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 strategy complexity and investor inexperience may discourage some 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 uncertain markets.

- Hedge funds can provide returns that are lowly correlated to traditional stocks and bonds.
- Managers can quickly adjust investment positions in response to changing market conditions to protect capital and seize opportunities.
- Historically, hedge funds have done well after US elections, with the HFRI Fund Weighted Index outperforming a 60/40 portfolio on five of the past eight occasions since 1992.

But some investors may be reluctant to invest owing 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 know-how to select the right mix of instruments to support their financial objectives.

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 7-11% of an overall portfolio.
- Second, invest in a "core" allocation that provides portfolio diversification and adapts to financial needs with "satellite" hedge fund investments focused on specific goals, such as 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?

- Positioning data show hedge funds have been allocating capital to AI, but their focus has evolved. They began 2024 investing primarily in semiconductor companies, before rotating into power and utility firms providing energy to the sector by midyear. Into year-end, managers have been pivoting into AI adopters and software beneficiaries.
- Equity market neutral funds stand 10.2% higher year to date, on course for the best annual performance since 2000 (based on HFRI EH: Equity Market Neutral Index data). We like this strategy, since US political and geopolitical uncertainty has the potential to drive sharp rotations between sectors, factors, and stocks.

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, smooth portfolio returns, 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.

Main contributors – Matthew Carter, Karim Cherif, Tony Petrov

Original report - **How can investors add hedge funds to a portfolio?, 13 December 2024.**