Allocating to Hedge Funds Amid Higher Rates

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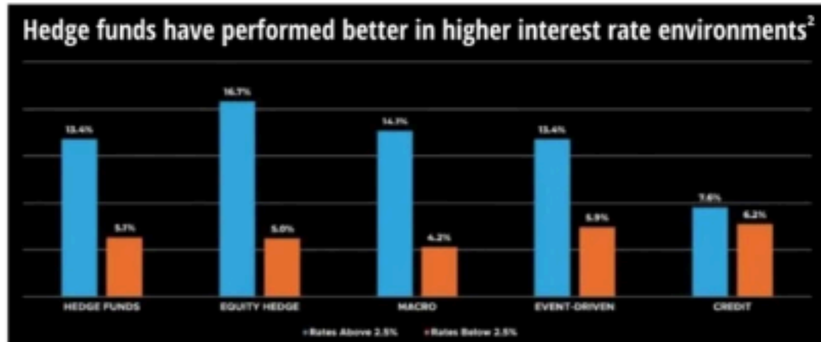

Every client's portfolio needs three primary inputs, namely investments that drive returns, protect capital and offer diversification. Within alternatives, private equity clearly falls into the first category and private credit the second. Hedge funds, most typically considered as a diversifying asset, can also provide clients the opportunity to enhance returns and protect against the downside, but the primary role is to deliver better outcomes through diversifying return sources which are uncorrelated to long-only stocks and bonds. This is especially valuable during periods when traditional assets are positively correlated.

Of course, a hedge fund allocation is no panacea, especially when the spread between top and bottom performing hedge funds varies dramatically. However, several of the largest hedge funds, notably global multi-strategy funds that manage billions of dollars can deliver high-quality results. This is even though historically, significant asset growth has often preceded declining performance, via muted returns or greater downside volatility. The three reasons for that are: (a) carefully managed growth, with tremendous foresight on capital deployment and liquidity management; (b) continuous reinvestment in operational infrastructure, better risk systems, enhanced data analytics, etc.; and (c) strong alignment of interest, with assets matching liabilities and significant GP capital invested alongside their limited partners. Should those factors persist, we expect many of these "mega-funds" to remain a valuable alternative.

Generally, there are certain conditions that typically help or hinder the returns of most hedging strategies. For example, throughout much of the 2010s, global interest rates were near-zero, an environment in which risk assets appreciated considerably, and fixed income functioned as a flight-to-quality hedge. Unfortunately for hedge fund investors, however, when correlations and equity valuations are high, and credit spreads are tight, hedging strategies are likely to underperform. More recently, with higher rates, wider spreads, and periods of elevated volatility driven by macroeconomic and geopolitical uncertainties, many hedge funds have performed far better.[1]

When many hedge fund strategies "underperformed" in the 2010s, some investors concluded the hedge fund approach had lost its lustre. We believe that market factors ultimately drive opportunities, good and bad, and the hedge fund outlook is "opportunity rich." We expect to see more funds and structures coming to market making it easier for all clients who meet the appropriate suitability and eligibility requirements, not just institutional and UHNW investors, to gain access to top-tier funds.

Finally, we expect a continuation of higher returns and greater diversification in certain equity sub-strategies like quantitative trading, and in credit-based funds that specialize in securitized credit. From a broader strategy level, we maintain our positive outlook on macro and multi-strategy investing. Discretionary and systematic macro trading can take advantage of increases in market volatility across multiple assets classes globally, with the ability to protect against losses given their focus on liquid trading instruments. Similarly, multi-strategy can monetize these opportunities on a market-neutral basis, resulting in the potential for high returns with low volatility. Accessing return sources independent of the direction of long-only stock and bond markets can add significant value in 2025 and beyond. ■

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Disclaimer

1. Source: eVestment; The performance of the HFRI Fund Weighted Composite Index up 14.5% since Nov. '23.
2. Source: eVestment; iCapital calculations. Period from January 1990 to September 2024. Hedge Funds are represented by the HFRI Fund Weighted Composite Index, HFRI Equity Hedge Index, HFRI Macro Index, HFRI Event Driven Index and HFRI RV: Fixed Income Corporate Index. For illustrative purposes only. Past performance is not indicative of future results.

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