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How hedge funds can help steady traditional portfolios

20 September 2024, 08:42 am CEST, written by UBS Editorial Team

As we approach key elections in the US and Japan, and the US begins a policy-easing cycle with a highly contentious trajectory, volatility in risk appetite and liquidity are set to rise. These could in turn generate more episodes of asset classes moving in tandem, increasing the returns volatility of even well-diversified traditional portfolios. We think select hedge funds can help reduce this with their uncorrelated returns, downside protection, and alpha generation.

Barely a month after the market tumult of early-August—when the VIX index that measures US equity volatility briefly surged to its sixth-largest increase on record since 1990—the S&P 500 is back near its all-time high hit in July. At the same time, the futures market has priced in a very dovish 250 basis popints of Federal Reserve rate cuts (we expect 200 bps) by December 2025, and the 10-year US Treasury yield has already fallen to close to where we expect it to be in 1Q2025. Additionally, the VIX has now settled in an elevated range compared to the levels in May through July. We are now also closer to both the US presidential election in November, and Japan's ruling party election (27 Sep) and likely snap parliamentary election by end-2024. These could significantly impact the respective monetary policy stances, and subsequently affect global risk appetite and liquidity.

This underscores the weakness in traditional portfolios. In times of sharp sentiment reversals or liquidity shocks, correlations between equities and bonds may tighten, resulting in higher portfolio instability. This would result in portfolio returns becoming highly volatile – a prospect that investors are facing as we approach 4Q2024.

But investors do have the means to mitigate this rising risk to portfolio returns. Hedge funds have the capacity to reduce the portfolio volatility in the following three ways.

Providing uncorrelated returns as a portfolio add-on. Hedge funds can serve as complements to traditional portfolios and help to offset spikes in asset price correlations during periods of acute market stress. Investors should select hedge funds that employ strategies like equity market-neutral, global macro, and multi-strategy platforms. These are designed to take advantage of market inefficiencies, price dislocations, and macroeconomic shifts, rather than broader market movements.

Downside protection benefits to portfolios. Historically, certain hedge fund strategies, known as diversifiers, consistently outperform portfolios consisting of traditional asset classes, during market selloffs. This is largely due to their low volatility or moderate correlation with equities and bonds. Generally, hedge funds with less market directionality tend to outperform those with more beta (overall market) exposure or outright duration during periods of elevated volatility.

Alpha generation through contrarian asset selection. Volatility spikes and market swings often result in mispricing and increase the potential for harvesting alpha (the share of an asset's returns unrelated to overall market directionality). During episodes of market dislocations, political uncertainty, or monetary policy divergence, asset prices can deviate significantly from their intrinsic values. Hedge funds can utilize these opportunities to buy assets at deep discounts or short overvalued securities, subsequently benefiting when prices revert to their natural averages as markets calm down. Select hedge funds like equity market neutral (EMN) funds, which hedge against broad equity market movements while capitalizing on increased dispersion and stock selection opportunities post-volatility, are thus well equipped to take advantage of market dislocations to harvest alpha during periods when traditional long-only portfolios suffer.

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