# 2022 HEDGE FUND OUTLOOK

As 2022 begins, the world seems to have shifted into a new macro backdrop, away from extraordinarily accommodative monetary and fiscal policies, which spurred economic growth and strongly benefitted risk assets, and into tightening mode to stymie the highest year-over-year change in headline CPI that we have seen in nearly 40 years. Concerns about inflation and the related "hawkish pivot" by central banks have already started to change market action and investor risk appetite. We believe that we have seen peak liquidity and are transitioning from a period during which most assets trended higher into an environment where individual security selection will matter a lot more. Some hedge fund strategies can struggle in the initial phase of a regime change when securities can trade more on macro variables and factor risks for a period of time; however, the volatility associated with that change creates new opportunities for alpha generation as fundamentals reassert themselves.

**Volatility beneath the surface should lead to rich alpha opportunities.** Broad equity indices finished the year near all-time highs, but that momentum was mostly carried by a handful of mega-cap stocks. Meanwhile, there has been significant volatility punctuated by sharp corrections in a wide swath of other stocks, especially those with a high growth rate and/or high multiple. Take, for example, the performance of stocks in the NASDAQ Composite Index: even though the index ended the second half of 2021 up 8%, over 30% of its constituent stocks had *halved* from their 52-week highs by year-end, and that figure grew closer to 40% of all NASDAQ stocks by early January 2022.[1] The pattern can be extended to other measures of equity market performance as well. As the table below shows, while the S&P 500, with its top-heavy concentration, was able to keep pace with mega-caps, the performance of riskier equities diverged significantly in the second half of the year, especially so in the fourth quarter.

**Relative Performance vs. U.S. Mega-Caps**

| | S&P 500 | Russell 2000 | MSCI ACWI ex-US | US IPOs[2] | ARKK[3] |
|---|---|---|---|---|---|
| 1H 2021 | 3% | 6% | -2% | -7% | -6% |
| 2H 2021 | -1% | -15% | -16% | -25% | -39% |

*Source: Bloomberg.* ***PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.***

Many of these stocks rightly corrected from steep valuations in the face of rising interest rates and fears of a potential slowdown in economic growth with the rise of omicron. We believe others were unjustly sold, or the move went too far. Skilled long/short equity managers can pick through these castaways to find individual stocks that are attractively priced and have strong fundamental prospects. If stock-level volatility in 4Q21 was any indication, though, fundamental managers likely will endure bouts of macro-induced turbulence, factor rotations, and deleveraging on their way to realizing this alpha potential. Thus, managers need to have done deep research to have courage in their convictions and to stick with, or even add to, positions when it may feel uncomfortable. In addition, to be successful, managers need proper risk controls to avoid forced selling in adverse environments as well as a stable base of investors that understand their strategy and its risk/return profile.

[1] https://www.bloomberg.com/news/articles/2022-01-06/number-of-nasdaq-stocks-down-50-or-more-is-almost-at-a-record
[2] U.S. Initial Public Offerings
[3] ARK Innovation Exchange-Traded Fund





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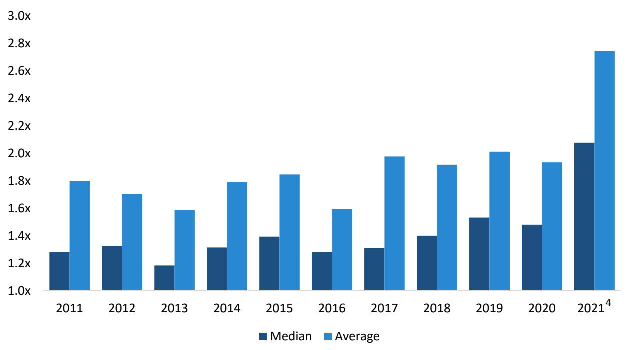
**Expect a better environment for short selling.** We witnessed a lot of speculative behavior in 2021, as many market participants threw caution to the wind. Retail investors reemerged as a meaningful market force, driven by a combination of low trading costs, new technology, pandemic-related boredom, and the fear of missing out. Further, social media platforms allowed individual investors to act collectively, and leverage in the form of derivatives added fuel to the fire, leading to parabolic moves in “meme” stocks, crypto, and themes such as electric vehicles. All of this led to months and months of frustration for short sellers and, for some managers, dangerous, existential landmines. As we look ahead, we expect the risk of short squeezes to remain, so managers, as ever, will need to prudently manage the size of individual short positions and overall short exposure. However, if changing monetary policy prompts risk aversion and more careful security selection, it may be a catalyst for improved performance on the short side in the coming year. Indeed, we already saw a positive turn in short-side performance in 4Q21 as some optically expensive stocks fell sharply.

**A record-breaking Initial Public Offering (“IPO”) market has expanded the playing field for long/short equity managers.** The IPO market exploded in 2021, both in terms of dollars raised as well as the number of offerings. The deal count was aided by a frenzy of IPOs of special purpose acquisition companies (SPACs), concentrated at the beginning of the year, and several outsized deals boosted the total value. Coinbase, Didi, Rivian, Coupang, Roblox, and Nubank each raised over $35 billion. Following an already strong year in 2020, this high level of IPO activity has expanded managers’ universe of stocks, in some cases opening the chance to transact in entirely new business models for the first time. Importantly, these opportunities present both long and short. Some managers were able to successfully bet against the frothy valuations of certain IPOs, benefiting from their subsequent underperformance, and see further shorting opportunities as IPO lockups expire and SPACs complete acquisitions. Others found new, core long holdings that they believe have incredible future growth prospects.

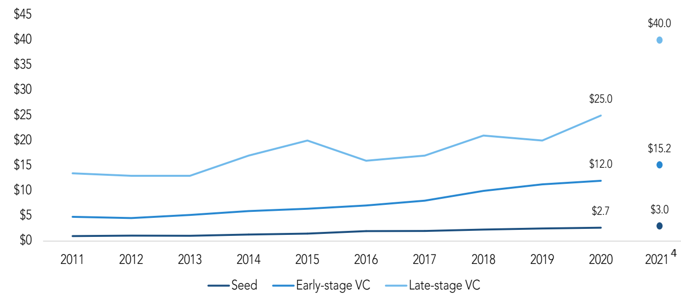
**Select managers can add value in crossover investing.** The conversion between public and private investing within hedge funds cemented itself as more than a passing trend in the past year. Not only are established managers seeking ways to do more private investing (within existing or new vehicles), but the ability to invest in privates is part of almost every new pitch that we hear from emerging long/short managers. There are very sound arguments that support this move. Chief among them: companies have been going public at a later stage in their life cycle, essentially robbing public-market investors of the opportunity to capture a portion of that value creation versus years past. This is especially true for managers that focus on identifying smaller and emerging businesses early, before they become clear winners. However, for most hedge fund managers and investors, we have words of caution. Private market valuations have surged in the last year, especially for late-stage deals with non-traditional investor participants, including hedge funds.

**Median Step-Up for Late-Stage Venture Capital Deals**




*Source: PitchBook*

**Median Deal Size for Deals with Non-Traditional Investors**




*Source: PitchBook*

In addition, the amount of capital raised by mega-funds dedicated to private equity has been staggering and so has the growth in hybrid hedge fund vehicles. With this amount of dry powder chasing after more expensive deals, we are skeptical that the high hit-rate on private investments among hedge fund managers in the last couple of years can continue, especially as some private winners have recently cratered post-IPO and numerous comparable public companies have sold off significantly.

## EVENT DRIVEN

**We are in the tail of the credit cycle, but great managers still have attractive prospects.** Credit markets have rallied significantly from the bottom in March 2020, and high-yield credit spreads (as measured by the BofA U.S. High Yield Index) are now tighter than their pre-pandemic levels. Most of that spread compression occurred quickly in 2020, while the degree of spread tightening in 2021 was much more subdued.

[4] As of 9/30/21



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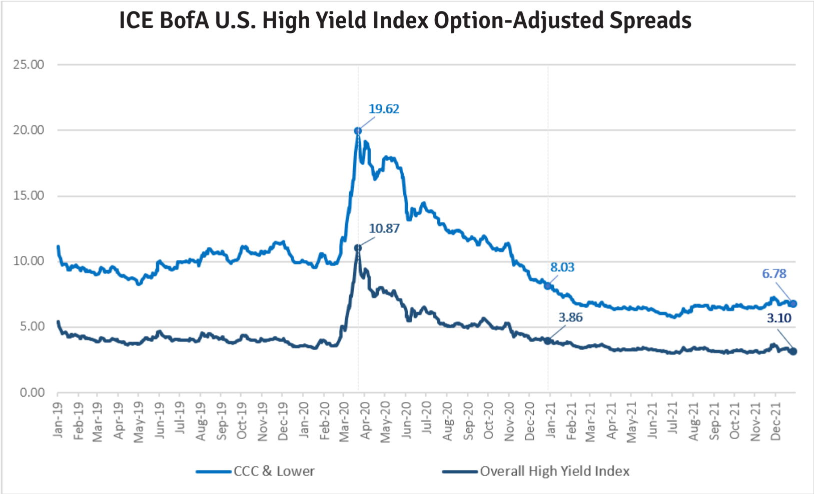


***Source: Federal Reserve Economic Data (FRED). Highlighted spread levels = peak on March 23, 2020, year-end 2020, and year-end 2021.***

Even so, Evanston Alternative Opportunities Fund's credit and distressed managers all performed strongly last year and substantially outperformed relevant benchmarks. Just as in prior credit cycles, there has been ongoing financial deleveraging even while the market broadly recovers, and skilled managers have been able to take advantage. Many of these opportunities have been in businesses impacted by COVID that need to restructure, both at home and outside of the U.S. But there also has been a steady stream of mispriced, idiosyncratic situations as well as pockets of new stress, such as within the Chinese property sector. In addition, our managers are seeing some securities being sold by other investors after having bounced, but they can sometimes be better, derisked investments now than they were in the depths of the pandemic. For example, collateralized debt obligations (CDOs) may hold post-restructured securities that the CDO manager decides to exit because they don't have the time or resources to fully analyze them. Meanwhile, a distressed debt specialist may understand the new capital structure and the company's fundamental prospects more deeply and see highly attractive return potential from today's price. We believe this set of opportunities will continue for much of the coming year. Skilled credit managers should benefit, especially if they don't have a bloated capital base.

**Inflation and rising interest rates are potential threats for highly leveraged borrowers.** Supply-chain problems, labor shortages, rising input costs, and wage pressures are already impacting many businesses. If inflation remains persistently high in the coming year, and central banks tighten monetary policy, as is now widely expected, economic growth may slow. Such a slowdown could be compounded by renewed COVID mitigation efforts with the rise of omicron or other variants. Also, although the maturity walls for many corporate borrowers have been extended, rising interest rates would increase the cost to service floating-rate debt. We believe lower-quality and smaller issuers would be the most vulnerable in such an environment, and therefore, credit managers that have the flexibility to play in the middle market will be in the best position to take advantage of potential stress.

**M&A activity will remain robust, providing a favorable backdrop for equity-oriented event-driven strategies.** Global M&A activity made records last year, and many of the ingredients that spurred those transactions remain in place heading into 2022. Financial buyers have a lot of capital to deploy—private equity firms are flush with capital commitments, and at year-end, there were 575 SPACs actively searching for a target. In addition, strategic buyers are often well funded and motivated to pursue transformative deals that can, for example, help them digitize their businesses or make progress towards ESG goals. Finally, although conditions appear to be tightening relative to a year ago, financing remains cheap on an absolute basis and, for now, readily available. However, high valuations, concerns about inflation and tighter monetary policy, and increased scrutiny of proposed tie-ups by antitrust regulators may slow activity from last year's breakneck pace. Even if the market cools a bit, we expect that managers with a focus on anticipating or advocating for corporate events will have an abundance of opportunities, especially in the first half of 2022.

**SPAC arbitrage currently offers interesting risk-adjusted return potential.** The wind was taken out of SPACs' sails earlier in 2021, causing a decent portion of the universe to retrench below trust value.[5] This created an opportunity to earn a small, unlevered yield (1.5%-2%) on a diversified pool of SPACs with relatively short duration. However, the risk associated with that expected return is also rather low. These SPACs generally have 12-15 months left to find a deal or the SPAC will be liquidated, when shareholders either will, or can elect to, receive back their pro-rata share of the trust's value. In effect, holding a SPAC below trust value is a form of Treasury bond arbitrage, if one does not hold it beyond this redemption window (or the "period of optionality"). Additional upside can be achieved by adding alpha from SPAC selection, or from the law of averages when holding numerous securities with option-like potential, as some SPACs may begin to trade above trust value when a potential merger is announced and well-received by the market. Managers can also apply leverage to amplify absolute returns, although that introduces more risk in the form of margin calls if there is significant mark-to-market volatility.

[5] For those less familiar, SPACs raise money in an IPO to make a business acquisition within a set period of time. The IPO proceeds are held in a trust and usually invested in U.S. government bonds until the SPAC consummates a deal or is liquidated. When a SPAC is liquidated all shareholders receive their pro-rata share of the trust's value. In addition, shareholder approval is required for a SPAC to acquire a target company, and shareholders also can redeem their share of the trust prior to merger's closing (commonly called the "de-SPAC" transaction).

## MACRO

**The specter of inflation and differing monetary policy across the globe will drive increased uncertainty.** Central banks and governments acted in a highly coordinated fashion to support financial markets and economies during the pandemic. However, we are now seeing more differentiation in their actions and timetables for withdrawing stimulus. Some central banks have already started to hike interest rates; others are just starting to taper asset purchases. Meanwhile, China is in easing mode after seeing a slowdown in economic growth and credit troubles among some real estate developers. We believe this should lead to good opportunities for the managers that can get both the macro forecast as well as trade timing and implementation correct. The consensus view among our macro managers today is that, given current inflation levels, the Federal Reserve will need to raise interest rates by more than the market expects. The pace of hiking won't necessarily be much quicker than current assumptions, but the terminal Fed Funds rate will be higher than what was priced into the market near year-end (1.5%). In addition, they see the potential for currency volatility to rise in the coming year with countries pursuing more individual policy paths. Equity and interest rate volatility have already risen, yet implied volatility in most developed market currencies has remained near lows.

**The groundwork has been laid for a potentially extended bull cycle in commodities.** Many countries around the world have adopted timelines by which to achieve environmental goals and reduce their carbon footprint, and all those initiatives will be resource intensive. Indeed, projected demand growth for industrial metals from electric vehicles and renewable energy is similar to the demand growth from China that drove the commodities boom of the early 2000s. In addition, the pace of divestment from fossil fuels has not been met with similar reductions in demand thus far, leading to shortages and spiking prices. Europe's natural gas crisis is a case in point. Barring renewed lockdowns or a recession, demand for oil is unlikely to be lower in the coming year or two than it was in 2021. At the same time, decline rates in oil production have climbed since the pandemic began, and so far, E&P companies have maintained capital discipline by not investing in new projects. Inventories will likely start to build given higher prices but will do so from a low base. These dynamics could further support fossil fuel prices for a period even while the energy transition continues to progress. Our macro managers are betting on the duration of this commodity cycle, more so than the direction of spot commodity prices, via certain commodity-linked equities. Our managers also hold long positions in some physical commodities, such as soybean oil, as well as carbon credits on the view that sustainability efforts will become more entrenched.

## RELATIVE VALUE

**Higher volatility should be a tailwind for convertible bond arbitrage and long/short credit strategies.** Convertible bond arbitrage typically benefits from higher equity volatility because the embedded option in convertible bonds rises in value as volatility rises. In addition, higher volatility provides more opportunities to capture profits from delta hedging (resetting the size of short equity positions as the sensitivity of the convertible bond to changes in stock price rises or falls). Similarly, we believe long/short credit strategies would be aided by increased volatility. Despite the intra-year swings that we saw in equities and interest rates, credit markets remained remarkably calm in 2021, which made it more challenging for long/short credit managers to generate alpha. A choppier backdrop would likely increase dispersion and the potential for price dislocations, and we believe that changing monetary policy in the coming year may precipitate such a change.

**Optimistic about select quantitative equity strategies.** We believe the opportunities to exploit the behavior of price-insensitive market participants has improved over the past year. Specifically, a strong IPO market and the continued proliferation of passive investment products should lead to predictable flows—for example, around IPO lock-up expirations and index rebalancing dates—from which short-term trading models can profit. In addition, the increased involvement of retail investors and their proclivity for securities with embedded leverage also have led to price distortions and arbitrage opportunities. We believe all these sources of alpha are capacity-constrained, and managers need to limit asset growth to avoid diluting expected returns.



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## IMPORTANT FUND INFORMATION AND DISCLOSURES

Evanston Alternative Opportunities Fund (the "Fund") is a continuously-offered, non-diversified, registered closed-end fund with limited liquidity. The Fund's shares are subject to legal restrictions on transfer and resale and you should not assume you will be able to resell your shares. No assurance can be given that the Fund will achieve its objectives. This letter does not constitute an offer to sell or a solicitation of an offer to purchase the Fund's securities. Any such offer will be made only by means of the Fund's Prospectus.

The contents of this letter are solely for informational purposes, are current as of the date set forth on this letter, and are subject to change from time to time. Neither the Fund nor Evanston Capital Management, LLC ("ECM") is obligated to notify you of changes to this information.

Certain statements made herein constitute forward-looking statements. These statements reflect ECM's current views about, among other things, future events and financial performance, and results may differ, possibly materially, from these statements. Neither ECM nor the Fund is obligated to update or revise the statements made or information presented herein.

**Fund Liquidity/Tenders:** The Fund intends to conduct quarterly tender offers. Each repurchase offer is expected to be limited to the repurchase of approximately 5-25% of the outstanding shares, in the Board of Trustees' discretion. No Fund investor can require the Fund to redeem shares, regardless of how the Fund performs.

**Early Withdrawal Fee:** Shareholders who seek to sell their shares back to the Fund less than one year after purchasing the shares will be subject to a 3% early withdrawal fee payable to the Fund.

**Fund Fees and Expenses:**

*Portfolio Fund Fees and Expenses:* The Fund is a "fund of funds" that invests in Portfolio Funds managed by Portfolio Managers unaffiliated with ECM. Portfolio Funds' management fees range from approximately 1% to 3% per annum, and incentive fees that a Portfolio Fund may charge range from approximately 15% to 35% of profits per annum.[6] Portfolio Fund fees and expenses may be substantially higher or lower as a result of the Fund's investments in new or different Portfolio Funds. The Fund anticipates that its total annual expenses, taking into account the Expense Limitation Agreement and the Portfolio Fund fees and expenses, but excluding any sales load that may be assessed, will be approximately 8.97% with respect to Class I and 9.72% with respect to Class A, as described in detail in the Fund's Prospectus. Actual expenses may be higher or lower than estimates provided due to the Portfolio Funds' fees and expenses.

*Distribution and Service Fee.* The Fund pays Foreside Fund Services, LLC (the "Distributor") a distribution and/or service fee equal to 0.75% per annum of the aggregate value of the Class A shares outstanding, determined as of the last calendar day of each month (prior to any repurchases of shares and prior to the Fund's management fee ("Management Fee") being calculated) ("Distribution and Service Fee") in accordance with a plan adopted by the Fund in compliance with the provisions of Rule 12b-1 under the Investment Company Act of 1940, as amended (the "1940 Act"). The Distribution and Service Fee is payable quarterly, and the Distributor pays all or a portion of the Distribution and Service Fee to certain financial intermediaries. ECM also pays a fee out of its own resources to financial intermediaries. Please see the Fund's Prospectus for more detailed information.

*Management Fee.* Effective January 1, 2019, Class A's and Class I's Management Fee is 1.0% per annum.

*Expense Reimbursement.* Effective August 1, 2021 through July 31, 2022, ECM has contractually agreed to limit the Fund's total annualized expenses (excluding any borrowing and investment-related costs and fees, taxes, extraordinary expenses, and the Portfolio Fund Fees and Expenses) to 1.5% with respect to Class I and 2.25% with respect to Class A (the "Expense Limitation Agreement"). Prior to January 1, 2019, ECM had contractually agreed to limit the Fund's total annualized expenses to 1.7% with respect to Class I and 2.45% with respect to Class A. ECM and the Fund may continue to renew the Expense Limitation Agreement for one-year terms thereafter, and may terminate it with 30 days' prior written notice to the other party. ECM will be permitted to recover from the Fund expenses it has borne in later periods, if Class I and Class A's expenses fall below the annual rate of 1.5% and 2.25%, respectively. The Fund is not obligated to pay any such amount more than 3 years after the fiscal year-end in which ECM deferred a fee or reimbursed an expense.

Please review the Fund's Prospectus for information about other fees, including the Fund's operating expenses.

## STRATEGY DEFINITIONS

Long-Short Equity: Seek to profit by taking positions in equities and generally involve fundamental analysis in the investment decision process. Long-short equity strategies may aim to have a net long directional bias, a net short directional bias, or be neutral to general movements in the stock market. Long-short equity Portfolio Managers tend to be "stock pickers" and typically shift allocations between long and short investments based on market conditions and outlook.

Event Driven: Seek to invest in opportunities that are created by significant transaction events, such as spin-offs, mergers and acquisitions, and reorganizations.

Relative Value: Seek to profit by exploiting pricing inefficiencies between related instruments, while remaining long-term neutral to directional price movements in any one market. Short selling is an integral part of this strategy.

Global Asset Allocation: Seek to exploit opportunities in various global markets. Portfolio Funds employing these strategies have a broad mandate to invest in markets and instruments they believe provide the best opportunity.

[6] The Portfolio Fund Fees and Expenses are estimated to be approximately 7.47%.



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**IMPORTANT RISK FACTORS CONCERNING THE FUND**

As described in the Fund's Prospectus and Statement of Additional Information, **an investment in the Fund is speculative, involves a substantial degree of risk, and an investor could lose all or substantially all of his or her investment. There can be no assurance the Fund will achieve its investment objectives or avoid significant losses.** The Fund is only available to "eligible investors" who can bear significant risk and do not require a liquid investment. Please see the Fund's Prospectus for important information about the Fund's terms, risks, and other disclosures.

The Fund's Portfolio Managers may, in some cases, be recently organized or may manage Portfolio Funds that are recently organized and have no or a very limited operating and performance history. The Fund is managed by ECM, and its success will depend, in large part, on ECM's skill and expertise. Although ECM has over 15 years managing privately offered fund of hedge fund products, ECM's experience managing registered investment companies is limited to the Fund, which launched in 2014.

The Fund's shares are subject to restrictions on transfer and have limited liquidity. The Fund does not list its shares for trading on any national securities exchange; there is no secondary market for the shares, and none is expected to develop. An investment in the Fund's shares is not suitable for investors that require liquidity, other than liquidity provided through the Fund's repurchase policy. There can be no guarantee that an investor will be able to sell any of its shares when it desires to do so. The Fund's repurchase offer policy may decrease its size over time absent significant new investments in the Fund. It could force the Fund to maintain more liquid investments, sell assets prematurely, substantially increase the Fund's ratio of illiquid to liquid securities for non-redeeming investors, and/or reduce the investment opportunities available to the Fund and cause its expense ratio to increase.

The Portfolio Funds are not registered under the 1940 Act, and therefore are not subject to the 1940 Act's restrictions and protections, such as fee limitations, asset coverage requirements, and reporting requirements. The Portfolio Managers may use investment strategies and techniques that are not generally permissible for registered investment companies, and Portfolio Funds may be less transparent in providing portfolio holding and valuation information.

ECM relies on the valuation of the Portfolio Funds to value the Fund's shares. Fair value estimates may prove to be inaccurate and may be subject to later adjustments from time to time. Similarly, inaccurate or delayed information that a Portfolio Manager may provide could adversely affect ECM's ability to accurately value the Fund's shares.

The net asset values received by ECM or the Fund's administrator from Portfolio Funds may be estimates only, and, unless materially different from the actual valuations, generally will not be subject to revision. ECM relies on these estimates in calculating the Fund's net asset value for, among other things, reporting the performance data reflected herein. Portfolio Funds are typically audited on an annual basis.

The Fund may borrow money for portfolio management and other purposes, and may have to pledge assets when borrowing, which could affect the Fund's operations in the event of an uncured default. The Portfolio Funds may use leverage to purchase instruments, sell securities short, and/or other means, which would increase any loss incurred. Consequently, the Portfolio Funds may be subject to major losses if market disruptions destroy any hedged positions, which would negatively impact the Fund's performance.

The Fund intends to meet the requirements necessary to qualify for favorable tax treatment as a "regulated investment company," or "RIC" under Subchapter M of the Internal Revenue Code. If the Fund fails to satisfy the applicable requirements, it may lose its status as a regulated investment company, and in such case, all of its taxable income would be subject to U.S. federal income tax at regular corporate rates without any deduction for distributions to shareholders. Disqualification as a RIC would have a material adverse effect on the value of the Fund's shares and the Fund's distribution amounts.

**You should consult with your own legal, tax, financial, and other professional or advisers before investing in the Fund.**

**Before investing, you should consider carefully the Fund's investment objectives, limited liquidity, risks, charges, and expenses. The prospectus contains this and other information about this investment company. You can obtain a copy of the prospectus by contacting ECM at investorrelations@evanstoncap.com or calling 847-328-4961 or by requesting a copy from your financial professional. Please read the prospectus carefully before you invest.**



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