UBS

**20 February 2024, 07:00AM UTC**
Chief Investment Office GWM
Investment Research

# Allocations to hedge funds should help mitigate risks

## UBS House View - Daily Europe

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### Thought of the day

Hedge funds trailed global equities, both for 2023 overall and in January, as investor optimism over artificial intelligence (AI) and the Federal Reserve's policy pivot propelled equities higher. The MSCI All Country World index was up 20% in 2023, while the HFRI Fund Weighted Composite index returned 8.1%. Last month, global stocks rose 0.5%, compared to a gain of 0.4% for the HFRI.

But this is not an indication that hedge funds have failed to fulfill their expected role in portfolios, in our view. The asset class overall is never likely to match stock returns during vigorous rallies, such as the one seen since October. The primary goals of adding hedge fund exposure to a portfolio are to inject alternative sources of return and mitigate risks. Recent economic uncertainty indicates this remains important. The equity volatility last week following stronger-than-expected US inflation data provided a reminder that the market is likely to be highly sensitive to disappointing news, especially with the S&P 500 trading close to all-time highs.

Indeed, a range of economic, geopolitical, and market risks remain, and we think an appropriate allocation to hedge funds should help offset potential equity declines and offer agility to navigate the evolving macro regime. This is provided that investors are aware of certain potential drawbacks of investing in hedge funds, including illiquidity.

**Select hedge fund strategies can both capture market gains and reduce market falls.** With equities near all-time highs, many investors are asking themselves where to allocate excess liquidity and whether to rebalance portfolios after recent equity market gains. Historically, due to their focus on risk management and downside mitigation, hedge funds have offered a natural portfolio complement to both equity and credit, capturing upside, adding differentiated returns, and providing some protection against unexpected sell-offs. Based on Bloomberg and HFR data,

### What to watch: 20 February 2024

- US January leading index
- Fourth-quarter results from Walmart and Home Depot

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the bursting of the "dot com bubble" led to a 47% fall for the MSCI All Country World index between 2000 and 2002, while equity market neutral funds lost just 0.4% and merger arbitrage shed 0.8% in the same period.

**Hedge funds can increase portfolio stability and diversification.** While inflation has continued to fall, the risk of stocks and bonds moving in tandem remains if it proves stickier than expected. This speaks in favor of adding a strategic allocation to hedge funds as an additional source of diversification in portfolios. The six-month rolling equity and bond correlation stood at around 0.6, similar to levels seen in 2022, when both stocks and bonds fell on rising interest rates. Separately, historical data showed moving 20% of a 60/40 portfolio from stocks to equity hedge funds would have lowered portfolio swings with little change in returns between 2000 and 2022. This smoothing can result in swifter compounding of returns and higher wealth over long-term horizons.

**Elevated interest rates can also support return potential for hedge funds.** We believe the Fed has clearly signaled its intention to cut rates this year. But the level of interest rates should remain relatively high, even after the 100 basis points of cuts assumed in our base case for 2024 overall. The path toward rate cuts is also likely to contribute to volatility, with the potential to widen the gap between winners and losers. This increased dispersion across securities, sectors, and countries creates opportunities for hedge funds to generate alpha and potentially achieve higher returns.

So, we continue to recommend allocating to hedge funds in a multi-asset portfolio. We currently favor low net equity long-short strategies for their potential to exploit stock pricing inefficiencies, credit long-short funds to profit from discrepancies in credit markets, and macro and multi-strategy funds for diversification purposes, as the latter stand to benefit from evolving economic and market dynamics.

## Caught our attention

**The next leg up for Japan stocks.** Despite a dip during Asian morning trading on Tuesday, Japan has been one of the best-performing markets this year amid positive sentiment in the US and a weaker yen. The TOPIX has risen 10.7% year-to-date, while the blue-chip focused Nikkei 225 is up 15.5%. Recently, Japanese companies overall reported the highest quarterly profit margin for 4Q23 since 2020, while three listed non-life insurers said they will accelerate the pace of selling their holdings of other listed companies amid the country's corporate governance reforms.

Our view: We believe the non-life insurers' commitment to rapidly unwind their cross-shareholdings is an important milestone in improving Japan's corporate governance. With shareholdings in more than 500 companies from different industries, we think the move could prompt share buybacks across sectors and become a key earnings growth driver for Japanese equities over the medium term. We are neutral on Japan within our global portfolios, but we see several supportive catalysts for the market over the next six months. We continue to prefer large-cap banks and real estate within Japanese equities, and see opportunities in high dividend and laggard cyclical stocks.

**Fed jitters might boost gold's glitter.** Buoyant inflation prints, coupled with robust employment data recently saw market expectations on the Fed finally turn decidedly hawkish. The total amount of rate cuts priced in for 2024 has now fallen to just 88bps, and the timing for the first 25bps rate cut

has been pushed back to June. Risk assets like US equities are rolling over, and the VIX has rebounded. Gold, however, has remained resilient despite the prospect of higher rates for longer—it continues to trade in the USD 2,015–2,020/oz range—which suggests risks of near-term dips.

Our view: We continue see gold as both an attractive standalone investment, and as a portfolio hedge against risk events. For the latter function, we recommend an allocation of around 5% in diversified and balanced USD-based portfolios. We continue to think that in the medium term, central bank buying, under-appreciated demand from China's central bank, and—ultimately—rate cuts by the Fed will keep the spot price of gold on an upward trajectory towards USD 2,250/oz. In the near term however, we expect the gold price to remain range-bound, which may include dips below the psychologically important level of USD 2000/oz. We continue to recommend adding gold on dips potentially to as low as USD 1,950/oz, with the market's ongoing repricing of Fed expectations potentially providing more of such opportunities.

**A slower electric vehicle transition in the US?** Several sources suggested the Biden administration is set to ease new Environmental Protection Agency (EPA) rules on exhaust emissions and electric vehicle sales. While the initial EPA proposals of April 2023 called for a 56% decline in new vehicle emissions by 2032 and for electric vehicles (EVs) to make up 60% of new auto production by 2030, pressure from both automakers and major unions may lead to a slower transition path. EVs comprise roughly 8% of US vehicle sales in 2023, according to Reuters.

*Our view:* We think decarbonization will be one of the major investment themes for the decade ahead, potentially supporting some of the highest equity returns of the next 10 years for those companies that can lead through disruption. That said, with the extent and pace of green regulation likely to differ across economies, we favor a diversified and selective investment approach. The long-term drive toward carbon neutrality and net zero should provide structural support to energy transition companies in public and private markets, in our view. We expect electrified vehicles (including battery electric and hybrid) to make up around 30% of global auto sales by 2025 and more than 60% by 2030, driven by incremental technological developments and regulatory changes. The electric vehicle value chain is integral to greentech investment themes, especially in Asia and Europe.

## Market update

| 19.02.2024 | Current (*) | 1D | 5D | 1M | YTD |
|---|---|---|---|---|---|
| | | Percent change. For volatility indices, net change in points. For yields, net change in bps | | | |
| VIX Index | 14.7 | +0 | +1 | +1 | +2 |
| MOVE Index | 109 | -3 | +3 | +4 | -5 |
| S&P 500 | 5006 | -0.5% | -0.4% | +3.4% | +4.9% |
| Russell 2000 | 2033 | -1.4% | +1.1% | +4.5% | +0.3% |
| Euro Stoxx 600 | 491 | -0.2% | +0.7% | +4.6% | +2.5% |
| Shanghai Composite | 2911 | +1.6% | +6.6% | +0.6% | -2.2% |
| US 10-year Treasury | 4.28 | +0 | +10 | +16 | +40 |
| US 2-year Treasury | 4.64 | +0 | +17 | +26 | +39 |
| Germany's 10-year Bund | 2.40 | -1 | +4 | +6 | +37 |
| Germany's 2-year Bund | 2.80 | -2 | +11 | +6 | +41 |
| EURUSD | 1.078 | +0.0% | +0.1% | -1.1% | -2.4% |
| EURCHF | 0.95 | +0.1% | +0.6% | +0.3% | +2.1% |
| USDCHF | 0.88 | +0.0% | -0.5% | -1.3% | -4.4% |
| USDJPY | 150 | +0.2% | -0.4% | -1.2% | -5.9% |
| Brent crude, USD/bbl | 83 | -1.0% | +0.8% | +5.2% | +7.3% |
| Gold, USD/oz | 2012 | +0.5% | -0.6% | -0.9% | -2.9% |

(*) or last close if not available

Source: FactSet, UBS, as of 19 February 2024

## Non-Traditional Assets

**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.
- 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.

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