19 pandemic has led to considerable turbulences in the global financial markets. Leading virologists also stress that the already critical situation is likely to worsen in the coming weeks in large parts of Europe, the USA and many developing countries as the pandemic spreads. Considering these prospects, it is difficult to make predictions about future developments in the financial markets. Comparisons with earlier crises triggered by (corona) viruses (cf. SARS, MERS, H1N1, Ebola) have become obsolete following the occurrence of widespread cases in Europe and the USA and the official upgrading of the COVID 19 virus to a pandemic: similar historical pandemics lie too far in the past (cf. Asian flu and Hong Kong flu), so that it is not possible to draw on corresponding comparative values in view of the globally networked markets of today. Possible future pandemic and market development forecasts can at present only be modelled by means of scenario analyses, and even this would prove difficult without recourse to the expertise of specialist virologists. Particularly as the forecasts for the further course of the pandemic vary greatly even among experts, and new forecasts are made almost daily. It is therefore all the more important to diversify portfolios so as to cover as many different risk scenarios as possible.

Hedge Fund Performance in February 2020

The opportunity for hedge funds to bet on both rising (long) and falling (short) prices through short sales and additionally to increase returns through leverage effects by raising additional debt capital, offers investors not only supplementary earnings opportunities in crisis situations but also stability for their portfolios. As a result, asset losses can be limited in the current market phase. For this reason, hedge funds can contribute positive diversification effects and reduce the overall risk of the portfolio in an institutional investor's traditional equity and bond portfolios, despite possible additional counterparty and market risks.

Historical performance of hedge fund indices demonstrates that hedge funds protect the capital invested by investors in difficult markets, either by suffering fewer losses than traditional investment funds or indeed by generating positive returns. A first comparison of hedge fund indices with stock indices for February 2020 significantly shows the stabilising effect of hedge funds on investor portfolios at the beginning of the crisis. Commercial database providers, such as PreqinPro, use the key figures reported to them by hedge funds to create indices. These indices can represent a single strategy, a group of strategies or the entire database (see Figure 1 on Preqin indices). Possible bias[1] in the databases is partly transferred to the indices, which are nevertheless useful for gaining an overview of performance data of hedge fund strategies. Hedge funds generally report their performance data to commercial data providers with a delay of several weeks, which is why reliable data

[1] Such as Selection Bias, Incubation Bias, Liquidation Bias, Multiperiod Sampling Bias and Smoothing Bias.

sets on hedge fund performance in February are available only now (end of March 2020).

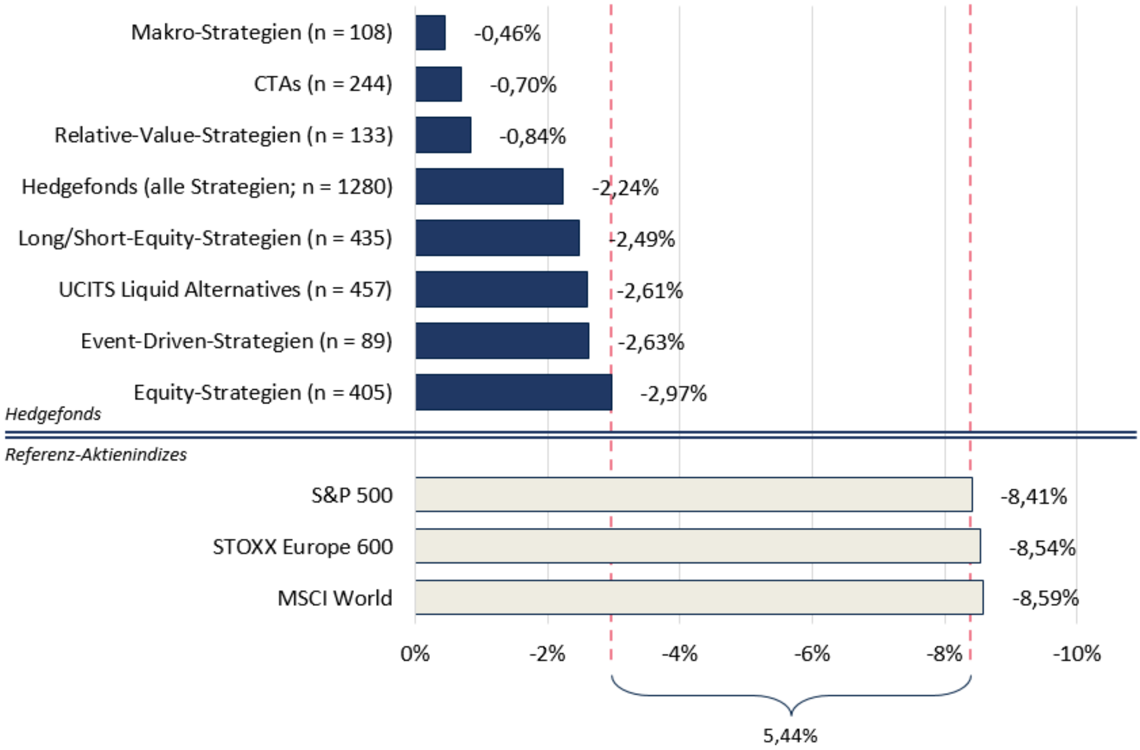

Figure 1: Hedge fund strategy indices performance vs. equity indices performance in February 2020 (n= Number of hedge funds included), in-house illustration, hedge fund index data: PreqinPro.

While hedge funds cannot completely escape the negative market trend, the losses are on average less severe than those of traditional stock indices (see Figure 1). The February data, which reflects the beginning of the bear market, already emphasises the advantages of diversification and regular portfolio rebalancing (also applies to rising markets). Exposure in Alternative Investments offers investors alternative sources of "beta" in their portfolio allocation. These can increase the degree of diversification, which in turn can have a significant positive impact on the overall volatility of the portfolio. Diversification effects should not only smooth out (upward) trends, but also reduce risks such as the tail risk currently observed (see Figure 2).

Hedge Fund Performance Prospects for March 2020

A first forecast of hedge fund index performance for March 2020 can be extrapolated from hedge fund-like strategies in the UCITS legal shell of exchange-traded liquid alternatives. Liquid alternatives have also proved to be an anchor of stability in investor portfolios during the corona crisis, although they generally correlate somewhat more strongly with common market indices than classic hedge funds, and are therefore not completely immune to broad market movements. Nevertheless, the current data from Absolut Research from mid-March shows that long/short strategies in particular can significantly reduce the risk of losses in the portfolio. In Figure 2, the performance of the "Barclay Hedge Fund Index" up to mid-March is extrapolated from listed liquid alternatives. This allows an initial forecast to be made which shows that hedge funds should, on average, have survived the first weeks of the COVID 19 crisis much better than classic long-only equity strategies.

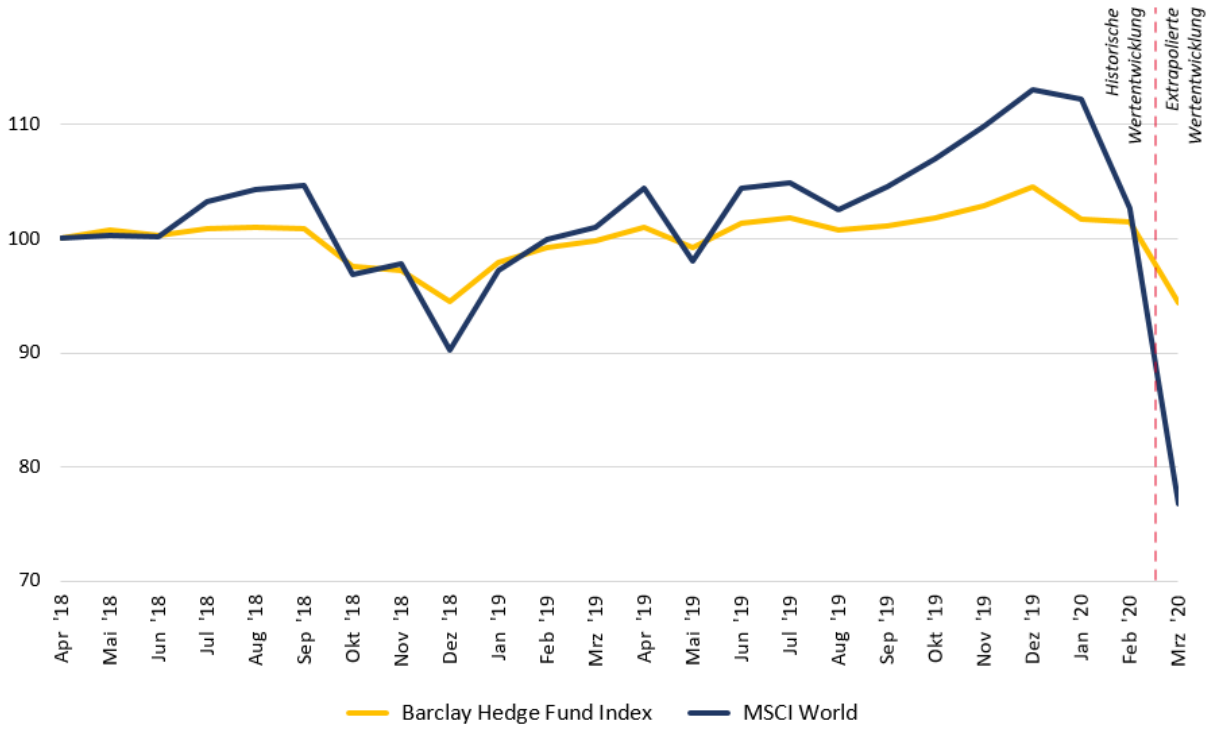

Figure 2: Minimising Tail-Risks: Barclay Hedge Fund Index vs. MSCI World Performance, In-house indexed illustration, source of hedge fund index data: Barclayhedge (data up to mid-March extrapolated from hedge fund-like UCITS indices by Absolut Research).

Hedge Funds in the Portfolio of German institutional investors

According to the BAI Alternative Investor Survey 2019, 23 % of institutional investors in Germany are invested in "liquid alternatives" (open UCITS liquid alternatives) and 13 % in "illiquid alternatives" (closed hedge funds). German investors are primarily invested in hedge funds of foreign origin. The results of the survey show hedge funds have recently become a rather unpopular alternative investment vehicle for German investors. One potential reason for this is the fact that equity markets have developed very positively in recent years so that hedge fund investments may not have been considered a necessity. This perception could change with the onset of a bear market. Against the backdrop of the market developments described above, the immense importance of hedge funds and hedge fund-like strategies as an expected anchor of stability for investor portfolios becomes apparent.

Short Selling Bans in the EU

On the basis of Art. 28 (1) (a) of Regulation (EU) No. 236/2012 of the European Parliament and of the Council of 14 March 2012 ("EU Short Selling Regulation"), ESMA, the European Securities and Markets Authority, has introduced a reporting obligation for holders of net short positions of

0.2 % to 0.1 % of the issued nominal value. The publication threshold of 0.5 % remains unchanged. Provisions of the EU Short Sale Regulation also apply outside the EU and to natural or legal persons from third countries. The positions must be reported to the national supervisory authority responsible for the market. The ESMA measure entered into force on 16 March 2020 and will apply for three months (market-making activities are excluded). The previous notification and publication thresholds pursuant to Articles 5 and 6 of the EU Short Selling Regulation continue to apply without change. Current reportable net short position change notifications from the months of February and March are listed in the appendix as an example for DAX-listed stock corporations (see Table 2). The scope of the previous short selling bans in the EU is summarised in Table 1.

Spain (CNMV) Measures apply until 17.04.2020	The measures apply to shares admitted to trading on Spanish stock exchanges and to all related instruments relevant to the calculation of the net short position.
Italy (CONSOB) Measures apply until 18.06.2020	The measures apply both to transactions in selected shares and to all related instruments relevant for the calculation of the net short position.
France (AMF) Measures apply until 16.04.2020	The measures apply to shares admitted to trading on French stock exchanges and to all related instruments relevant for the calculation of the net short position.
Belgium (FSMA) Measures apply until 17.04.2020	The measures apply to shares listed on Euronext Brussels and Euronext Growth.
Greece (HCMC) Measures apply until 24.04.2020	The measures apply to shares admitted to trading on the Athens Stock Exchange and to all related instruments relevant for the calculation of the net short position.
Austria (FMA) Measures apply until 18.04.2020	The measures apply to all shares admitted to official trading on the Vienna Stock Exchange.

Table 1: Scope of the short selling bans in the EU (as of 24.03.2020), in-house illustration. Further information can be found in the links.[2]

The stock markets continued to slump even after the short-selling bans came into force. Although bans in the EU, South Korea, India and numerous other countries (Asia) may be advantageous in terms of market psychology and also prevent possible "short and distort" activities, they have virtually no effect on volatility or pricing on the stock market, but may have a negative impact on the liquidity of individual securities. Current market slumps are not primarily due to short sales by hedge funds and other market participants. Instead, they can be attributed to fundamental reasons. Price slumps are unavoidable in view of the pandemic wave described by Chancellor Angela Merkel as the most severe crisis since World War II. Short selling is essential for the functionality of hedge fund strategies. Short selling bans should in principle be the last resort of national supervisors. Regarding the pros and cons of short selling bans, please also refer to the literature below.[3]

[2] BaFin notice dated 23.03.2020: Instruments based on the Euro STOXX 50®, STOXX® Europe 600, MSCI Europe, MSCI EMU indices are exempted from the short selling prohibitions, i.e. trading in the instruments is possible and not covered by the prohibitions. Instruments based on the Euro STOXX® Banks index are partially excluded (see link). The restrictive measures only apply to index-related instruments if the shares covered by the prohibitions represent more than a defined threshold value of the index weighting in each case. This is not the case for instruments based on the Euro STOXX 50®, STOXX® Europe 600, MSCI Europe, MSCI EMU.

[3] On the question of the regulation of short selling, see for example Zetzsche/Lehmann in: Schwark/Zimmer, Kapitalmarktrechts-Kommentar, 5. Aufl. 2020, § 53 WpHG Rn. 4 ff.; zum Aufsichtsrecht der Leerverkäufe vgl. *F.*

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Appendix: DAX net short position change notifications > 0.5 % in February/March 2020

Issuer	Position Holder	Position	Date
Bayerische Motoren Werke AG	Susquehanna International Group Ltd.	0.71%	24.03.2020
Covestro AG	Citadel Europe LLP	1.09%	24.03.2020
Covestro AG	D. E. Shaw & Co., L.P.	0.57%	24.03.2020
Deutsche Lufthansa AG	BlackRock Investment Management (UK) Ltd.	1.31%	17.03.2020
Deutsche Lufthansa AG	Citadel Advisors LLC	1.,21%	20.03.2020
Deutsche Lufthansa AG	Citadel Europe LLP	1.84%	24.03.2020
Deutsche Lufthansa AG	Marshall Wace LLP	2.63%	24.03.2020
Deutsche Lufthansa AG	Viking Global Investors LP	1.68%	23.03.2020
MERCK KGaA	Citadel Advisors LLC	0.72%	13.03.2020
MERCK KGaA	Marshall Wace LLP	0.85%	20.03.2020
MTU Aero Engines AG	Citadel Europe LLP	0.57%	19.03.2020
MTU Aero Engines AG	Marshall Wace LLP	0.52%	20.03.2020
RWE AG	AQR Capital Management, LLC	0.79%	16.03.2020
thyssenkrupp AG	AHL Partners LLP	0.53%	18.03.2020
thyssenkrupp AG	AQR Capital Management, LLC	2.27%	16.03.2020
thyssenkrupp AG	BlackRock Institutional Trust Company, National Association	0.70%	18.03.2020
thyssenkrupp AG	Capital Fund Management SA	0.80%	26.02.2020
Wirecard AG	Greenvale Capital LLP	0.95%	20.03.2020
Wirecard AG	Marshall Wace LLP	1.20%	17.03.2020
Wirecard AG	Slate Path Capital LP	1.18%	12.03.2020
Wirecard AG	TCI Fund Management Ltd.	0.89%	13.03.2020

Table 2: In-house Illustration, Source: Bundesanzeiger (Stand: 25.03.2020).[4]

Schäfer in: Assmann/Schütze/Buck-Heeb, Handbuch des Kapitalanlagerechts, 5. Aufl. 2019, § 21 Rn. 9 ff., with further evidence in each case; for the effects of short-selling bans, see for example):. ESRB (2018): Short-selling bans and bank stability, Working Paper Series No 64 / January 2018; CFS (2013): The 2011 European Short Sale Ban on Financial Stocks: A Cure or a Curse?, CFS Working Paper No. 2013/17; Beber/Pagano (2013): Short-Selling Bans Around the World: Evidence from the 2007–09 Crisis, in: Journal of Finance, VOL. LXVIII, NO. 1.

[4] As a tabular overview, the current reports (as of 25.03.2020) of net short positions are displayed. For each position holder/ISIN combination, only the current position in relation to the date of the position is listed if the percentage is above 0.5%.