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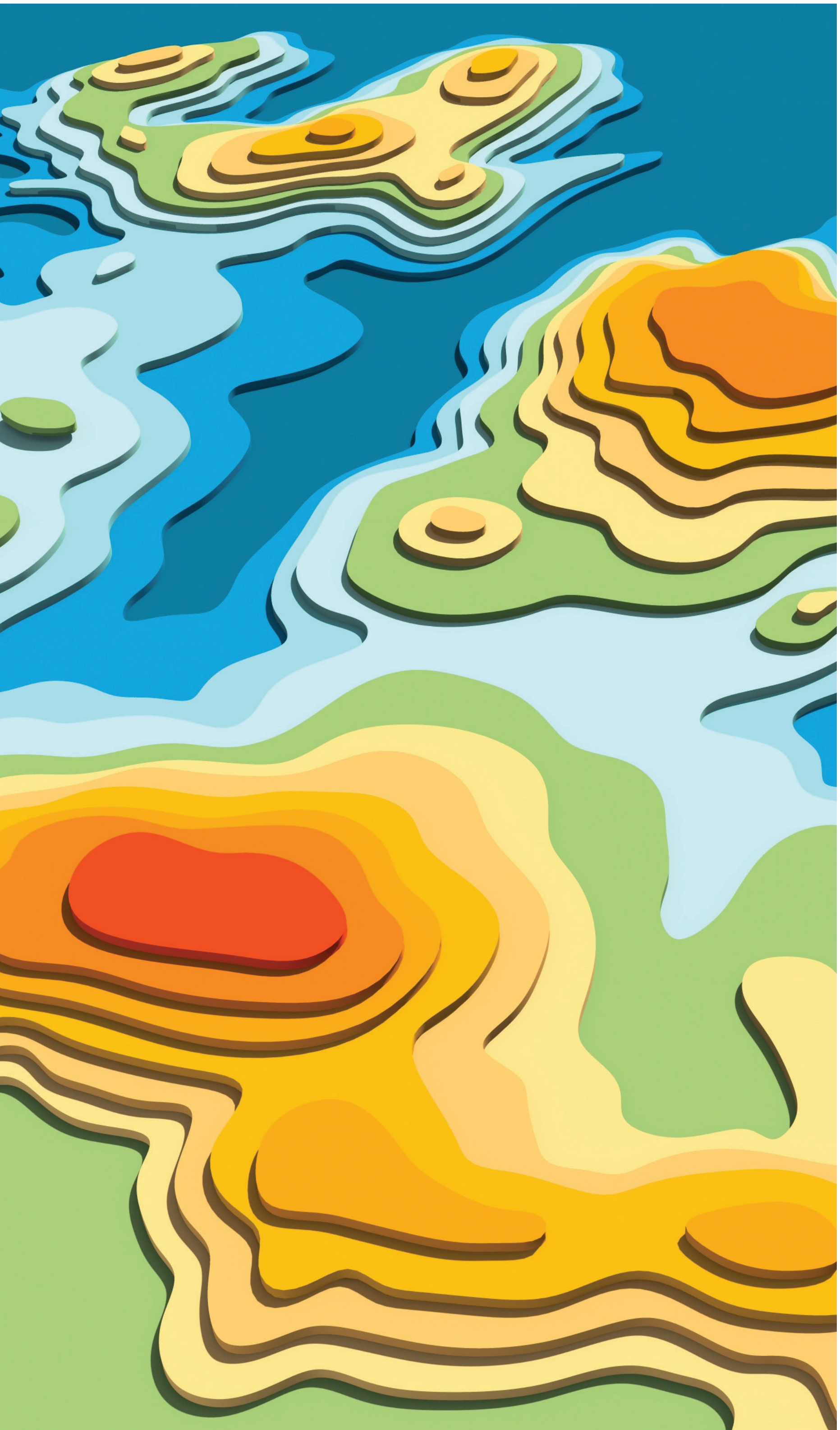
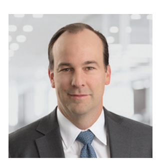


2021 Market Outlook

Today's Hedge Funds: Solutions to a 60/40 Problem

With most risk markets near historical highs and rates pinned near zero, return expectations for traditional 60% equity/40% bond (60/40) portfolios are below the historical average. In fact, they are at the lowest level they've been in more than 10 years. Challenged by a minimal yield environment and its implications for 60/40 portfolios, investors seem to be falling into two main camps: One is focused on finding higher returns that don't amplify the equity risks embedded in the 60/40 portfolio, and the other is searching for ways to mitigate elevated levels of equity and fixed income risk. The latter group is particularly tested because long duration has become an even less reliable means of risk reduction. Against this backdrop, we see renewed interest in hedge funds, particularly in strategies that have evolved to complement 60/40 risk in very specific ways.



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AIP Hedge Fund Solutions

Effective Implementation of Active Management Is More Important Than Ever, and Today's Hedge Funds Are Positioned to Deliver

Over the years, hedge fund investors have learned that delegating decisions about beta management and being permissive about volatility exposure, because of flawed correlation estimates or ill-conceived hedges, can lead to disappointment. Increasingly, investors have grown focused on strategies that are designed to achieve more exacting payoff profiles. In today's environment, with concerns about the outlook for 60/40 portfolios magnified by a global pandemic, investors are understandably seeking solutions to two specific challenges: how to generate significant returns over a benchmark in a differentiated way and how to minimize total portfolio volatility and provide downside risk mitigation.

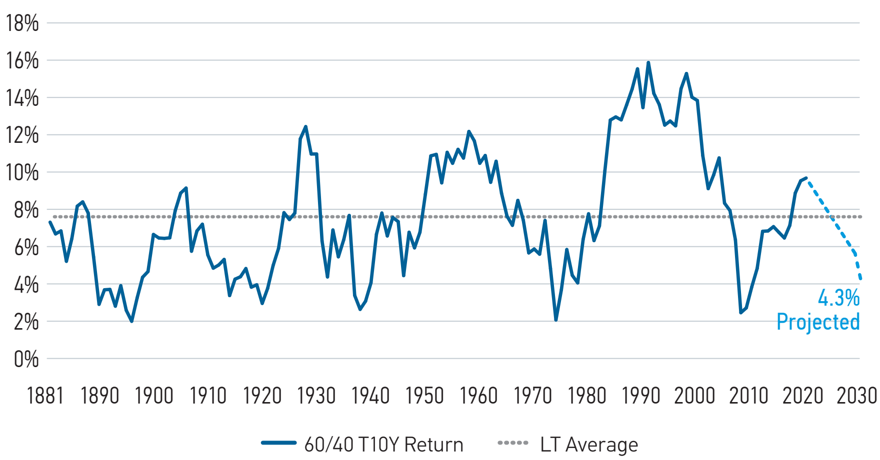
We believe hedge funds that are purpose-built with specific risk/reward profiles—which we think of as "today's" hedge funds—can help investors achieve these goals. As the most unconstrained form of active management, hedge funds have proven nimble in how they capture opportunities and innovative in the way they meet investor needs. In this article, we present a framework for understanding how today's hedge funds can offer solutions to 60/40-related investment challenges.

1. **HIGH ACTIVE RISK:** 2020, the first quarter in particular, provided a decisive test for hedge fund managers. For many, it was the final nail in the coffin, but for others, it was proof of their dominance. In the latter category are multi-manager platform hedge funds—institutionalized, global organizations that have created oligopolies on talent, resources, information and technology management. These platforms comprise groups of seasoned, highly specialized portfolio managers who focus on taking active risk in the sectors of their expertise. Their aggregate exposures are monitored and managed centrally to achieve the type of fund-level return profiles that have come to define their durable value proposition: strong risk-adjusted returns, minimal beta and a natural diversification element. Hedge Fund Research, Inc. data shows that investors maintain a healthy appetite for these time-tested sources of active risk and a willingness to pay for it. At a collective $750 billion in AUM, multi-manager platform hedge fund AUM represents 24% of the overall hedge fund industry. The 10 largest of these funds have seen their AUM grow

DISPLAY 1

Expected Returns for Traditional 60/40 Portfolio Below Historical Average

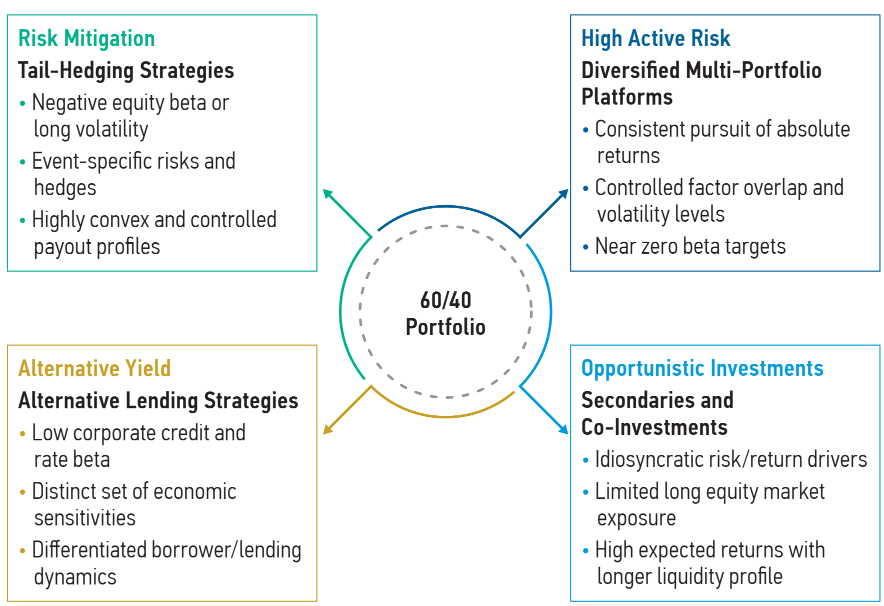
U.S. 60/40 Equity/Bond Portfolio Realized T10Y Returns (Ann.)



Source: NBER, Jordà-Schularick-Taylor Macrohistory Database, Bloomberg, Morgan Stanley Research. Note: Dotted line based on our long-term expected return estimates. As of December 10, 2020.

DISPLAY 2

Hedge Fund Solutions to 60/40 Challenges



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35% over the last five years, outpacing the total hedge fund industry, up only +17%.[1] Going forward, we expect this trend to continue. However, we believe there are important ways that the return delivery mechanism for such funds can and should be optimized.

2. **OPPORTUNISTIC INVESTMENTS:** We believe investors can earn higher-than-average compensation in the form of a liquidity premium for taking on only modestly longer investment horizons of two to five years. The market dislocations created in the wake of the pandemic produced an environment ripe with co-investment opportunities for specialized investment teams with medium-term capital to deploy, who are able to assess pools of trade claims, rescue finance obligations, aviation asset-backed securities and reinsurance, for example. Post-pandemic disruptions also opened interesting avenues to capitalize on rising contract law disputes, distressed first- and second-lien debt investments, capital structure arbitrages in holding company/stub trading structures as well as real asset and post-reorganization equity investments. Looking ahead, as the economy heals and businesses return to normal, a large supply of private credit secondary transactions from 2010 to 2015 vintages will reach end of life and become available, revealing opportunities in higher yield distressed, leasing/royalty and trade finance.

3. **ALTERNATIVE YIELD:** For investors struggling to find sufficient yield from traditional fixed income, fintech-driven, alternative lending is a form of consumer-focused private credit that we find offers potential yield pickup with low duration. In what we see as a K-shaped economic recovery, U.S. consumers' balance sheets, especially those in prime, near-prime and Alt-A lending segments, should continue to benefit from an upward-sloping reacceleration. In this scenario, higher savings rates, limited opportunities to spend and home price appreciation would help to improve their financial standing. Beyond providing exposure to the resilience of the U.S. consumer, alternative lending can be diversifying versus other major asset classes, including traditional fixed income and, notably, corporate credit, which dominates so many 60/40 portfolios.

4. **RISK MITIGATION:** Concern about the likelihood of lower future returns is increasing investor focus on capital preservation. Tail-risk hedging strategies seek to optimize portfolio efficiency by magnifying returns during loss scenarios while reducing costs in normal markets. Importantly, they have the potential to deliver diversifying performance profiles and allow for continued exposure to desired risks. Some programs are designed to even provide liquidity during times of significant market crisis. Contemporary volatility asset managers have become well-equipped at rotating conditional payout profiles to maximize the dollars spent on premiums and minimize theta decay—the amount of value an option loses as it moves closer to its maturity date. Other more traditional approaches involving discretionary global macro managers and systematic strategies that can target risk-off characteristics through dollar, rate and equity expressions can also offer 60/40 diversification benefits. Given the continued uncertainty about the long-term impacts of the pandemic and the fact that traditional diversification techniques don't always work, a thoughtfully designed portfolio would do well to allocate to risk offset strategies, in our view.

Conclusion

More than at any other time in the recent past, hedge funds may offer investors viable solutions to their 60/40 dilemmas. The market volatility of Q1 2020 laid bare the inherent risk in equity markets and the degree to which fixed income can diversify. Global monetary and fiscal authorities stepped in, employing a variety of tools, but they may have pushed their effectiveness close to the limit. As the economy recovers, new opportunities will emerge related to changes in consumer behaviors and adapted business models. At the same time, we expect that economic fallout and scarring will unveil risks, market fragility and unforeseen longer-term damage. Investors seeking to optimize their portfolios away from the risks inherent in the traditional 60/40 mix may be well-served to approach their investment objectives, considering desired payout profiles and risk/return trade-offs, through the framework we've presented here. In short, we believe today's hedge funds offer an array of compelling ways for investors to address the risk and return challenges associated with their 60/40 portfolios.

[1] "Multi-strategy Funds: The Landscape." UBS Capital and Consulting Services, 2H 2020

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