# Investing in Uncertain Times - Hedge Funds are back!

Actual market dynamics continue to increase the significance of Hedge Funds in a well-diversified portfolio. We share our perspectives of the comeback of Hedge Funds, their role in a portfolio and the expectations for this asset class going forward.

## Summary

- The elevated global uncertainty overturned the classic investment paradigms of the past and the classic 40:60 portfolio construction is now 'dead'
- Central bank's artificial manipulation of interest rates and liquidity, with yields at historically low levels delivering even negative returns.
- Investors shift towards alternative asset classes to generate returns, with rising consideration and interest for liquid alternatives such as Hedge Funds
- Wide fundamental dispersions in valuations and growth prospects for various asset classes such as equities and fixed income, tapering and reflation efforts and government policies provide a fertile trading environment for Hedge Funds going forward.
- Hedge Funds posted their best risk-adjusted returns over two decades. Manager selection remains key due to high performance dispersion across all strategies.
- Favourable tailwinds for selected strategies, such as Event Driven and Global Macro
- Increasing ESG/Sustainable awareness and structural changes provide an abundant opportunity set for Hedge Funds to play a pivotal role for a more sustainable future.

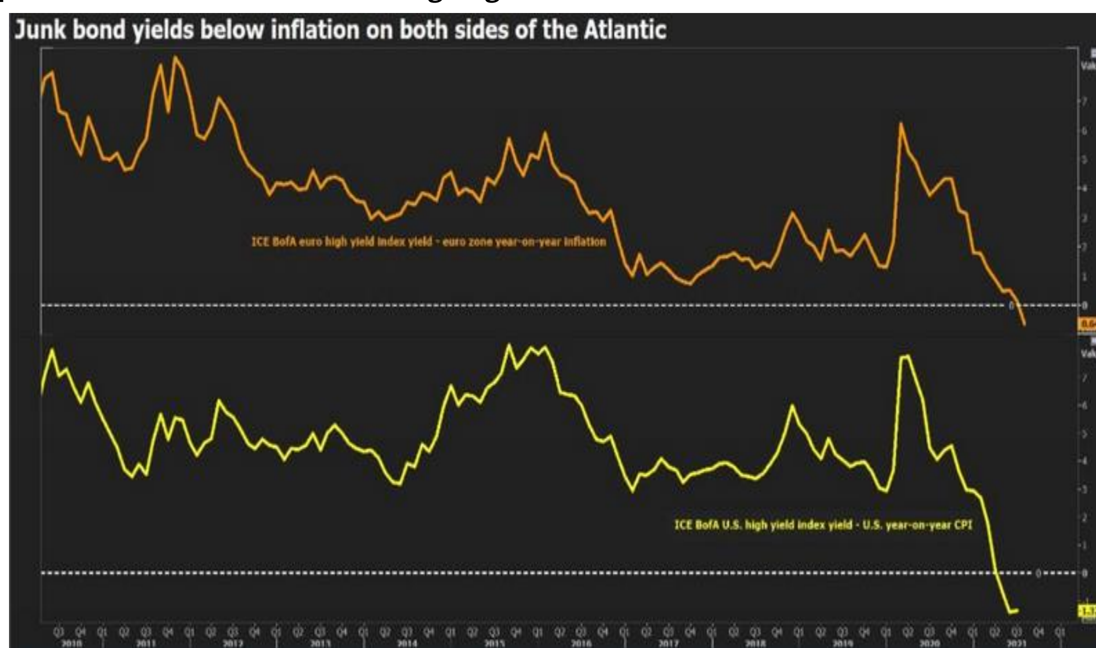
**Graph 1. Expected returns of a 60/40 Portfolio**

## The Actual Market Environment

The current economic scenario is characterized by high global uncertainties post-Covid19, where the classic investment paradigms are no longer valid. Classical portfolio construction based on a mix of 60% equity and 40% bonds, "60/40", no longer generates appealing risk-adjusted returns. Equity markets are now in their longest bull trend ever with valuations that are considered particularly expensive in some sectors according to traditional market metrics. At the same time, interest rates are artificially being kept at historic low levels by central banks and are not expected

to diversify equity in turbulent times as well as in the past: Equity-bond correlation has become positive. As said, developed markets yields on both investment grade and high yield bonds trade at historically low levels, with investors that are not getting paid on a risk / reward basis, not even at nominal levels.

**Graph 2: Junk-Bonds Real Yield Turning Negative**




Source: Bloomberg

These trends exacerbated in recent years and motivated investors to allocate to alternative asset classes, with the objective to generate more attractive returns as a premium for bearing a certain degree of different risks. Hedge Funds have largely been left out of this trend over the last decade, when flows predominantly targeted private markets such private equity and private debt investments. However, liquid alternatives such as Hedge Fund are gaining strong interest again from investors as liquidity, correlation and risk-adjusted returns is more and more in their favour. Inflows have been substantially increasing over the past quarters and are expected to persist on the upward trend, contributing to the positive momentum. In today's investment climate with lower expected returns from traditional investments and material downside risks broadly due to uncertain times post-Covid19, it is our view that sophisticated investors must seek alternative sources of return and portfolio diversification with liquid Hedge Funds.

## The Role of Hedge Funds

In this context, a natural question to pose is: where should allocators place the money to reach their diversification targets and improve the risk-adjusted returns of the portfolio? Against the above-mentioned backdrops of equity and bond markets, Hedge Funds, with their unique characteristics in terms of investment flexibility and their ability to manage downside risks, offer an ideal complement and in particular, as a replacement for fixed income and credit long-only portfolios. On an historical basis, Hedge Funds offered very attractive risk-adjusted return.

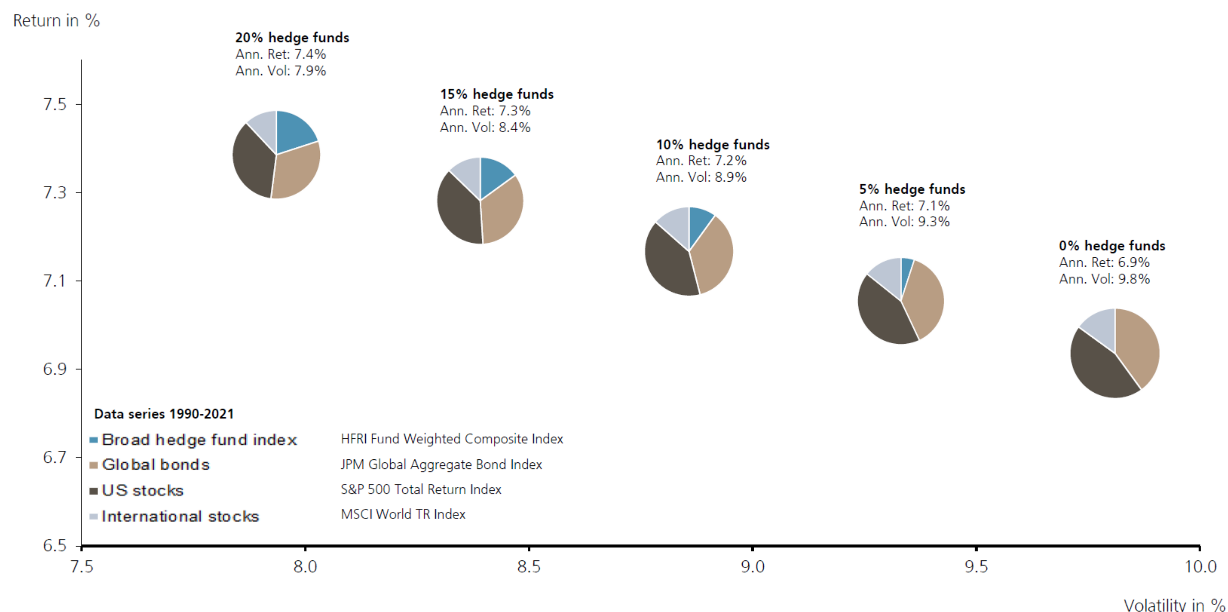
Portfolio construction has become a multifaceted process and became even more difficult to diversify the foundations of a portfolio's risk and return just by blending Credit/Fixed Income and Equity assets. Hedge Funds offer different return patterns not readily available in long-only investment strategies. Hedge Funds have the ability to secure returns that are beyond the reach of traditional bond and equity portfolios. But this is not the only characteristic that drives investors towards Hedge Funds:

**Graph 3:**

Source: Bloomberg (white: HFRX Global Index; red: BarCap Global Agg. Index; Green: MSCI World Index)

An important distinguishing feature is the performance during periods of financial stress. Over the past thirty years, in almost every year during which the MSCI World Index has underperformed, Hedge Funds have outperformed the equity index, strengthening their capital preservation aspects. In addition, after posting losses, Hedge Funds tend to recover more quickly, a feature that makes them a defensive alternative for gaining market exposure. To conclude and to reiterate the point, Hedge Funds reinforce portfolios and improve the risk-adjusted performance of a diversified portfolio. Therefore, we believe Hedge Funds are necessarily to be included as a core portfolio allocation or even beyond that, given the fact that credit/fixed income does not offer any longer a return beyond inflation.

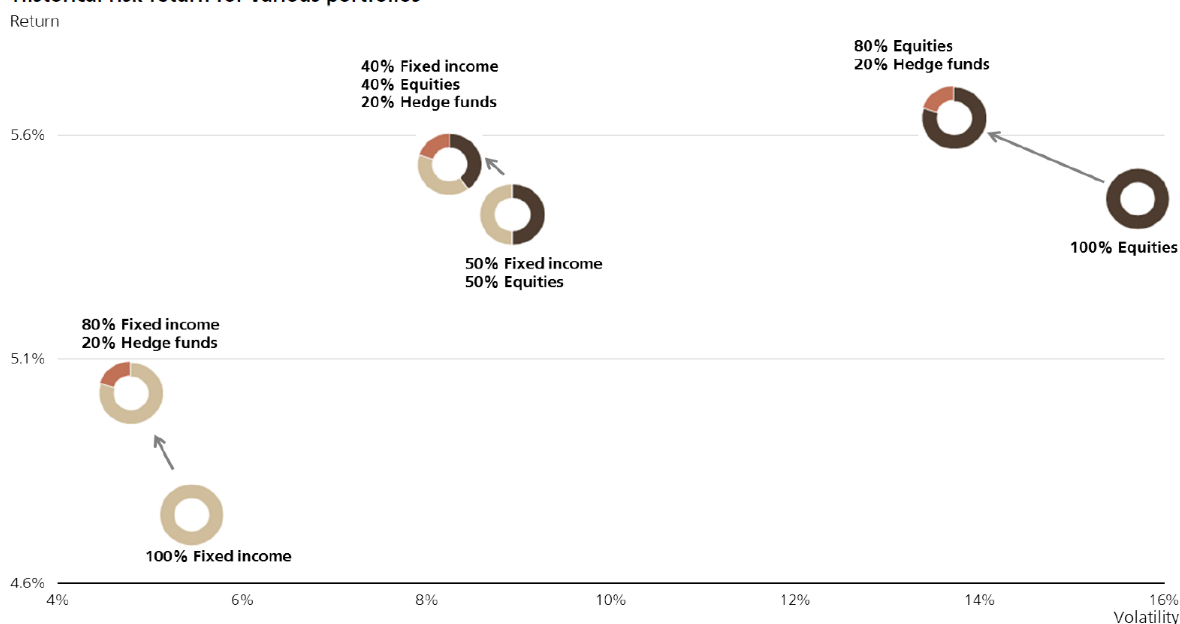
**Graph 4: Improving risk-return of a balanced portfolio**




Source: Bloomberg, UBS, as of August 2021

Graph 4 and 5 highlight the fact of low correlation of Hedge Funds with traditional equity and bond portfolios, while enhancing at the same time the overall portfolio return. For example, the impact is very spectacular with a focus on extremes by introducing 20% of Hedge Funds in a portfolio of only stocks and bonds, where risk is reduced by -19.4% (almost one fifth!), while at the same time the overall return increases by +6.8%.
Hedge Funds in a portfolio context can be used in various ways. An investor can build a portfolio of long/short equity hedge funds to use it as a complement for this long-only equity portion. Or in this low fixed income yield environment, investors can invest in a diversified multi-strategy portfolio as a fixed income diversification.

**Graph 5: Hedge Funds in a Portfolio Allocation**




Source: Bloomberg, UBS, as of August 2021

Within the Hedge Fund universe, there are clearly certain strategies that are in the front position to enjoy positive performance: In our opinion, Event Driven strategies, favored by a particularly conducive environment in the M&A market and the continuation of the SPACs phenomenon. The attention to Chinese Hedge Funds is also gaining momentum, as the market is dominated 80% by retail investors and presents considerable inefficiencies. Global Macro strategies with a discretionary approach are also among the most favored, given their ability to offer low correlations to equity and bond markets and to exploit the uncertainty surrounding the intensity of post-covid growth, monetary and fiscal policy decisions and growing tensions between the US and China. In such an uncertain environment, we believe that investors should be particularly aware and evaluate the risks of those strategies based on a strong directional bias, in particular in the Long-Short Equity market: active and fundamental managers in this space have been indeed highly challenged by volatile market rotations and short squeezes from retail investors, with similar conditions likely to continue in conjunction to a lack of long-term clarity in terms of monetary policy.

## ESG and Sustainability

Although Hedge Funds have been lagging behind traditional players in the implementation and adoption of sustainability considerations, they are quickly catching up. With the interest for ESG-centered funds up +33% compared to the first quarter 2021[1], it is clear that how a Hedge Fund

[1] BofA Prime Brokerage Capital Strategy Group

integrates ESG into the investment process has become increasingly important. We support the increasing sustainability pressure on the industry and believe it to be fully motivated, considered the driving force the Hedge Fund industry can exercise. Hedge Fund managers are leveraging on their unique features, such as the possibility to establish short positions and drive change though a direct engagement with the management of a company. With the effects of climate change becoming more and more evident, increasing regulatory interventions and shifts in consumer preferences, the investment landscape is also full of alpha opportunities, and we expect the dispersion in returns to be high. In this context, Hedge Funds are set to play a leading role for a more sustainable future.

## AQUIS Fund of Hedge Funds Approach

*Simplicity, Visibility and Diversification*

AQUIS investment team has more than two decades of investment experience in investing in Hedge Funds. Over the years, we observed the disadvantages and the overwhelming advantages a Hedge Funds allocation can offer to an investor's portfolio. AQUIS novel approach in selecting Hedge Funds comes with the promise of "Simplicity, Liquidity and Diversification".

*Simplicity and Visibility*

We prefer back to basics! Just simple traditional hedge funds strategies, either discretionary or systematic. For instance, the two most favored and well understandable Hedge Fund strategies are Long/Short Equity and Long/Short Credit. As the names indicate, the Long/Short Equity and the Long/Short Credit strategies are composed of incorporating long and short positions mainly in Equity, respectively in Fixed Income/Credit and its derivative instruments.

Hedge Funds utilizing a Long/Short approach use primarily comprehensive and traceable, bottom-up, fundamental, and either discretionary or systematic methods to approach with an investment assessment. Long/Short strategies usually trade on exchange listed liquid instruments and their derivatives, i.e. they can be liquidated within a short timeframe. AQUIS shies away of investing in any model-based, market-to-model, or any potential illiquid strategies in time market stress within our current existing Hedge Fund offering, ensuring its clients no liquidity mismatch between our offering and underlying investments. Furthermore, we emphasize on 'Visibility' as one of our key aspects; AQUIS only invests in Funds where we have direct access to the portfolio manager, being able to trace back their investment decisions. To put it simply, we only invest in what we understand.

*Diversification*

We strongly believe in our future oriented multi-strategy offering by avoiding concentration risk in any asset class. Why? Asset prices are skyrocketing high and Multi-Strategy Hedge Funds have the advantage to use a range of investment strategies to generate positive returns irrespective of overall market environment as they are not married to a single approach or purpose. Their scope encompasses, inter-alia Long/Short Equity, Long/Short Credit/Fixed Income, Event Driven, Arbitrage, Global Macro or even quantitative systematic strategies to manage the perceived market environment.
Multi-Strategy Funds have the tendency to have a high priority on capital preservation and generating higher risk/adjusted returns. This approach is especially nowadays a very important aspect, where certain industries, sectors or even geographies look overpriced compared to other ones. Hence, diversification not only in terms of correlation but also styles, approaches and scope are key components in today's and ongoing portfolio management environment.

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