Heightened Volatility? Hedge Funds could help weather the storm

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HSBC Asset Management

Key Investment Risks

Investors in hedge funds should bear in mind that these products can be highly speculative and may not be suitable for all clients.

The value of investments and any income from them can go down as well as up and investors may not get back the amount originally invested. Past performance does not predict future returns. The return may increase or decrease as a result of currency fluctuations.

There are several key issues that one should consider before making an investment into hedge funds. The risks specific to this type of investment may include, but are not limited to:

Regulation

The hedge fund industry is lightly regulated, with the majority of funds domiciled in offshore jurisdictions. Hedge funds are generally classified as "unregulated" and are not typically subject to the same levels of scrutiny and protection as a traditional investment fund. A thorough due diligence process can mitigate these concerns.

Gating

In event that redemptions requests on a particular dealing date are much higher than the normal level and full satisfaction would jeopardise the longer term portfolio balance, a gate or partial execution of redemption requests may be implemented generally on a pro-rata basis.

Side pocket

There may be instances when certain assets in a fund portfolio could become less liquid and the fund manager may segregate these illiquid positions from the main portfolio into a side pocket (or a separate vehicle).

Suspension of redemption

Suspension of redemption is a temporary halt in exiting the fund during a given redemption window. This is a stronger measure than gating because there is no dealing for the fund. This is generally used under special circumstances such as when liquidity conditions have markedly deteriorated in a short period of time or when there are heavy asset outflow such as the loss of a core investor.

Access

Hedge funds operate larger investment minima than traditional investment funds. Investors are often unable to access a hedge fund unless they were willing to invest US$500,000 to US$2million.

Liquidity

Hedge funds typically have much longer dealing cycles than traditional investment funds. Depending on the strategy being utilised, a hedge fund may only allow subscriptions and redemptions on a monthly or quarterly basis. Furthermore, some hedge funds have long lock-up periods, where an investor is not permitted to redeem from the hedge fund unless a period of 6 months, a year or even 2 years has passed. Some may allow a redemption before the lock-up period is over, but the investor would have to pay a hefty penalty to be able to do this.

Transparency

Many hedge fund managers are wary of regularly publishing their positions in the belief that this will remove any advantage that they have over their peers. This can pose a problem to the investor, as he or she cannot be certain to which stocks, geographies, markets or even strategies he or she will be exposed to when investing in the hedge fund. However, trusted investors who have built strong relationships with the hedge funds can access this information for the majority of funds, enabling thorough monitoring of the investment.

Manager failure

Over time, a number of hedge funds will close or fail, due to weak performance or operational difficulties. An investor must take this into consideration before making an investment, seeking professional advice to help minimise the risk of investing in a fund that is likely to fail.

The risk factors listed above are not exhaustive. Please refer to the official product documentation for the detailed risk disclosures specific to the HSBC GH Fund.

History would say that volatility is set to increase

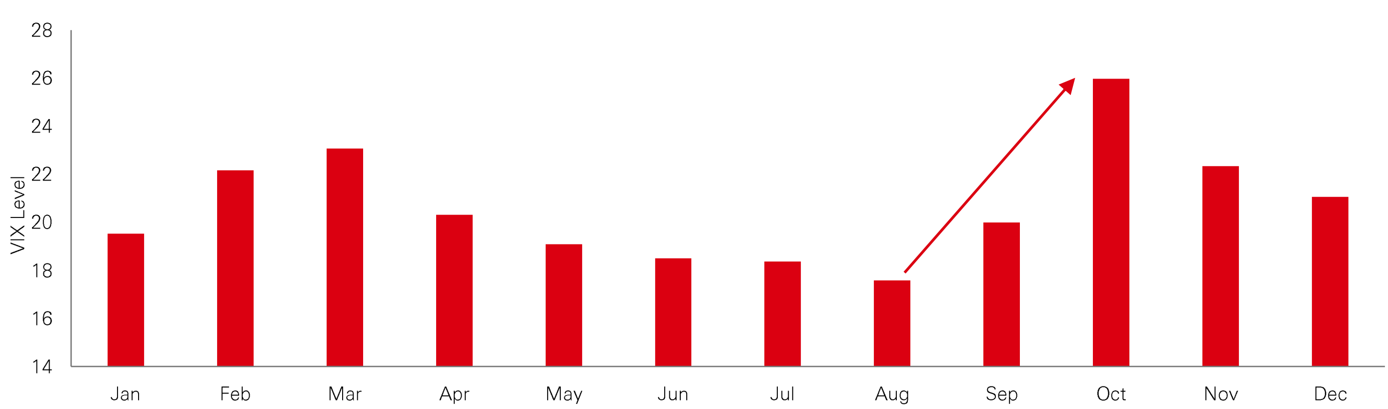
2024 has been a year which, for many, has confounded market expectations. Heading into the year, the market had priced in a number of interest rate cuts, with the idea from a macroeconomic perspective of a 'soft-landing' looking more tangible than alternative scenarios. Indeed, markets seemed to be following this script for the first half of the year. Equities reached new highs, powered by continuous enthusiasm for artificial intelligence, semiconductors, and healthcare and expectations for interest rate cuts during the second half of the year. Meanwhile, bond markets struggled, with central banks keeping rates steady in the US, resulting in further monetary policy uncertainty.

Moving into the second half of the year , we have experienced a different environment. From the mid-July peaks, equities pulled back as allocators crystallised profits and rotated into other asset classes. The tension underpinning monetary policy and geopolitics came to a head in early August, as markets experienced a sharp, albeit temporal, sell off. This concurrently witnessed the VIX spiking in one of its highest ever one day rises, thrusting asset class volatility into the forefront of investors' minds.

VIX Index (since January 2023)[1]

Uncertainty in monetary policy has been an ever-present consideration so far this year, but changes in the geopolitical environment have also been a driver of market movements. Electoral uncertainty has already affected asset prices across the globe, with the repercussions of surprise election victories and election candidate drop-outs heightening their unpredictable direction. With the US election set to take place in November, history would tell us to expect a more persistent uptick in asset class volatility. Investors ought to be wary of how to navigate these potentially choppy markets, and which asset classes are likely to benefit from the wider opportunity set, which volatility gives rise to.

Average VIX Index level in US election years (since 1982)[2]



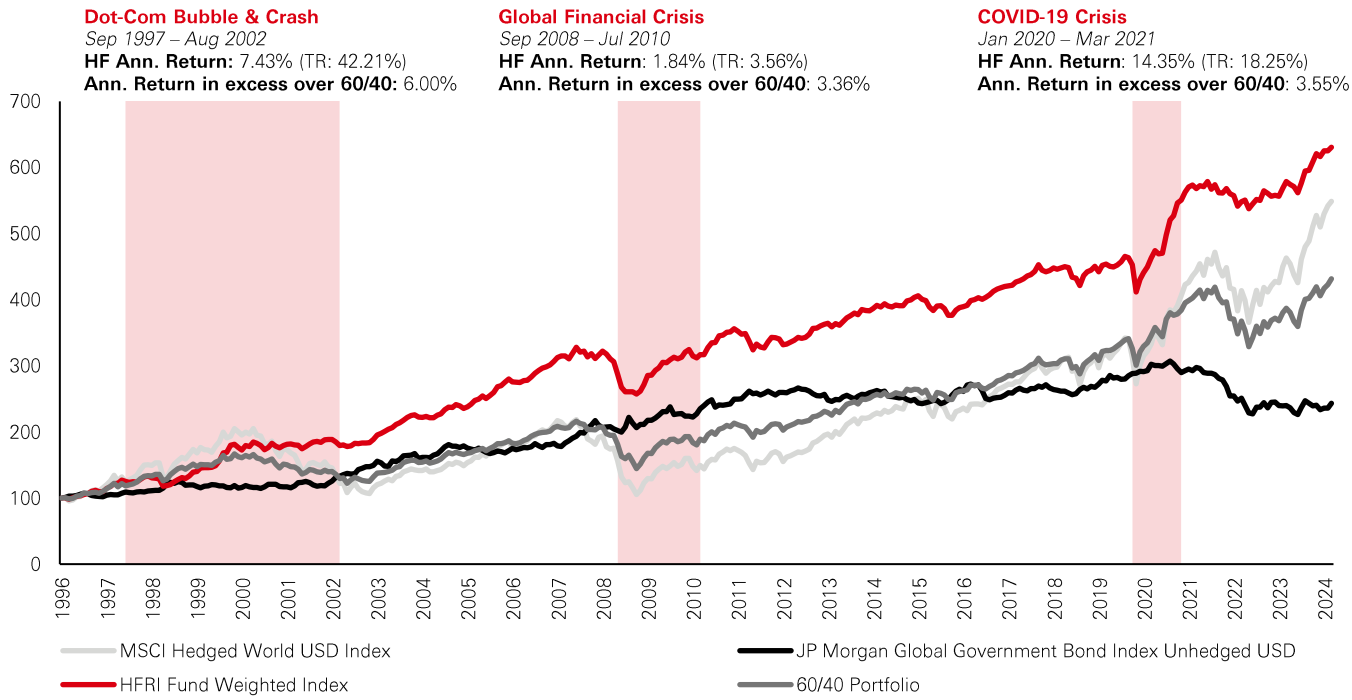
For illustrative purposes only. Past performance does not predict future returns. The return may increase or decrease as a result of currency fluctuations.

1. & 2. HSBC Alternative Investments Limited, Bloomberg.

Hedge Funds – uniquely positioned to benefit?

With the uncertain theme of markets likely to continue in the coming months, investors are naturally open to expanding their avenues for return accrual. As uncertainty breeds volatility, it is to be expected that allocators will seek greater exposure to asset classes which traditionally elicit opportunity in choppier markets. In our view, hedge funds provide a solution to meet the need of diversifying portfolios without compromising on return.

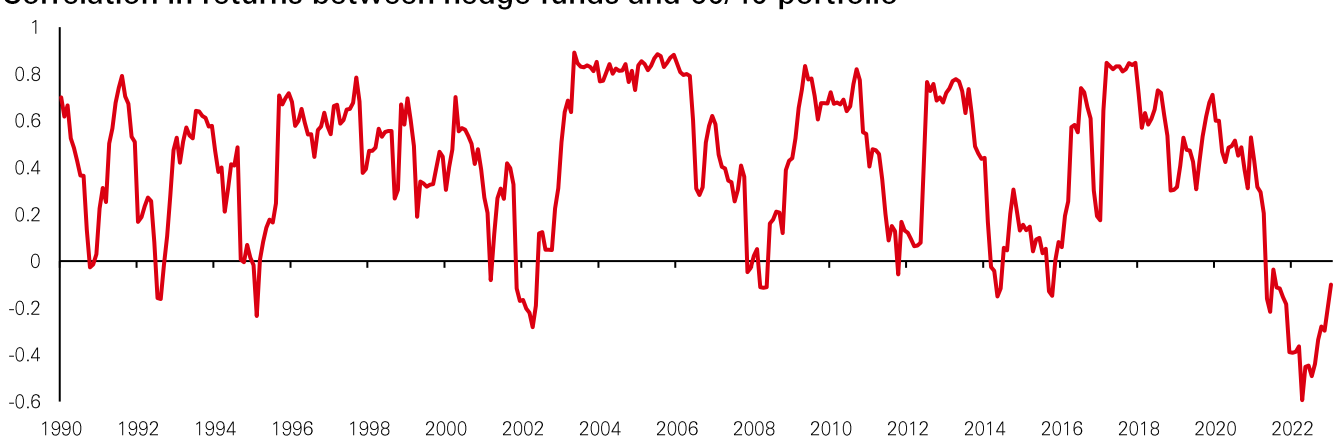
Performance of hedge funds in periods of high volatility[1]



Looking back at previous periods of particularly high volatility, we see hedge funds outperforming global balanced portfolios. The volatility profile of a well-managed diversified hedge fund portfolio also stacks up favourably over the longer term against traditional asset classes. The unique ability of hedge funds to position themselves long and short a given asset represents a particular advantage during volatile markets. Combining this with what is often best-in-class risk management (amongst other advantages), the superior alpha generative capabilities of hedge funds is highlighted in these periods.

A concurrent relevant point is the negative correlation which exists between hedge funds and global balanced portfolios in periods of stress. This is depicted below and indicates a relationship whereby hedge funds are capable of capturing the upside, whilst also delivering returns in market downturns.

Correlation in returns between hedge funds and 60/40 portfolio[2]



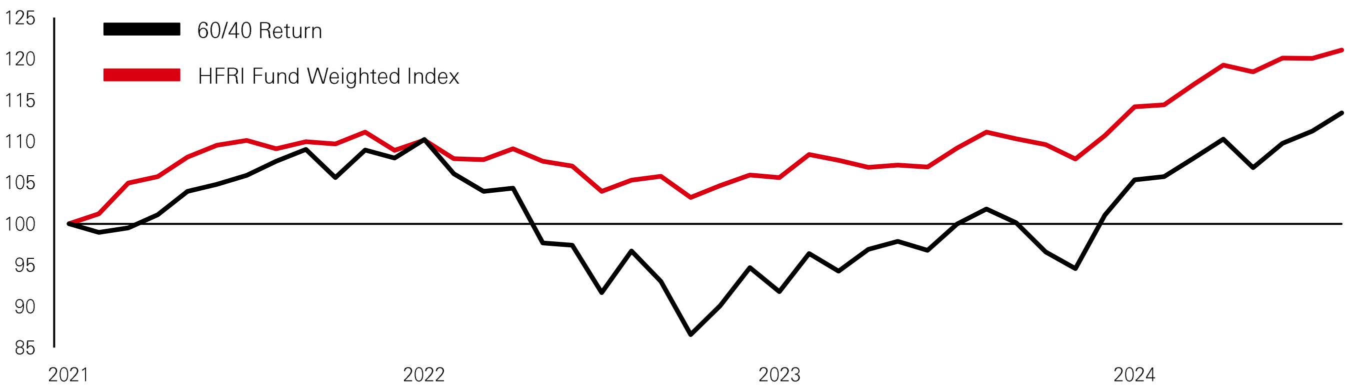
Past performance does not predict future returns. There is no guarantee that the fund objectives or target returns will be achieved. The return may increase or decrease as a result of currency fluctuations. Diversification does not ensure a profit or protect against loss.

1. Source: HSBC Alternative Investments Limited, Bloomberg. As of 30 July 2024. 60/40 portfolio is represented by: 60% allocation to MSCI Hedged World USD Index; 40% allocation to JP Morgan Global Government Bond Index Unhedged USD.
2. Source: HSBC Asset Management, Bloomberg, HFRI. Time period presented is from January 1990 to December 2023. Traditional 60/40 portfolio is made up 60% Global Equities (MSCI World Index) and 40% Global Bonds (JP Morgan Global Government Bond Index unhedged in USD). Hedge Funds are represented by the HFRI Macro Index. Correlation is calculated on a 12-month rolling basis.

Trends bolster the case for hedge fund allocations

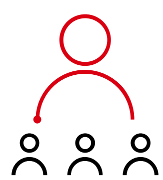
With heightened uncertainty in mind, looking at recent performance hedge funds have offered favourable returns relative to global balanced portfolios. In the light of this 60/40 investors are likely to start questioning the efficacy of simple 60/40 portfolio construct, with allocations to bonds failing to cushion the downside over the last 3 years due to new monetary policy regime since Q4 2021. At the same time, hedge funds have generally performed within expectations, namely delivering returns in a non-correlated fashion through the cycle.

Outperformance of hedge funds vs global balanced portfolios[1]



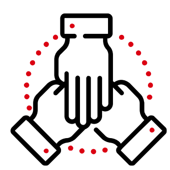
At the time of writing, we believe the opportunity set for hedge funds is especially wide as a number of market dynamics appear to be offering managers the potential to generate alpha.

Wide Opportunity set for hedge fund managers



Geopolitical Risk

Geopolitical landscapes are as pivotal as ever in shaping market dynamics. With almost half of the world's population headed to the polls during 2024, markets have experienced volatility, excluding the additional market effervescence expected from the US presidential election. Compounding this effect with the ongoing conflicts in Europe and the Middle East, there are many possible outcomes for asset class performance. We foresee **Macro** and **Multi-Strategy** managers benefitting the most from this backdrop

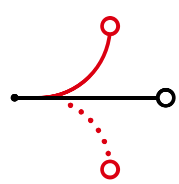


Corporate Activity

The first half of 2024 has seen an uptick in M&A activity, as well as in the number of activist campaigns deployed globally. Despite recent volatility, we see **Event-Driven** managers continuing to deploy capital in the form of activism, as well as in speculation of further M&A. These managers have the inherent ability to cancel out the noise of the market and focus on their view of a true value of a prospective investment.

Elevated Cost of Borrowing

Rates remaining 'higher for longer' has arguably been the theme of the year thus far in 2024. Whilst consensus is for rates to gradually start to fall, we expect to see market breadth grow as the repercussions of higher rates are experienced, much to the benefit of **Equity Long/Short** managers. The uncertain path of interest rates evokes volatility in credit markets too, where we would envisage **Credit long/short** managers are able to profit.



Market Dispersion

Equity markets have seen growth in dispersion in 2024, meaning the performance difference in returns between underlying assets has grown. Hedge funds, particularly **Equity long/short**, are likely to benefit from the wider stock picking environment and more diverse earnings picture.

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Conclusion

Looking forward into both the short and medium term, One can make the case that asset class volatility is set to increase and stay elevated for the foreseeable future. The backdrop of uncertainty surrounding inflation, the geopolitical landscape, election uncertainty as well as the prevalence of market trends, leads us to this conclusion.

Whatever one's views on which macro scenario will prevail, history tells us that in periods of volatility hedge funds can produce returns in excess of other asset classes. We would argue that a well-diversified, fund of hedge funds product is a key allocation investors should have as part of their wider portfolios, especially in the current and forecast market environment.

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