Absolute Return Strategies Market Commentary and Outlook
Mid-Year 2020

It Has Been Quite a (Half) Year

The year began optimistically. The U.S. and China signed a trade deal, unemployment rates were at or near record lows across most major economies, and consensus expectations among analysts were for record corporate earnings amid one of the longest economic expansions on record. However, as the first quarter unfolded, the rapid escalation of the global COVID-19 crisis pushed the world economy into recession and markets into a tailspin.

As the impact of the virus became apparent and energy markets tumbled, equity and credit markets began a decline with few historic parallels with respect to both speed and depth. Following unprecedented global government and central bank stimulus packages, risk assets staged a sharp second quarter recovery; however, investor sentiment about an uncertain future remains volatile – swinging between extremes of optimism and pessimism.

In our view, these turbulent times support the case for active management generally and hedged strategies in particular. As has been the case historically, prudent and less market-sensitive investment strategies implemented by hedge funds are among the most appropriate for extracting returns from an increasingly mercurial market. In the following, we provide a brief overview of the year so far and explore where potential opportunities exist.

Impact of the COVID-19 Crisis

It has been said that markets can act like an escalator on the way up, but an elevator on the way down. That was certainly the case in early 2020, with years of gains across asset classes erased in days, as markets began to discount the substantial economic impact of the pandemic on the global economy.

Data source: Bloomberg Finance, L.P.

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In response, policymakers extended massive fiscal stimulus packages alongside monetary efforts designed to provide ample liquidity to corporate funding markets and capital markets, and to reduce interest rates. Equity and high-grade credit markets quickly incorporated this new information. They recovered a significant portion of their losses, with many large-cap technology stocks now trading at all-time highs, despite the U.S. being in a pandemic-driven recession.

The meteoric recovery in stock prices alongside deteriorating forward earnings expectations leaves equity markets at extremely high forward multiples (by historical standards) and potentially at risk of retracement, should policy efforts fail to stimulate a sufficient economic recovery. In addition to valuation risk, other challenges facing capital markets include elevated domestic and geopolitical risks, which can become further pronounced in a U.S. election year.

In any event, we would expect forward returns from equity beta to be materially below average (and certainly below those observed over the past decade) as the market appears to have “pulled forward” several years of returns, and appears to be trading on lofty expectations.

Meanwhile, individual stock dispersion has been rising, driven by the divergence in fundamental business prospects and heightened market volatility. As has been the case in past crises, we believe this wider spread between the top and bottom performing stocks (and bonds) provides a fertile environment for alpha generation among hedge fund managers, despite the more challenging backdrop for beta-driven returns.

Within credit, policy responses have led to an uneven rebound along the spectrum of credit asset classes and ratings. Investment grade and other high-quality credit assets have benefited from explicit Fed support, stabilization of market liquidity, and compression in government bond yields across duration – with outright yields for investment grade corporate bonds in the U.S. at or near record lows. Meanwhile, lower-rated high yield and distressed credit have materially lagged, as many businesses are under extreme distress, particularly below the top of the capital structure.

**HISTORICALLY HIGH MULTIPLES A HEADWIND FOR EXPECTED EQUITY ‘BETA’ RETURNS**

| S&P 500 P/E Ratio (12m Consensus Forward Earnings) |
| December 31, 2009 to June 30, 2020 |

**HISTORICALLY LOW YIELDS REDUCE RETURN EXPECTATIONS IN LONG-ONLY CREDIT MARKETS**

| Bloomberg Barclays U.S. Aggregate Corporate Yield to Worst | December 31, 2009 to June 30, 2020 |

Data source: Bloomberg Finance, L.P.

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A Favorable Environment for Hedge Funds

While elevated valuations and a tenuous macroeconomic environment are typically headwinds for equity beta returns, rising dispersion can provide a tailwind for hedge fund alpha generation. On June 17, the dispersion of S&P 500 returns was at its widest point since 2009.


Spread between top & bottom quartile returns (trailing 90 days) for underlying stocks in the S&P 500: January 1, 1991 to July 1, 2020

**HIGHER RATES OF EQUITY MARKET DISPERSION HAVE HISTORICALLY BENEFITTED HEDGE FUND ALPHA GENERATION**

Next 24 months HFRI FW Index annualized alpha vs. trailing S&P 500 dispersion 1991-2020 | As of July 1, 2020

Process-oriented strategies, like distressed credit investing and other event-driven strategies – when appropriately hedged – may provide an idiosyncratic source of “non-beta” returns, which are driven principally by the efforts of an investment manager, rather than by market-level, systematic risk factors.

Dispersion also was elevated among credit securities. In late April, only 18% of bonds included in the HY index (even excluding commodity-linked businesses), were trading within 100 bps of the index spread, down from 40% as recently as January 2020. That figure reverted to around 30% at the end of June. Still, we believe the significant dispersion in bond pricing prevalent today provides a rich environment for potential alpha generation driven by fundamental long/short credit analysis and active management.

Additionally, the pre-crisis surge in high-risk borrowing, combined with COVID-19 induced economic turmoil, leads to what we expect to be a growing pool of stressed and distressed credit securities. We anticipate that this will provide a ripe backdrop for both fundamental and distressed credit strategies in the coming quarters (see charts on the following page).
LEVERAGED CREDIT HAS GROWN SUBSTANTIALLY

Billions outstanding in face value

<table>
<thead>
<tr>
<th>Ye 2000</th>
<th>Ye 2008</th>
<th>Ytd 2020</th>
<th>High Yield</th>
<th>Leveraged Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>$320</td>
<td>$542</td>
<td>$1,523</td>
<td>$1,420</td>
<td>$1,420</td>
</tr>
<tr>
<td>2.8x</td>
<td>4.8x</td>
<td>13.5x</td>
<td>3.1x</td>
<td>4.8x</td>
</tr>
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HIGH YIELD SPREADS REMAIN ELEVATED ON A HISTORICAL BASIS

Credit Suisse U.S. High Yield Spread to Worst


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As anticipated corporate distress, defaults, and restructurings increase in the coming quarters, we expect the associated refinancing and “rescue funding” needs should create material opportunities for hedge funds with expertise in these strategies. Dislocated market conditions have caused the cost of capital to rise, particularly in complex situations. This will present an improved opportunity for hedge funds to act as lenders and financial intermediaries to stressed businesses and owners. Due to a large number of companies with significant cash needs, we believe hedge fund investors can be highly selective, with increased opportunities to negotiate equity-like returns with debt-like risk.

While we believe the current market environment is favorable for some opportunistic strategies, we are focused on the “middle of the barbell” consisting of hedge fund strategies designed to be “all-weather” and we seek to mitigate losses in declining and volatile market environments. We believe manager selection is particularly critical in constructing an attractive hedge fund program today. The elite hedge fund firms continue to attract deep talent and possess a sustainable “edge” in our view.

As many long-only fixed income investments have changed from diversifying sources of return to potentially “return-less risk” as yields reach historic lows, investors are considering shifting the strategic asset allocation of their portfolios. Therefore, we are having conversations about the value of increasing the allocations to absolute return strategies in our portfolios.

Opportunities Exist

The COVID-19 pandemic is accelerating some market trends that had already taken root before the outbreak. Online shopping and e-commerce have been the most discussed, but others have accelerated, and the crisis will fuel more technology adoption and innovation. These trends are not only benefiting new innovators, but existing firms like Microsoft, where CEO Satya Nadella said in April, “In this era of remote everything, we have seen two years’ worth of digital transformation in two months.”

Past performance is not necessarily indicative of future results.
Against this backdrop, we believe there is an evolving and broad opportunity set across equity and credit for hedge fund managers. Within equity:

- The **Technology, Media, and Telecommunication (TMT)** sector is at the forefront of innovation and enjoys robust secular growth independent of traditional economic cycles and GDP growth. At the micro-level, TMT is rich in businesses with advantages that include highly recurring revenues, scale/network effect advantages, and regulatory/innovation-driven barriers to competition.

  The crisis is creating further TMT-specific opportunities, given the potential long-term shift in societal preferences towards tech-enabled offerings.

- **Healthcare** is characterized by innovation, long-term growth, scientific and regulatory complexity, and persistent dispersion driven by idiosyncratic factors. Companies in clinical development have a continuous need to raise capital to fund the development of drugs prior to generating revenues. This creates opportunities for healthcare managers to invest in these companies at attractive prices.

  The market dislocation created by COVID-19 has accelerated many companies’ capital needs and created better priced entry points for managers.

- **COVID-19 dislocations** have created a number of opportunities, including:
  - Long world-class companies with healthy businesses and deep moats, whose share prices were adversely impacted by indiscriminate selling and have not fully retraced
  - Long/short strategies: long companies in TMT, healthcare, and consumer spaces that stand to benefit from a post-COVID-19 world, and short companies that may never recover, or those with business models may not fit a post-crisis world

- **Short selling** opportunities are attractive, given the increase in market activity among passive/index investors, quantitative strategies, and other short-term or non-fundamental investors. As these strategies account for a larger portion of trading activity, more securities diverge from managers’ estimates of intrinsic values, and the magnitude of these divergences increases. The potential returns available to short sellers that can identify and execute on these divergences have increased in recent years.

Within credit, dislocations arising from the pandemic are expected to drive opportunities not seen in over a decade. As mentioned above, we expect a large and growing opportunity to invest in high-quality businesses and assets that may offer “senior-like” risk at “equity-like” returns. The multi-sector and multi-class opportunity set could include securities spanning corporate credit, structured credit, distressed equity, and other sub-segments of the private capital markets.

We have defined three stages of the opportunity set in credit. With the aggressive and unprecedented policy response in the U.S., we believe we are currently in stage 2.

- **Stage 1: Liquidity and stressed dislocation** – highly-rated corporates and structured credit opportunities created by forced sellers during periods of volatility. Purchasers seek equity-like returns generated by claims atop the capital structure (this opportunity has largely, but not completely, played out).

- **Stage 2: Effectuate balance sheet restructuring** – privately negotiated transactions meant to stabilize balance sheets of high-quality businesses with over-levered balance sheets in the face of COVID-19-related economic slowdowns. These out-of-court “restructurings” seek to deleverage and extend the duration of a company’s liabilities while generating attractive risk/return opportunities for investors who can provide certainty of execution and scalable capital solutions.

- **Stage 3: Recovery opportunities** – investing in a fulcrum security of a distressed, economically challenged issuer and participating in debt restructurings. The purchaser acquires control of businesses at a discount and helps strengthen the balance sheet and helps drive an operational turnaround.

Past performance is not necessarily indicative of future results.
Hedge funds in the current environment

Hedge funds mitigated much of the downside of global equities’ decline stemming from the COVID-19 crisis while capturing a reasonable upside during the second quarter market recovery.

Hedge funds mitigated losses of an extreme and rapid downturn

<table>
<thead>
<tr>
<th>MSCI World</th>
<th>HFRI FoF</th>
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</thead>
<tbody>
<tr>
<td>Trailing 12-month Max PTT</td>
<td>Q1 2020 Returns</td>
</tr>
<tr>
<td>-34.0%</td>
<td>-9.1%</td>
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</table>


Conclusion

We believe that today’s market environment is as unpredictable as we have seen in many years, and investor sentiment is volatile and uncertain. In our view, a prudent investor should favor an active management approach and consider increasing their allocations to absolute return strategies. Two primary beliefs underscore this view:

1) Investors are getting “paid” to take long-only risk considering the vulnerable state of capital markets and a low margin-of-safety.

2) The current environment favors a hedged approach due to:
   * Tailwinds for fundamental long/short strategies
   * Opportunities to extract returns from a broad and growing opportunity set across dislocated assets
   * Ability to mitigate losses should the pandemic cause a retracement of the correction/crisis

Given the current market environment, we believe our size, scale, and industry relationships allow us to secure access to high-quality persistent alpha-generating managers to potentially reduce market risk.* Additionally, our investment team and investment process, which are highly focused on rigorous due diligence, manager selection, portfolio construction, and monitoring, are well-positioned to mitigate risks and deliver desired risk-adjusted returns.

* Defined as managers that historically generated alpha above a threshold as determined by GCM Grosvenor in its sole discretion.

Past performance is not necessarily indicative of future results.
NOTES AND DISCLOSURES

DATA SOURCES
Bloomberg Finance L.P.

Hedge Fund Research (HFR).

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GCM Grosvenor is a global alternatives investment firm with $55 billion in assets under management in hedge fund strategies, private equity, infrastructure, real estate, credit, and multi-asset class opportunistic investments. We have specialized in alternatives since 1971, and we are dedicated to unlocking value for our clients by leveraging our cross-asset class and flexible investment platform.

Our experienced team of approximately 500 professionals from diverse backgrounds serves a global client base of institutional and high net worth investors. The firm is headquartered in Chicago, with offices in New York, Los Angeles, London, Tokyo, Hong Kong, and Seoul.

Total AUM
$55.7 bn
Hedge Funds
$23.8 bn
Private Equity
$21.3 bn
Infrastructure
$5.6 bn
Real Estate
$3.4 bn
Credit
$10.4 bn
Multi-Asset
$2.5 bn
Employees
~500

Employee data as of July 1, 2020. AUM data as of March 31, 2020.