Quick takes

Investor Insights from UBS Asset Management

What's the alternative?

Amid volatile markets a multi-strategy investment may be a good idea

There are a lot of misconceptions about hedge funds: they're only for the ultra-rich, they take big risks in order to make outsized returns, they lock your money up for years, just to name a few.

In reality hedge funds represent a large and diverse universe of investment managers with a broad range of investment styles. Historically they have experienced less volatility than other isolated asset classes and have been more accessible than most investors think. Multi-strategy hedge funds, which employ a number of different and usually complementary investment styles, can enhance the diversity in an investor's portfolio and seek attractive returns over time, while placing a priority on limiting losses.

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Why are investors interested in hedge funds?
Many investors are reexamining their traditional stocks and bonds portfolios as markets have become more volatile. After recovering from the financial crisis, equities in many developed countries have bounced back and generally performed well, while in the US it has been a historic bull run. This period, especially in 2017, has also been marked by generally lower volatility.

On the fixed income side, investors have struggled to find good sources of low risk income from bonds. Until the US Federal Reserve (Fed) began raising rates in December of 2016, benchmark interest rates in most developed countries had been at or near zero, and in some cases negative. And even with the Fed raising rates, yields on bonds are still low by historical standards.

In 2018 things changed. Volatility has roared back across all asset classes. Rising yields, policy uncertainty, higher geopolitical risks, including trade tensions and tariffs and late cycle fears, have all been concerns.

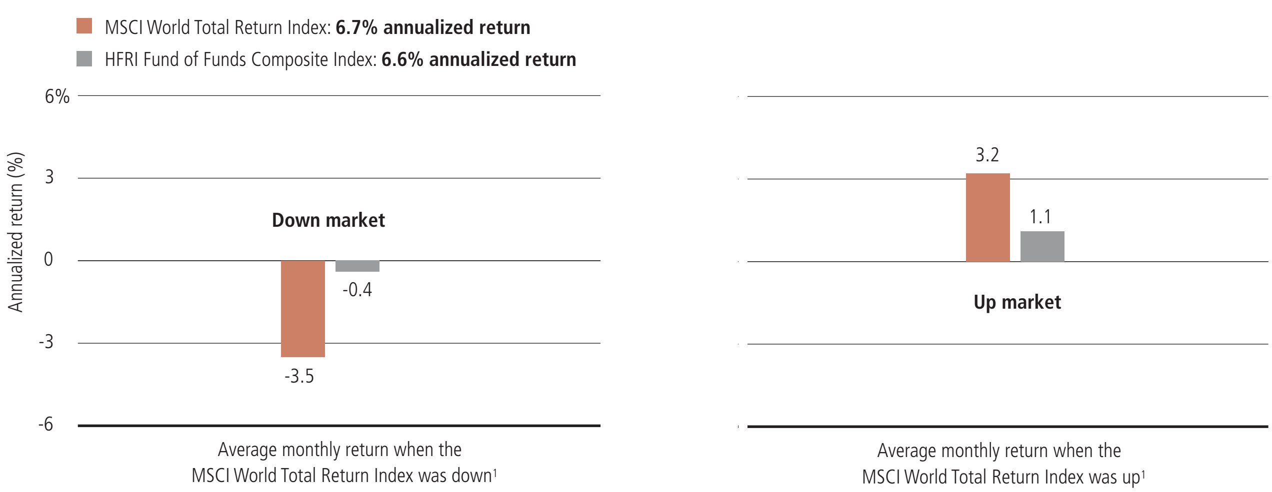
Investors are looking for an alternative to both diversify their portfolio and provide less volatile returns. Hedge funds may be just that—historically they have offered the following: returns that are largely uncorrelated to stocks and bonds, lower volatility than equities and smaller drawdowns when markets have had significant downturns.

On the downside
Consider the returns in two periods of extreme market turbulence. The first occurred between 2000-2002, which coincided initially with the Dot Com Bubble bursting and the beginning of a recession in the US. During that period, equities and hedge funds experienced varying returns under extreme pressure.

- Equities: The MSCI World Total Return Index, which includes approximately 85% of the free float-adjusted market capitalization across the world's developed markets, had significant losses of 13.2% in 2000, 16.8% in 2001 and 19.9% in 2002.
- Hedge funds: The HFRI Fund of Funds Composite Index, a global asset-weighted index comprised of over 2,000 single-manager funds, had gains of 4.1% in 2000, 2.8% in 2001 and 1.0% in 2002.

The second was 2008—in the first year of the Great Recession, where the difference in returns was extremely stark. The MSCI World Index was down 40.7% for the year and the HFRI Fund of Funds Composite Index was down 21.4%.

Figure 1: Hedge funds generally participate less in up markets but can avoid large losses in downturns
Global equities versus hedge fund portfolios—January 1990-September 2018



Source: UBS Hedge Fund Solutions, Bloomberg.

[1] The left side of the graph depicts the average monthly return for both indices during the 132 negative months for the MSCI World Total Return Index. The right side of the graph depicts the average monthly return during the 213 positive months for the MSCI World Total Return Index. Based on USD total returns from January 1990 through September 2018. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS**. The indices are for illustrative purposes only. See endnotes for further information and for index descriptions.

So, what are hedge funds?
In the most basic terms, hedge funds are investment vehicles that generally employ a variety of alternative strategies as opposed to straightforward long stock and bond investments.

Hedge funds generally have broader mandates—with more flexibility and discretion—and access to a larger investment toolset than mutual funds. And, because of their legal structure, hedge funds can employ investment options that are prohibited for mutual funds, such as leverage, short-selling and derivatives, and are not necessarily available to all investors.

Multi-strategy hedge funds invest in multiple diverse and complementary strategies in order to potentially smooth returns and dampen losses by employing investment styles that may perform differently in various market environments or economic cycles.

There are a dizzying array of hedge funds in operation, more than 8,000[2] worldwide. Such a selection can be daunting for investors. As a result, an appealing option is to invest in a fund of hedge funds, which invests in a pool of hedge funds on their behalf. These types of products are actively managed portfolios of hedge funds, which can potentially serve as a powerful diversifier to a traditional stock and bond portfolio.

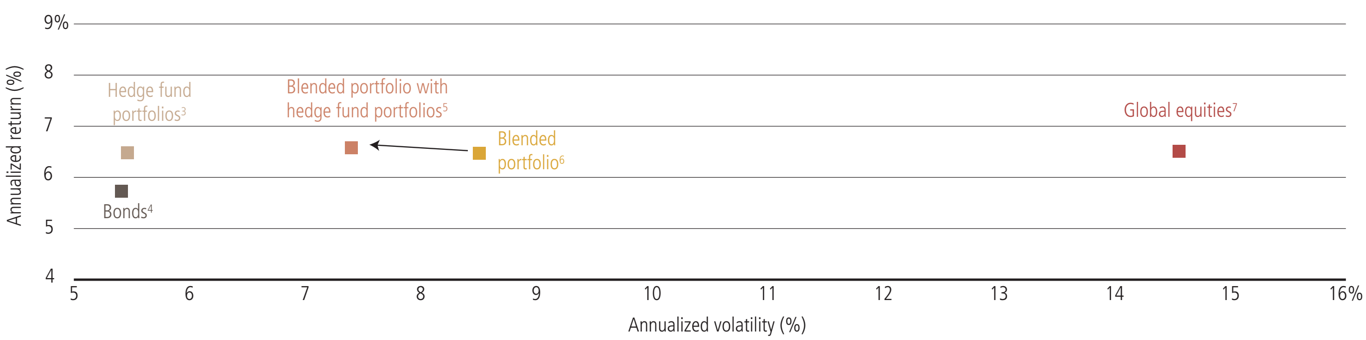
Funds of hedge funds employ portfolio managers and analysts who assess the performance, management, execution and strategies of a large universe of hedge funds. Using independent research and proprietary models, a manager can select the funds that seek comparatively lower volatility and more consistent returns. Within these products, managers place a high priority on diversification and loss aversion through risk management, aiming to offer a variety of risk / return profiles.

A word about risk
There may be a perception that hedge funds will generally outperform the broader equity market or that managers are looking to "hit it out of the park." While that may be true for some funds, for many hedge funds the case is actually somewhat the opposite: giving up some of the upside to offer a lower risk alternative.

The chart below illustrates this. Of three types of investment allocations shown, global equities have the highest risk portfolio, while both the bond and hedge fund universes have lower risk profiles. Adding a 20% hedge fund allocation to a 50 / 50 blended stock and bond portfolio can lower the risk without affecting the return.

Increasingly, more and more investors are seeing the potential benefits of an allocation to hedge funds in their investment portfolio. Work with your Financial Advisor to assess whether an alternative investment strategy may be right for you.

Figure 2: Lowering risk with hedge funds?
Adding hedge fund portfolios to a traditional portfolio—Annualized risk/return (January 1990-September 2018)



Source: UBS Hedge Fund Solutions, Bloomberg.

[2] HFR Global Hedge Fund Industry Report, Q3 2018.
[3] HFRI Fund of Funds Composite Index.
[4] Barclays Global Aggregate Total Return Index.
[5] 40% Bloomberg Barclays Global Aggregate Bond Index, 40% MSCI World Total Return Index, 20% HFRI Fund of Funds Composite Index.
[6] 50% Bloomberg Barclays Global Aggregate Bond Index, 50% MSCI World Total Return Index.
[7] MSCI World Total Return Index.

Past performance is not indicative of future results.

Disclosure:
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Asset allocation, diversification and rebalancing strategies do not ensure gains nor guarantee against loss.

Index definitions:
- The MSCI World Total Return Index, includes approximately 85% of the free float-adjusted market capitalization across the world's developed markets.
- The HFRI Fund Weighted Composite Index is a global asset-weighted index comprised of over 2,000 single manager funds.

The **Bloomberg Barclays Global Aggregate Bond Index** is a flagship measure of global investment grade debt from twenty-four local currency markets.

Limited Regulatory Oversight
Since Alternative Investments are typically private investments, they do not face the same oversight and scrutiny from financial regulatory entities such as the Securities and Exchange Commission ("SEC") and are not subject to the same regulatory requirements as regulated investment companies, (i.e., open-end or closed-end mutual funds) including requirements for such entities to provide certain periodic pricing and valuation information to investors. Hedge fund offering documents are not reviewed or approved by the SEC or any US state securities administrator or any other regulatory body. Also, managers may not be required by law or regulation to supply investors with their portfolio holdings, pricing, or valuation information.

Portfolio Concentration; Volatility
Many Alternative Investments may have a more concentrated or less diversified portfolio than an average mutual fund. While a more concentrated portfolio can have good results when a manager is correct, it can also cause a portfolio to have higher volatility.

Strategy Risk
Many Alternative Investments employ a single investment strategy. Thus, a Hedge Fund or even a fund of Alternative Investments may be subject to strategy risk, associated with the failure or deterioration of an entire strategy. Strategy specific losses can result from excessive concentration by multiple Hedge Fund managers in the same investment or broad events that adversely affect particular strategies.

Use of Leverage and Other Speculative Investment Practices
Since many Hedge Fund managers use leverage and speculative investment strategies such as options and short sales, investors should be aware of the potential risks. When used prudently and for the purpose of risk reduction, these instruments can add value to a portfolio. However, when leverage is used excessively and the market goes down, a portfolio can suffer tremen- dously. Also, managers can face additional risk when selling short. In theory, the loss associated with shorted stocks is infinite, because stocks can go up indefinitely. So, while selling short can add return and risk reduction to a portfolio, managers need to pay special attention to their short positions. In the same way, when options are used to hedge a portfolio (i.e., short calls and buy puts), the portfolio's volatility can be reduced. However, when options are used to speculate (i.e., buy calls, short puts), a portfolio's returns can suffer and the risk of the portfolio can increase.

Valuations
Further there have been a number of high profile instances where Hedge Fund managers have mispriced portfolios, either as an act of fraud or negligence.

Past Performance
Past performance is not necessarily indicative and is not a guarantee of a Hedge Fund's future results or performance. Some Alternative Investments may have little or no operating history or performance and may use hypothetical or pro forma performance that may not reflect actual trading done by the manager or advisor and should be reviewed carefully. Investors should not place undue reliance on hypothetical or pro forma performance.

Limited Liquidity
Investors in Alternative Investments often have limited rights to redeem or transfer their investments. In addition, since Alternative Investments are not listed on any exchange, it is not expected that there will be a secondary market for them. Repurchases may be available, but only on a limited basis. A Hedge Fund's manager may deny a request to transfer if it determines that the transfer may result in adverse legal or tax consequences for the Hedge Fund.

Investors in certain jurisdictions and in Alternative Investments generally may be subject to pass-through tax treatment on their investment. This may result in an investor incurring tax liabilities during a year in which the investor does not receive a distribution of any cash from the Fund. In addition, an investor may not receive any or only limited tax information from Hedge Fund and funds of Alternative Investments may not receive tax information from underlying managers in a sufficiently timely manner to enable an investor to file its return without requesting an extension of time to file. In certain jurisdictions a lack of tax information may result in an Investor being taxed on a deemed basis at an adverse rate of tax.

Fees and Expenses
Most Alternative Investments charge both an asset-based management fee and a performance-based incentive fee or allocation. In addition, many Alternative Investments are more actively traded than a long-only mutual fund and thus have greater commission expenses for securities trading. As a result, the fees and expenses associated with Hedge Fund investing may exceed those of a long-only mutual fund.

Reliance on Fund Manager; Lack of Transparency
A Hedge Fund's manager or adviser has total trading authority over the Hedge Fund. There is often a lack of transparency as to a Hedge Fund's underlying investments. Because of this lack of transparency, an investor may be unable to monitor the specific investments made by the Hedge Fund or to know whether the investments are consistent with the Hedge Fund's historic investment philosophy or risk levels. Due to the risks mentioned above, it is important to perform proper due diligence in evaluating and choosing Hedge Fund managers to place your money with. There have been occasions when Hedge Fund managers took on too much risk in their portfolio and lost a substantial amount of their investors' money.

Interests of Alternative Investment Funds (the "Funds") are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of the Funds, and which Clients are urged to read carefully before subscribing and retain. This communication is confidential, is intended solely for the information of the person to whom it has been delivered, and should not be reproduced or otherwise distributed, in whole or in part, to third parties. This is not an offer to sell any interests of any Fund, and is not a solicitation of an offer to purchase them. An investment in a Fund is speculative and involves significant risks. The Funds are not mutual funds and are not subject to the same regulatory requirements as mutual funds. The Funds' performance may be volatile, and investors may lose all or a substantial amount of their investment in a Fund. The Funds may engage in leveraging and other speculative investment practices that may increase the risk of investment loss. Interests of the Funds typically will be illiquid and subject to restrictions on transfer. The Funds may not be required to provide periodic pricing or valuation information to investors. Fund investment programs generally involve complex tax strategies and there may be delays in distributing tax information to investors. The Funds are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits. The Funds may fluctuate in value. An investment in the Funds is long-term, there is generally no secondary market for the interests of the Fund, and none is expected to develop. Interests in the 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 a Fund. Investors should consider a Fund as a supplement to an overall investment program.

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