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.
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

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**DISPLAY 1**

**Expected Returns for Traditional 60/40 Portfolio Below Historical Average**

<table>
<thead>
<tr>
<th>U.S. 60/40 Equity/Bond Portfolio Realized T10Y Returns (Ann.)</th>
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<tbody>
<tr>
<td>18%</td>
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<tr>
<td>8%</td>
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<td>4%</td>
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<td>16%</td>
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<td>2%</td>
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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.

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**DISPLAY 2**

**Hedge Fund Solutions to 60/40 Challenges**

- **Risk Mitigation**
  - Tail-Hedging Strategies
    - Negative equity beta or long volatility
    - Event-specific risks and hedges
    - Highly convex and controlled payout profiles

- **High Active Risk**
  - Diversified Multi-Portfolio Platforms
    - Consistent pursuit of absolute returns
    - Controlled factor overlap and volatility levels
    - Near zero beta targets

- **Alternative Yield**
  - Alternative Lending Strategies
    - Low corporate credit and rate beta
    - Distinct set of economic sensitivities
    - Differentiated borrower/lending dynamics

- **Opportunistic Investments**
  - Secondaries and Co-Investments
    - Idiosyncratic risk/return drivers
    - Limited long equity market exposure
    - High expected returns with longer liquidity profile

For illustrative purposes only.
For investors

Concern 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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