CIO thinks adding exposure to equity market neutral strategies has the potential to mitigate a range of potential market risks and smooth portfolio returns. (UBS)

Navigating market highs with hedge funds

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Leading equity markets around the world have been hitting all-time highs, including 20 record closes for the S&P 500 so far this year. The tech-heavy Nasdaq 100, Japan's Nikkei 225, and the STOXX Europe 600 indexes all stand at or near their record levels.

All-time highs often generate investor concern that markets have peaked. Such worries are not supported by history. Over the past 60 years, the S&P has traded within 5% of a record high 60% of the time. And since 1960, the average return in the 12 months following a record high for the S&P 500 has been 11.7%, the same as when the market was below record levels.

Despite this, some investors may hesitate to add to equity allocations at market highs. For such investors, certain hedge funds—like equity market neutral strategies (EMN)—can ease these worries.

Equity market neutral funds can continue to perform well, even if markets run into headwinds. These strategies try to make money through mispricing between stocks, no matter what the overall market does. Typically, EMN managers seek to buy undervalued stocks and sell overvalued ones, "hedging" away exposure to the overall market—making them "beta neutral." As a result, these funds have the potential to mitigate concerns related to tech bubbles, central banks' policy uncertainties, and high market valuations by employing strategies that take both long and short positions in stocks.

Based on historical data between 1990 and 2024, EMN funds have experienced shallower losses than major equity markets and captured 14%of market gains, while performing positively on average in years of equity sell-offs (based on HFRI EH: Equity Market Neutral Index data).

Current equity market conditions are generating an abundant opportunity set for managers of such strategies. Active managers typically perform better when correlations within an asset class are low—with a wide dispersion in the performance of individual stocks within an index. This is the case at present. Single-stock dispersion within the S&P 500 index, for example, is close to the highest it has been since 2005. This creates opportunities for skilled stock pickers.

Against this backdrop, adding exposure to EMN funds could provide some reassurance to investors who are concerned, for example, that the tech sector is overbought. If this proves to be the case, EMN funds can potentially benefit from both overvalued and undervalued tech stocks through pairs-trading or other strategies that seek to hedge away sector-specific and market-wide risks.

Historically, EMN funds have delivered returns that are unrelated to stock and bond market movements, capturing gains but smoothing portfolio returns. The fact that these strategies are market agnostic can contribute to steadier portfolio growth, complementing the traditional growth and income components of a 60/40 portfolio. Adding EMN strategies into a global 60/40 portfolio has yielded in the past a meaningful enhancement in risk-adjusted performance. In the past five years, equity market neutral managers have produced steady returns of 3–4% a year—with volatility of below 3% (based on HFRI EH: Equity Market Neutral Index data).

So, while we remain positive on the outlook for markets, a variety of risks remain. We think adding exposure to equity market neutral strategies has the potential to mitigate a range of potential market risks and smooth portfolio returns. Alongside equity market neutral funds, we also like specialist credit hedge fund strategies and discretionary macro funds. Investors should understand the inherent risks of hedge funds, including illiquidity, lack of transparency, and use of leverage. Specific risks for equity market neutral strategies include manager misjudgment in stock selection, overreliance on borrowed money to generate returns, and liquidity constraints.

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Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

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In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, "junk bonds," derivatives, distressed securities, non-U.S. securities and illiquid investments.
- Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
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- Private Equity: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer's "home" currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.