GCM GROSVENOR

INSight

Hedge Fund Strategies
Market Commentary & Outlook

Published February 2020

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GCM GROSVENOR

1. Overview

Despite recent industry challenges, we believe hedge funds remain an important component of a well-constructed investment portfolio. Below, we share our perspectives on the current market environment and the value hedge funds can provide.

+ 2019 capped an exceptionally strong decade for asset prices, with equity valuations and bond yields ending the year at extremely expensive levels relative to historical standards. These valuations, combined with elevated geopolitical risks and below average liquidity in global capital markets, suggest that it is more important than ever to include "non-directional" exposure in a portfolio.
+ While expected returns for traditional equities and bonds have been reduced by most strategists and consultants, the opportunity set for select hedge fund strategies has been improving. High quality hedge funds are designed to mitigate losses in declining markets, and to capitalize on opportunities created by dislocations.
+ The hedge fund model is not broken, but manager selection is critical due to high performance dispersion across all strategies. Top-tier firms have adapted to industry challenges to offer what we believe are excellent sources of less-correlated returns and diversification.

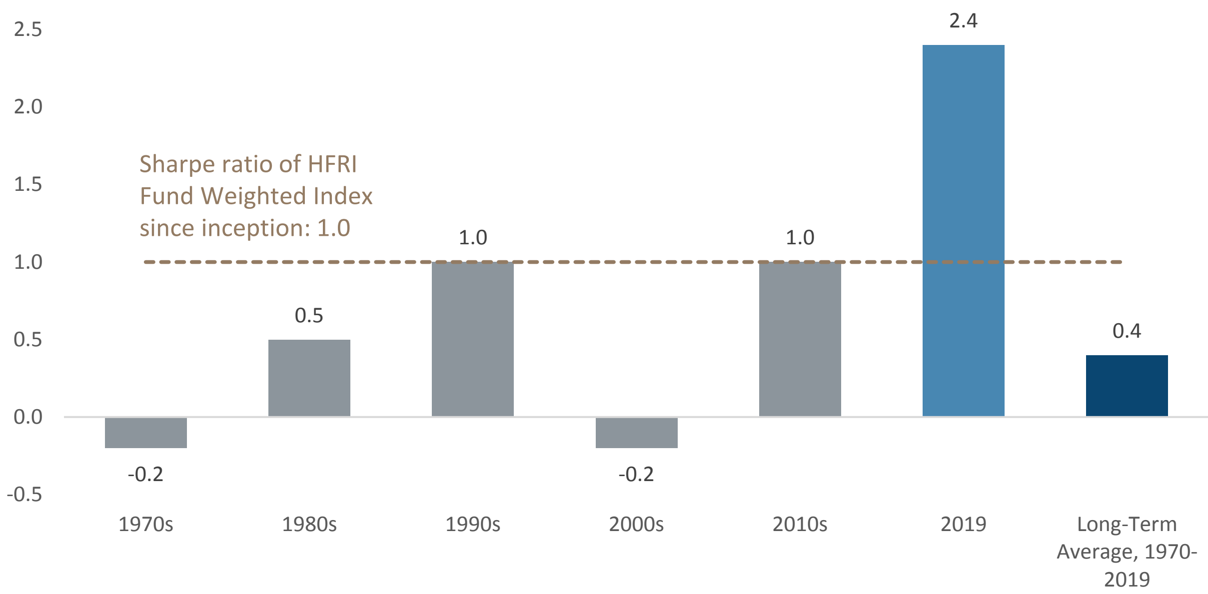
2. Market Outlook

2019 REVIEW

2019 capped an exceptionally strong decade for risk-adjusted equity returns

The market returns and risk metrics over the past decade were highly anomalous. As illustrated below, the S&P 500 Index generated a Sharpe ratio of 2.4 in 2019 and 1.0 for the decade as a whole – both well above the index's long-term average of 0.4 since the 1970s. While it is fairly unusual for the S&P 500 Index to maintain a Sharpe ratio over 1.0 for an extended period of time, we believe high-quality hedge funds are capable of reliably generating a Sharpe ratio around this level, as illustrated by the HFRI Fund-Weighted Index ratio of 1.0 since its inception.[1]

EXHIBIT 1 **Attractive risk-adjusted returns in 2019**
S&P 500 Index Sharpe ratio by decade



Sources: S&P, Hedge Fund Research (HFR). **Past performance is not necessarily indicative of future results.** Sharpe ratio calculated using monthly returns.

1 The Sharpe ratio is a common measure of risk-adjusted returns often used to measure the quality of a fund's return. It is defined as an asset's return in excess of the risk free rate divided by the volatility of that asset's return stream.

MARKET POSITIONING

Markets are positioned for lower expected returns

Market returns in 2019 appear to have been "pulled forward" from future years, as multiple expansion, rather than corporate earnings growth, drove most gains globally. The substantial majority of gains were derived from price/earnings multiple expansion, while dividends and share buybacks represented a much smaller portion. Earnings-per-share were flat to negative across most global markets. As current valuations are at top decile historical levels, it will be more challenging to deliver returns similar to what we've seen, and most long-range "sell-side" forecasts are now reflecting this view.

EXHIBIT 2 **Global equity returns in 2019 were driven by multiple expansions....**
Index returns through 12/31/2019

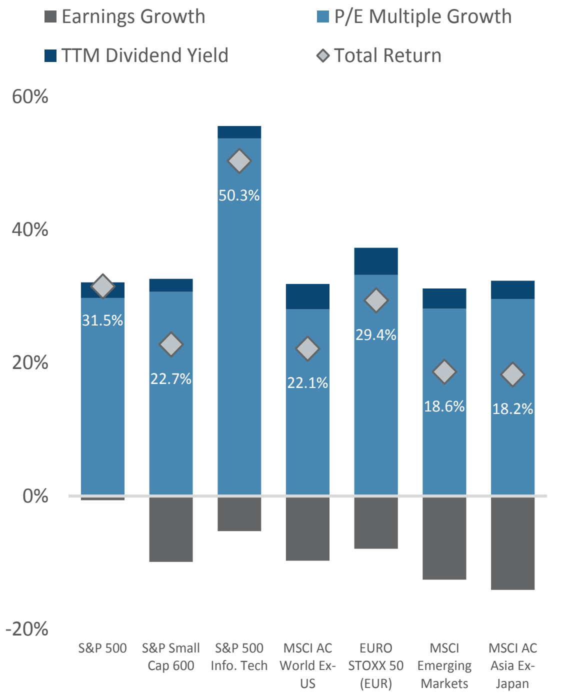
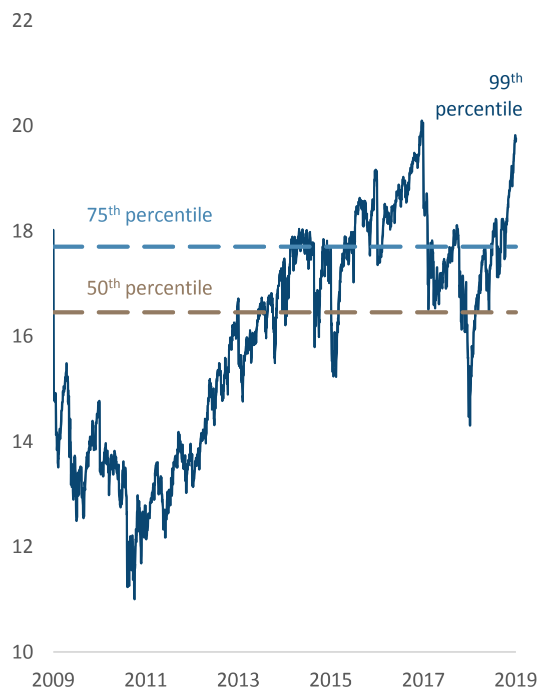


EXHIBIT 3 **....leaving the market relatively expensive on a historical basis**
S&P 500 Index forward P/E ratio through 12/31/2019



Source: Bloomberg Finance, L.P. **Past performance is not necessarily indicative of future results.**

Similarly, in fixed income markets, outright yields and corporate bond spreads enter the new decade near all-time lows, mathematically constraining the return potential across fixed income asset classes.

EXHIBIT 4 **10-Year U.S. Government Bond Yield**
Through 12/31/2019

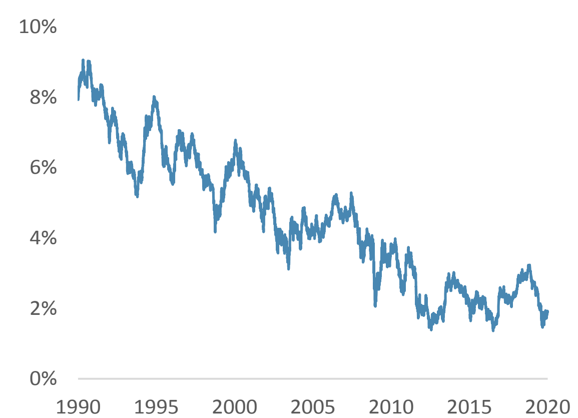
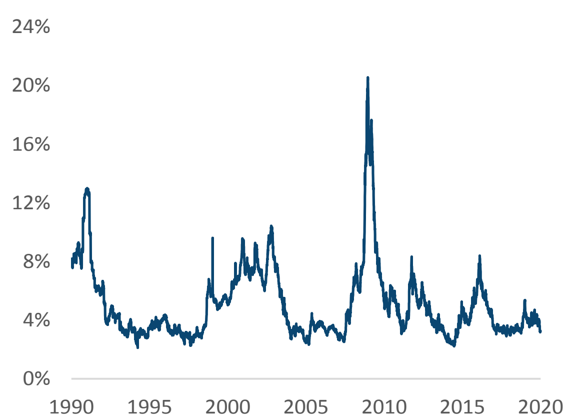


EXHIBIT 5 **Bloomberg Barclays U.S. Corporate High Yield Index Spread**
Through 12/31/2019



Sources: Federal Reserve Bank. Bloomberg Finance, L.P.

HEADWINDS IN TRADITIONAL MARKETS

Fundamental pressures appear to be building below the surface of the post-financial-crisis market expansion. Persistently low interest rates have allowed both corporations and governments to increase leverage significantly. Meanwhile, yield-starved investors are accepting reduced protections in credit markets. As dealer inventory of corporate debt in the U.S. continues to fall relative to outstanding corporate debt, liquidity in "liquid" credit markets has become an area of concern. The combination of these factors creates an environment that bodes poorly for post-default recoveries in the next distressed credit cycle.

EXHIBIT 6 **Concerning liquidity in debt markets**
Primary dealer corporate debt inventory relative to U.S. corporate debt outstanding, 2001-2019

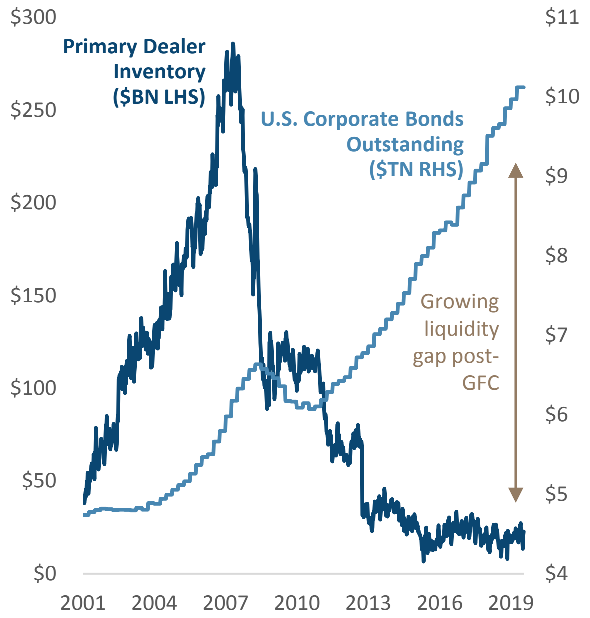
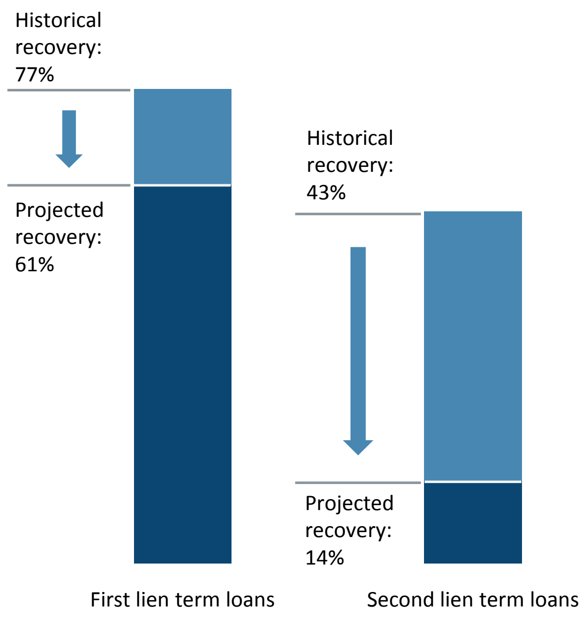


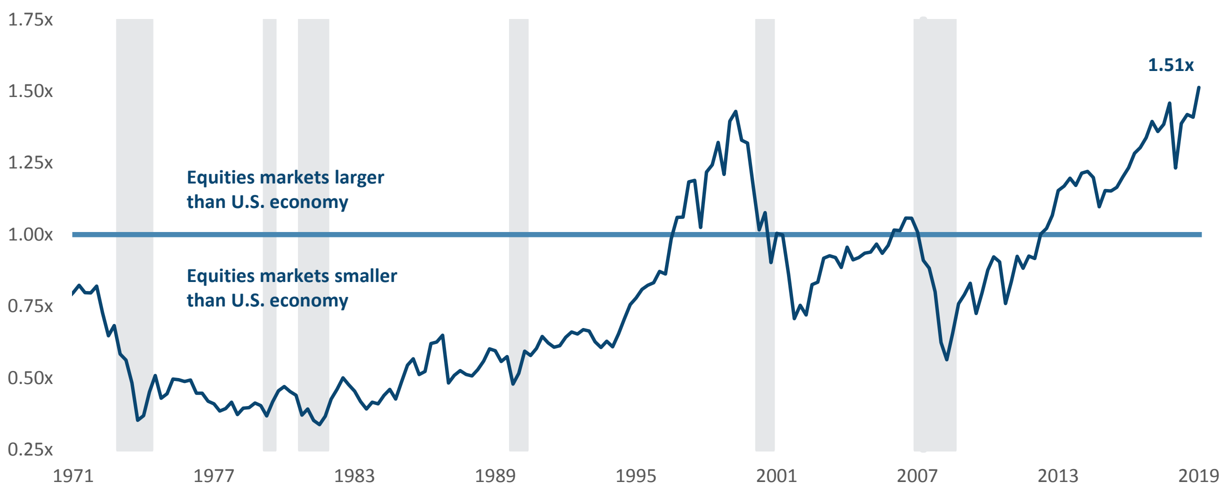
EXHIBIT 7 **Declining recoveries expected**
Moody's impairment rate as of December 2018.
Historical average: January 1988 to December 2018



Sources: Bloomberg Finance L.P.; Moody's Investors Service.

Another fundamental measure, the "Buffett Indicator" – equity market capitalization versus GDP – now exceeds its peak achieved during the 1990's tech bubble, which brings into question the ability of the "real economy" to support financial markets.

EXHIBIT 8 **U.S equity market cap historically large relative to the real economy**
Wilshire 5000 Index / nominal GDP, through 12/31/2019



Source: Bloomberg Finance, L.P.

3. Hedge Fund Strategies Outlook

THE ROLE OF HEDGE FUNDS

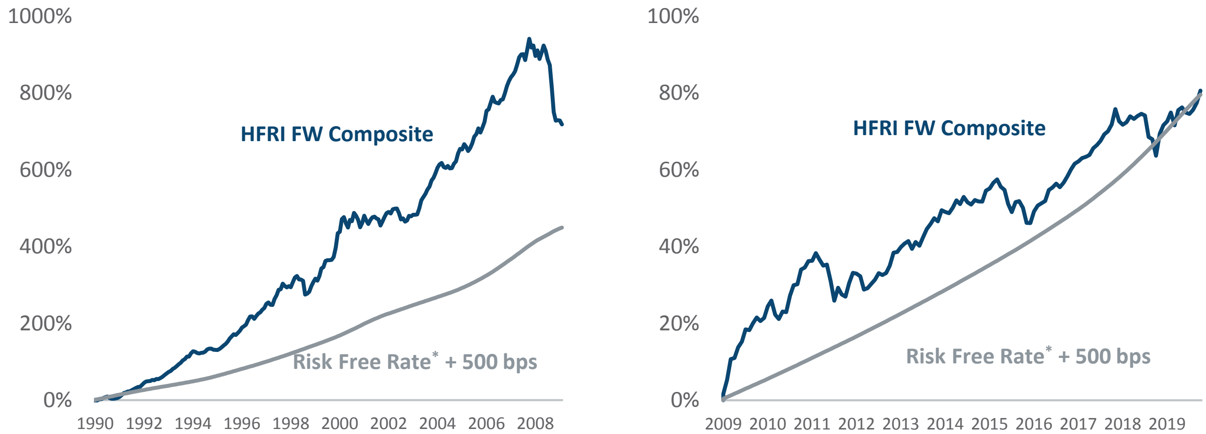
In today's investment climate, with lower expected returns from traditional investments and material downside risks broadly, it is our view that forward-looking investors must seek alternative sources of return and portfolio diversification. Focusing on absolute returns and limiting drawdowns are essential aspects of hedge fund investing.

There are a number of hedge fund strategies that we believe can provide uncorrelated or less-correlated return streams. Examples include fundamental market-neutral and low-net equities, non-directional quantitative strategies, relative value and macro strategies, as well as effort-driven, more complex investment strategies including distressed securities, arbitrage, and a wide range of special situations across regions. Over time, this approach has been effective and has displayed less than half the volatility of broad equity markets.

EXHIBIT 9 **Relative performance of hedge funds**

Pre-Global Financial Crisis
Cumulative returns: 1/1/1990 to 2/28/2009

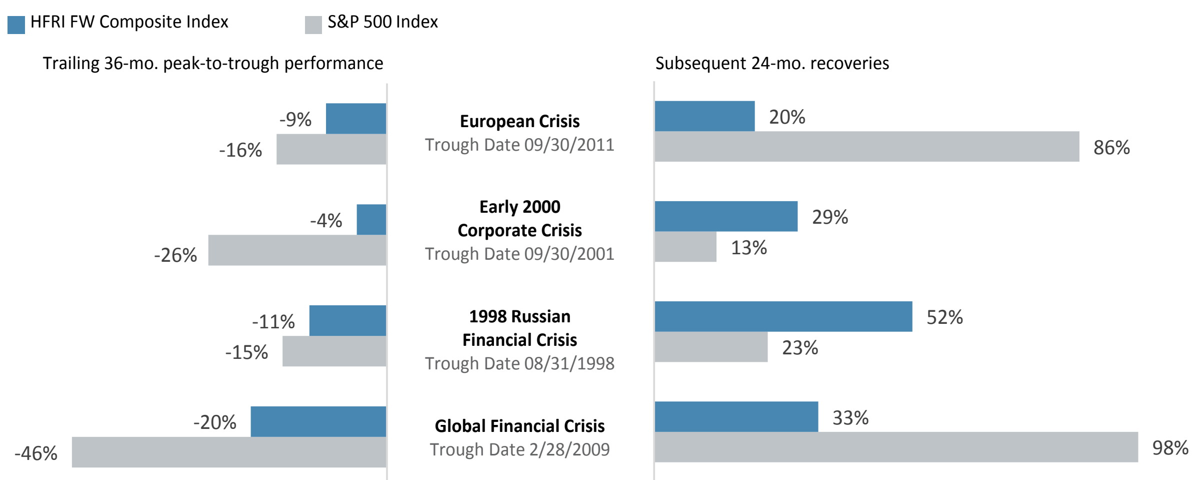
Post-Global Financial Crisis
Culumlative returns: 3/1/2009 to 12/31/2019



*Risk-free rate defined as the FTSE 3-Month U.S. Treasury Bill Index.
Source: Hedge Fund Research (HFR). **Past performance is not necessarily indicative of future results.**

As part of a well-constructed portfolio of hedge funds, we anticipate these strategies will function in an "all-weather" manner and generate absolute returns across a wide range of market environments. As illustrated below, hedge funds have consistently outperformed during recent market drawdowns, and have provided upside capture in the subsequent recoveries.

EXHIBIT 10 **Relative performance of hedge funds during and after recent negative market events**



Source: Bloomberg Finance, L.P. Trough dates set to nearest month-end date for this analysis. **Past performance is not necessarily indicative of future results.**

A CHALLENGING PERIOD FOR HEDGE FUNDS

As markets culminated their record-setting decade, hedge funds faced their share of challenges, with a number of cyclical changes affecting the industry. During the last 11+ years, we observed a highly correlated and near-continuous period of rising securities prices, characterized by:

- Largely one-way markets
- A lack of dispersion among securities pricing
- High correlations among asset classes

During this period, short positions and hedges detracted significantly from performance. In hindsight, many managers maintained overly conservative positioning. Returns were muted further as low interest rate levels reduced short rebate and interest income on cash balances. Note that a number of strategies maintained cash balances as collateral, despite being "fully invested."

Additionally, the hedge fund industry has faced challenges stemming from certain structural factors, such as:

- Overpopulation – there has been an excess number of entrants, many of mediocre quality
- Increased position crowding
- Proliferation of quantitative strategies, such as CTAs, risk parity, risk premia, quantitative, etc.
- Hedge fund fee levels remained high relative to available return levels

MANAGER SELECTION

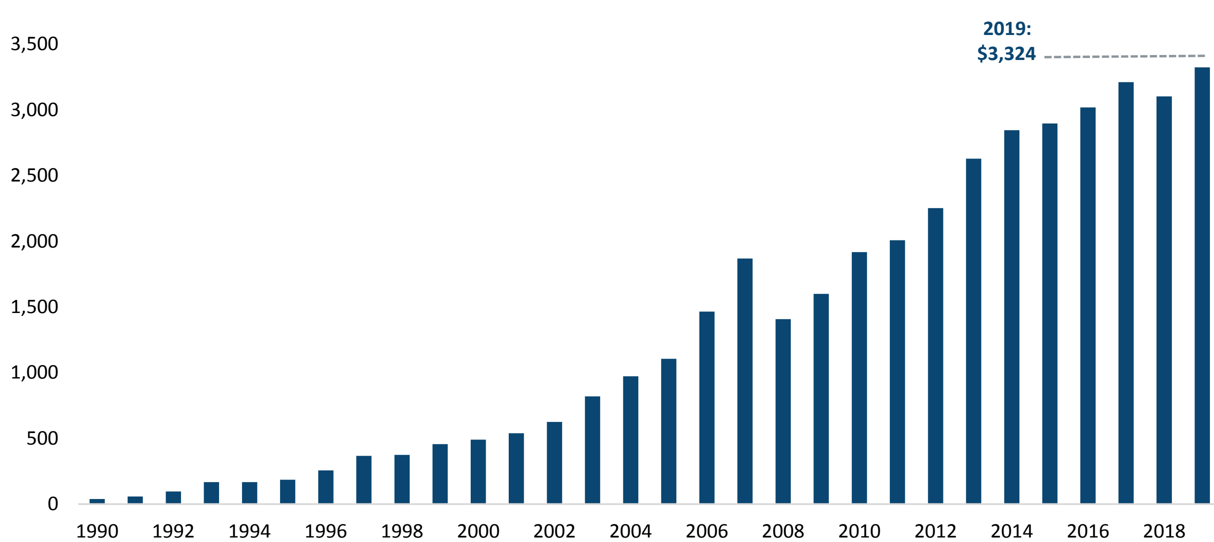
Manager selection is more important than ever

Despite recent performance that is below expectations, and occasional adverse press, many institutional and individual investors find hedge fund investments to be stable sources of return and important portfolio tools. In fact, hedge fund industry assets are currently at an all-time high, as illustrated below. In an environment where there is little "income" left in most fixed income returns, and equities exhibit material impairment risks, many investors find the stable value proposition of hedge funds appealing.

Growth in the hedge fund industry over the past two decades created a competitive environment, eroding median returns for hedge funds. Consequently, according to HFR, the number of hedge funds has contracted as new launches have declined and underperforming firms continue to close. We view this as a positive dynamic for top-tier firms as: i) it reduces competition for "alpha," and ii) it allows strong firms to attract talented investment professionals from lower-tier firms.

EXHIBIT 11 **Hedge fund industry AUM continues to grow**

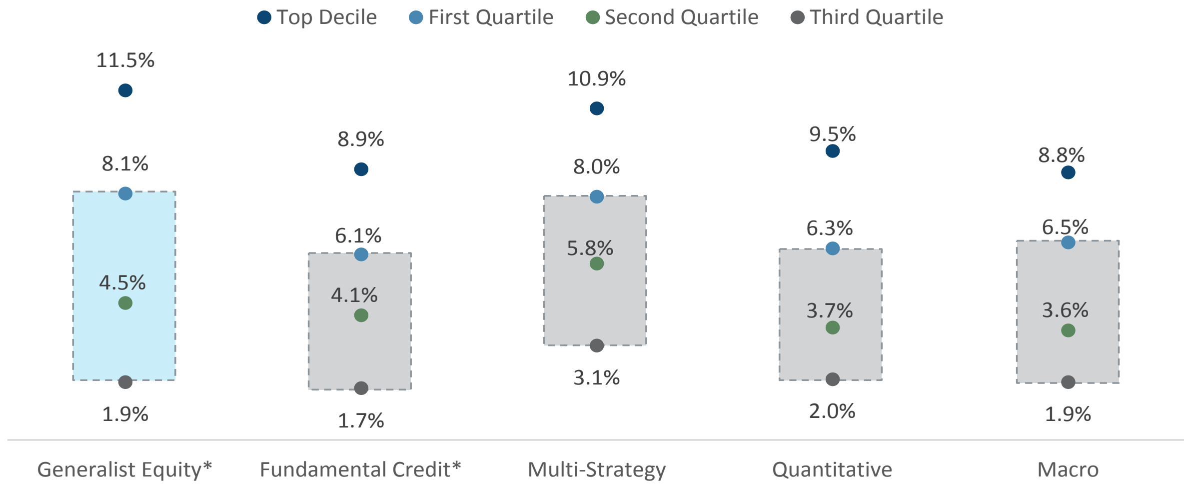
Est. hedge fund industry AUM ($ BN) through Dec 2019



Source: HFR

As the hedge fund industry has evolved, individual manager selection has become even more important. Top-performing managers represent a small percentage of the hedge fund universe. In our view, there is little value in owning an "average" hedge fund today. We have seen consistent and significant dispersion in managers' performance across strategies, as top managers have delivered high-quality returns and alpha, and vastly outperformed their strategy peers.

EXHIBIT 12 **High dispersion between top- and bottom-performing funds across strategies**
Trailing 5-year annualized rate of return across GCM Grosvenor actively tracked hedge fund strategies
As of 9/30/2019



Past performance is not necessarily indicative of future results. Information includes all managers actively-tracked by GCM Grosvenor within each strategy presented. Excludes funds with insufficient length of track record or insufficient return data for full 5-year analysis. *Generalist equity and fundamental credit are the largest and most representative peer subgroups in our tracked universe of equity and credit strategies.

HOW HEDGE FUND INVESTORS CAN ADAPT TO THE CURRENT ENVIRONMENT

In response to market and industry challenges, thoughtful hedge fund investors and allocators have adjusted their implementation models. For example, GCM Grosvenor has made the following enhancements:

- Obtained more granular transparency to drive better and more predictive data analytics
- Increased investment concentration in top alpha-producers with limited correlation
- Enhanced optimization and other portfolio construction tools
- Improved alignment in GP/LP fee arrangements
- Implemented sector specialization and regional expansion
- Modestly extended illiquidity tolerance for select strategies that utilize a complex, process-driven approach

Importantly, implementing the above changes also requires active negotiation and strong relationships with world-class hedge fund firms to obtain capacity, and we continue to pursue such opportunities.

4. Conclusion

No one can predict the next recession or market drawdown, not even the most informed investors. Given that traditional assets are facing lower return expectations, we have sought to position portfolios to take advantage of an improving opportunity set for hedged strategies. Since material market declines occur periodically, building portfolios that can withstand a drawdown, while targeting consistent absolute returns, is important for any long-term investor seeking to grow capital in 2020 and the decade to come.

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 $57 billion in assets under management in hedge fund strategies, private equity, infrastructure, real estate 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	$57.4 bn
Hedge Funds	$26.4 bn
Private Equity	$21.1 bn
Infrastructure	$5.3 bn
Real Estate	$2.9 bn
Multi-Asset	$2.6 bn
Employees	~500

FOR MORE INFORMATION

Website: gcmgrosvenor.com

Email: inquiries@gcmlp.com

LinkedIn: @gcmgrosvenor

Employee data as of January 1, 2020. AUM data as of September 30, 2019.

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