CIO believes hedge funds can add potential value to long-term portfolios through diversification, risk reduction, and fresh sources of return. (UBS)

A three-point plan to build hedge funds into portfolios

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CIO believes hedge funds can be a valuable addition to a diversified portfolio, providing fresh sources of return and low correlations to traditional assets that help reduce overall portfolio swings. But complexity, the asset class's diversity, and inexperience may discourage some investors from investing in hedge funds.

CIO outlines three steps to building a hedge fund allocation, subject to their unique risks.

We believe hedge funds can help investors navigate today's uncertain markets.

- Hedge funds can provide returns that are lowly correlated to traditional stocks and bonds.
- Certain hedge funds, known as diversifiers, can mitigate portfolio losses during market downturns.
- While no guarantee of future performance, hedge fund strategies have historically delivered above-market risk-adjusted returns by capitalizing on mispricing during market dislocations.

But some investors may be reluctant to invest due to perceived challenges.

- Hedge funds can deploy complex strategies and structures that are difficult for individual investors to monitor.
- Investors require a certain experience and knowhow to select the right mix of instruments to support their financial objectives.

So, CIO outlines a three-point plan to build hedge funds into portfolios.

- First, investors can make an investment plan tailored to their objectives, risk profile, and liquidity needs. A typical hedge fund allocation might be 7% to 11% of an overall portfolio.

- Second, Invest in a “core” allocation that provides portfolio diversification and adapt to financial needs with “satellite" hedge fund investments focused on specific goals like capital appreciation or risk reduction.
- Third, reviewing and rebalancing a portfolio can help capitalize on tactical opportunities and manage hedge funds' unique risks, including illiquidity, leverage, and transparency.

Did you know?

- CIO analysis shows that adding around 10% of equity market neutral (EMN) hedge funds to a global 60% equity/40% bond portfolio can deliver comparable expected annual returns, but lower expected annual volatility by roughly 1 to 3 percentage points, respectively, based on Bloomberg data since 1990.
- In 2023, the difference between the best-performing and worst performing hedge fund strategies (HFRI ED Activists and HFRI Macro: Systematic Diversified respectively) stood at 21.8%.

Investment view

CIO believes that alternative investments, including hedge funds, should be a key component of long-term portfolios for those investors willing and able to bear their unique risks. They have the potential to help diversify return sources and smooth portfolio returns, as part of a well-diversified and multi-asset investment strategy. Investing in hedge funds may help investors diversify portfolios and exploit market dislocations. However, investors should consider the risks inherent to hedge funds before investing, including illiquidity, operational complexity, transparency, leverage, and strategy-specific risks.

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Original report - **How can investors put hedge funds in a portfolio?, 30 September 2024.**

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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.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

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.
- Real Estate: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- 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.
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