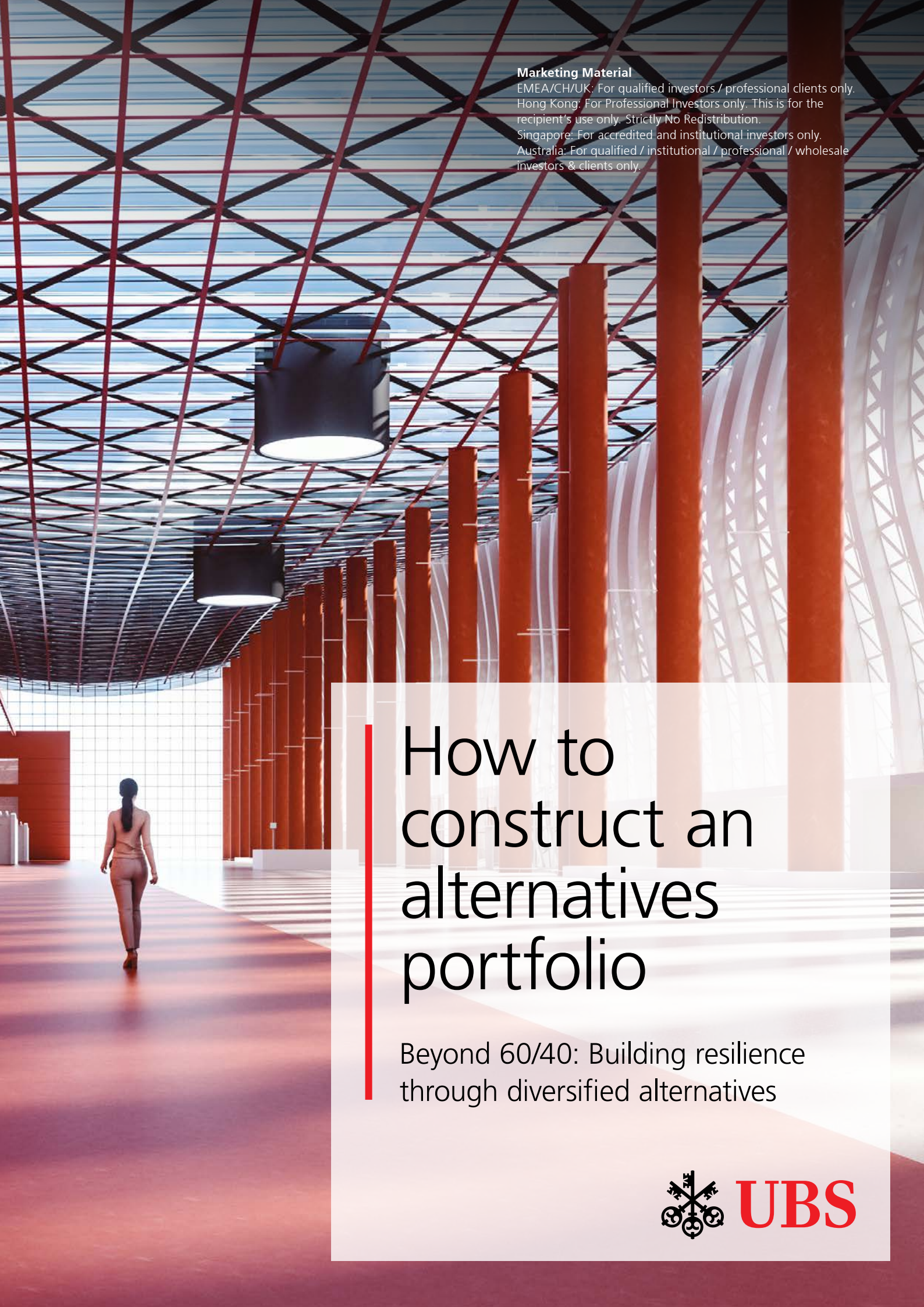


How to construct an alternatives portfolio

Beyond 60/40: Building resilience through diversified alternatives

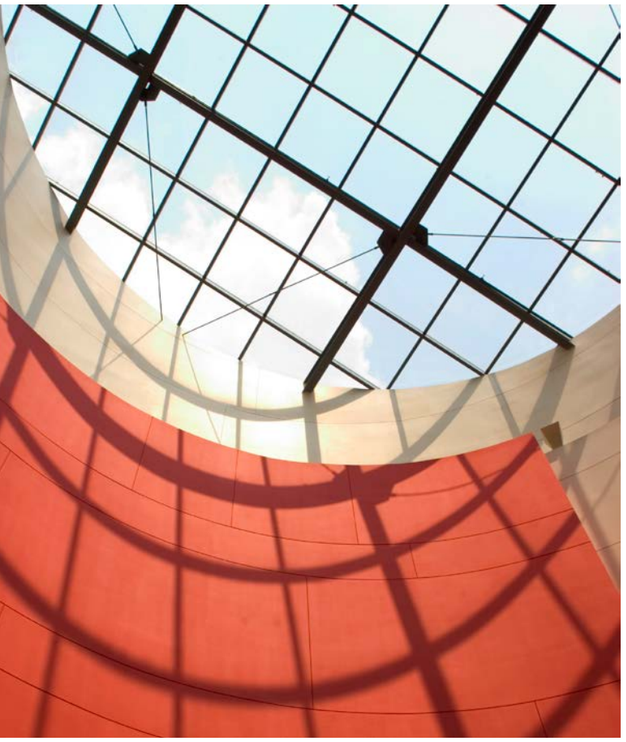
UBS

For decades, the 60/40 portfolio – 60% equities and 40% bonds – was the cornerstone of wealth management. Yet, the traditional model is facing significant headwinds. Changing macroeconomic conditions, inflation uncertainty, and shifting equity-bond correlations have all eroded the reliability of this approach. In this context, alternative investments are gaining attention as a potential complement to traditional strategies.

Private equity, private credit, real assets, and hedge funds are no longer viewed solely as niche allocations. Instead, they are increasingly considered components of a broader, more resilient portfolio framework. Among these, hedge funds may deserve renewed consideration – not only for their diversification characteristics but also for their potential to navigate complex market conditions with greater flexibility.

Rethinking diversification:

the rise of alternatives[1]



Alternatives are not a monolith – they include a diverse spectrum of investment types that may behave differently from traditional asset classes.

Each type can serve a distinct role:

01 **Private equity** targets high-growth companies, often inaccessible through public markets.

02 **Private credit** may offer stable income through direct lending and bespoke financing.

03 **Real assets** like infrastructure and real estate can act as hedge against inflation and contribute to portfolio diversification.

04 **Hedge funds** long overlooked by private investors, might offer both diversification and liquid flexibility – particularly in volatile or uncertain markets.

While private equity and credit typically require long-term capital commitments, hedge funds can offer more liquid exposure and may respond more dynamically to changing market environments. A carefully constructed allocation across these segments could support improved portfolio resilience over time.

1 Risks and considerations are on page 8.

Building an alternative allocation:

a three-part framework

Define your strategy
Constructing an alternatives portfolio begins with clear intent:

Return focus:
Seeking growth, income, or absolute returns?

Risk appetite:
How much volatility and drawdown can you withstand?

Liquidity profile:
Are you prepared for illiquid investments – or do you need tactical flexibility?

Time horizon:
Are you thinking in decades or business cycles?

Allocations vary, but a strategic exposure of **20-40% to alternatives** is a level some investors may consider, depending on their objectives and risk tolerance.

Combine illiquid and liquid alternatives thoughtfully
A diversified portfolio may benefit from a blend of long-term strategies and shorter-term flexibility:

Segment	Role	Liquidity	Return profile
Private equity	Long-term growth	Low	Higher volatility
Private credit	Income generation	Low	Moderate risk-return
Real assets	Inflation sensitivity and income	Low	Cyclical exposure
Hedge funds	Tactical flexibility and stability	Medium	Strategy-dependent

Some investors may choose to implement this through a core-satellite structure, combining broadly diversified strategies with select, higher-conviction opportunities.

Use a **core-satellite structure:**
- Core: Multi-manager platforms or diversified funds of funds for stability.
- Satellite: High-conviction single-strategy funds for opportunistic exposure.

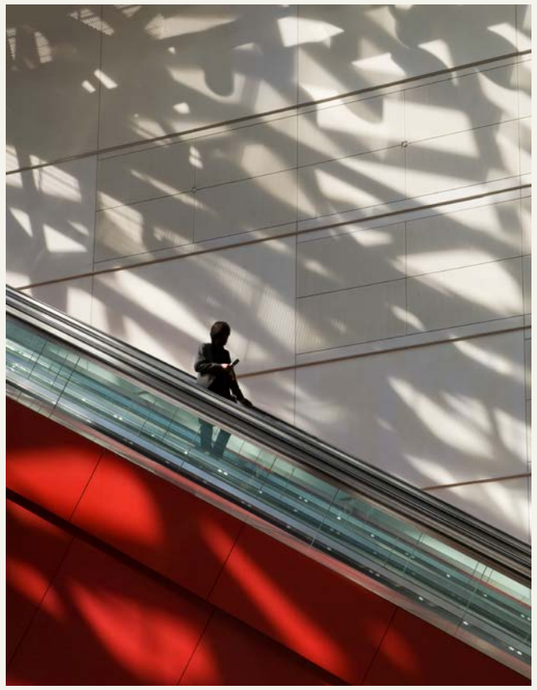
Stay committed for the long term

Private markets require careful pacing. Capital is often deployed gradually, and distributions may occur years later. Without continued reinvestment, exposure can decline. A long-term capital plan may help mitigate vintage concentration and maintain consistent exposure.

Hedge fund allocations, in contrast, may offer more liquidity and flexibility. Some investors adjust allocations tactically – scaling exposures to directional or diversifying strategies based on changing macro conditions.

For private markets, commitment pacing is crucial:
– Capital is deployed gradually (over 3-5 years).
– Distributions return capital later – so without reinvestment, exposure declines.
– A **programmatic commitment cycle** supports consistent compounding and helps mitigate vintage risk.

In contrast, hedge funds can play a more dynamic role:
– Tactically adjust their positions to capitalize on changing market conditions. Rebalance into or out of directional strategies depending on macro trends.
– Maintain consistent exposure to diversifiers for structural portfolio support.



Why hedge funds now?

In today's market environment – characterized by shifting macro regimes and stretched valuations – hedge funds may offer several potential benefits to an alternatives portfolio:

Diversification with downside mitigation
Certain hedge fund strategies are designed to perform independently of market direction. Strategies such as equity market neutral, merger arbitrage, and macro trading have demonstrated the ability to reduce portfolio drawdowns during market sell-offs. Historical analysis shows that incorporating hedge funds into a traditional portfolio not only smooths performance but accelerates recovery from drawdowns.

Example: In one illustrative scenario, a 20% hedge fund allocation in a 60/40 portfolio, sourced equally from equities and bonds, would have reduced volatility from 9.2% to 8.5%, and increased annualized returns from 5.7% to 5.9% over the period from 1997 to 2024 (UBS, HFRI, 1997-2024).[2]

Flexible exposure in shifting markets
Hedge funds are unconstrained vehicles with access to tools beyond the reach of most long-only managers. This includes short positions, derivatives, and structured instruments. That flexibility enables them to capture opportunities and mitigate risk across asset classes, regardless of market direction.

Styles like:
– Relative value (exploiting pricing inefficiencies)
– Macro (positioning across global themes)
– Event-driven (capitalizing on corporate actions)
– Equity hedge (long/short equity strategies)

Substitute or complement? Both.
Depending on the strategy, hedge funds may act as a complement to – or a substitute for – traditional assets.
– Diversifiers (e.g., systematic CTAs, macro multi-strategy) act as low-correlation stabilizers and have shown the potential to be effective complements to bonds or equities.
– Substitutes (e.g. equity hedge, convertible arbitrage) offer targeted exposure and have historically demonstrated more favourable risk-return dynamics compared to traditional asset classes.

Hedge funds have historically shown beta-like participation during up markets, while helping to protect capital in drawdowns – a combination that may support more stable long-term outcomes.

2 Hypothetical performance based on back tested index data from 1997- 2024. Not actual results. Does not account for trading costs or investor behavior. Past performance is not indicative of future results.

How endowments have led the way

Large endowments and institutions have played a pioneering role in allocating to alternatives.

Yale and Harvard paved the path decades ago:
- Holding 30-50% of assets in alternatives.
- Diversifying across vintages, managers, and geographies.
- Using hedge funds not just to generate alpha – but to reduce portfolio fragility.

While private investors may not fully replicate this model, we believe the core principles – diversification, discipline, and manager selection – are broadly applicable. They can adopt similar principles using structured programs, evergreen funds, and guided solutions, depending on their individual circumstances.

[1]Risks and considerations

Alternative investments offer attractive long-term benefits – but they also come with distinct risks:

Illiquidity:
Many alternative strategies, particularly private equity and credit, require long lock-up periods.

Leverage:
Some hedge fund and credit strategies use borrowing to enhance returns, which increases downside risk.

Transparency:
Information on fund holdings and strategy shifts may be limited.

Operational complexity:
Manager selection, risk oversight, and governance structures vary widely.

Performance dispersion:
Within each style, outcomes can differ significantly by manager. Indices are not directly investable and may not reflect actual portfolio performance.

The future of portfolio construction

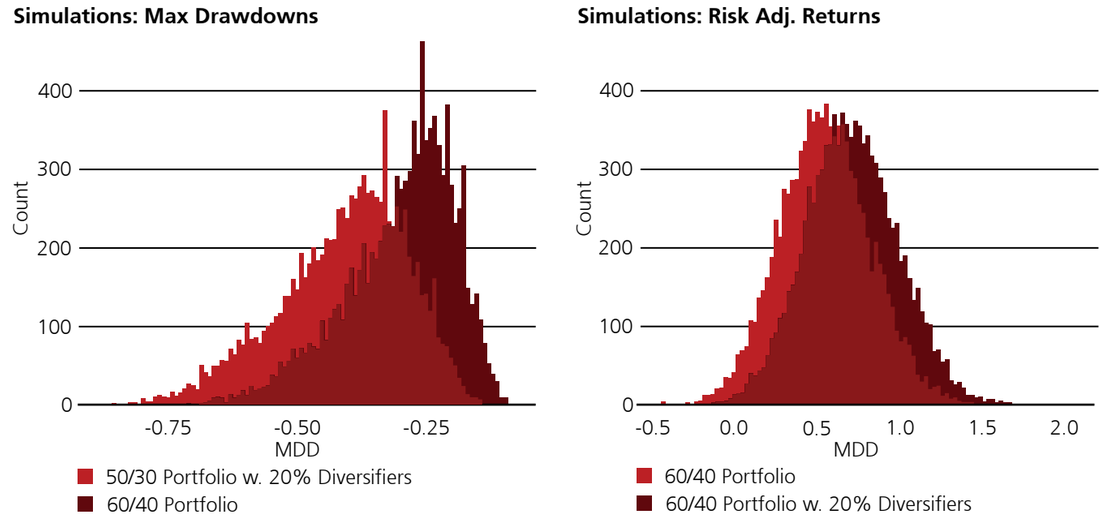
The traditional 60/40 model may no longer provide the same level of diversification or downside mitigation as it once did. For investors looking to navigate today's more complex market environment, a broader approach – including private equity, private credit, real assets, and hedge funds – may offer added resilience and potential long-term benefits.

While alternative investments are not suitable for all investors, those who can accommodate the unique risks and characteristics may find value in constructing a thoughtfully diversified alternatives portfolio.

In figure (1), we compare the results of statistical simulations showing the range of maximum drawdown possibilities (left) and possible risk-adjusted returns (right) of the 60/40 benchmark in grey versus the same 60/40 portfolio mix with hedge fund diversifiers in blue.

In both cases, the blue distribution appears to be to the right of the grey one. The simulation results indicate that adding hedge funds to the 60/40 mix reduces drawdown losses by a third while proportionally increasing risk adjusted returns. Specific to drawdowns, the blue line shows a more positive skew and lower probability of a severe left-tail (large drawdown) outcome.

Figure 1. Simulated probability distributions of traditional 60/40 mix vs 60/40 mix with diversifiers



Source: Based on historical dates: 2000-2022. UBS, HFR, Bloomberg as of September 2022
Note: Block bootstrap simulations with fixed block lengths of 6 using historical data. Indices used MSCI ACWI Index, Bloomberg Global Aggregate TR USD Index and Hedge Fund Research (HFR) to proxy for alternative investments hedge fund style returns
Illustrative purposes only. Past performance of investments whether simulated or actual is not necessarily an indicator of future results..

Hedge funds in a portfolio context

In a multi-asset portfolio, these features are especially attractive, as they can dampen losses in a bear market, improve diversification, and preserve capital.

An investor who held a balanced portfolio of 50% equities and 50% bonds over the past 27 years could have increased annualized returns from 5.7% to 5.9%, while reducing volatility from 9.2% to 8.5% by moving 20% of their traditional asset class allocation to hedge funds.

During the global financial crisis, holding a 20% allocation to hedge funds in a balanced equity/bond portfolio could have lowered maximum loss from -31.2% to -29.3% (see Table 1).

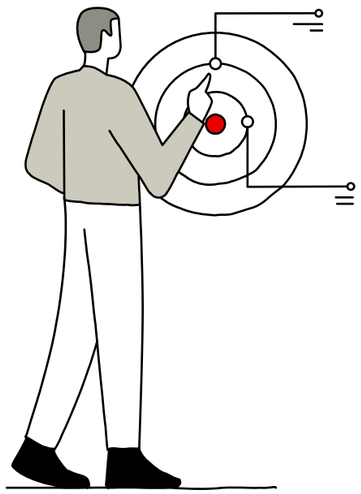
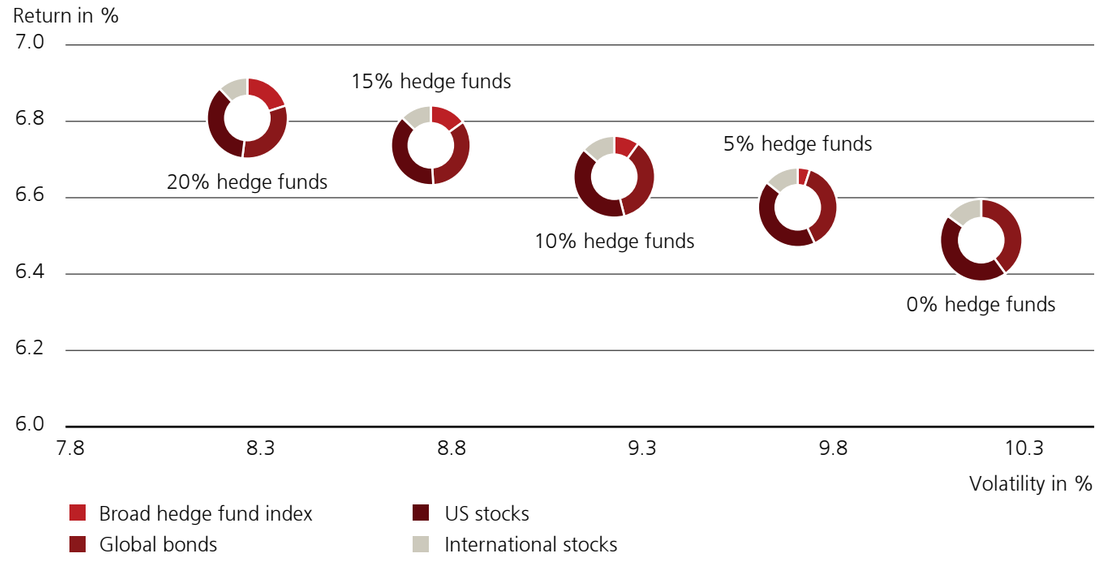


Table 1: Performance analysis (1997-2024)
Hedge fund delivered higher returns than global equites but with much lower volatility

Portfolio allocation	100% Equities	100% Hedge funds	50% Bonds 50% Equities	20% Hedge funds 40% Bonds 40 Equities
Performance (ann.)	7.5%	6.7%	5.7%	5.9%
Volatility (ann.)	15.6%	6.8%	9.2%	8.5%
Sharpe Ratio (2.3%)	0.34	0.65	0.37	0.43
Maximum Drawdown	-54.0%	-21.4%	-31.2%	-29.3%

Source: HFR, Bloomberg, UBS; as of January 2025. Note: Indices used include MSCI World TR, Barclays Global Aggregate Bond TR and HFRI Fund Weighted Index.

Figure 2: Hedge fund can improve the risk-return profile of a multi-asset portfolio (1990-2024)
Historical risk-return for portfolio with various hedge fund allocations



Source: HFR, Bloomberg, UBS; as of January 2025. Note: Indexes used include S&P 500 TR, MSCI World TR, JPM Global Aggregate Bond Index and HFRI Fund Weighted Index.
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The difference in start dates between Figure 2 and table 1 reflects the inclusion of hedge fund strategies with shorter data series. For consistency across our educational hedge fund series, we use the longest available time periods for each strategy, beginning in 1995/1997 or later where appropriate.

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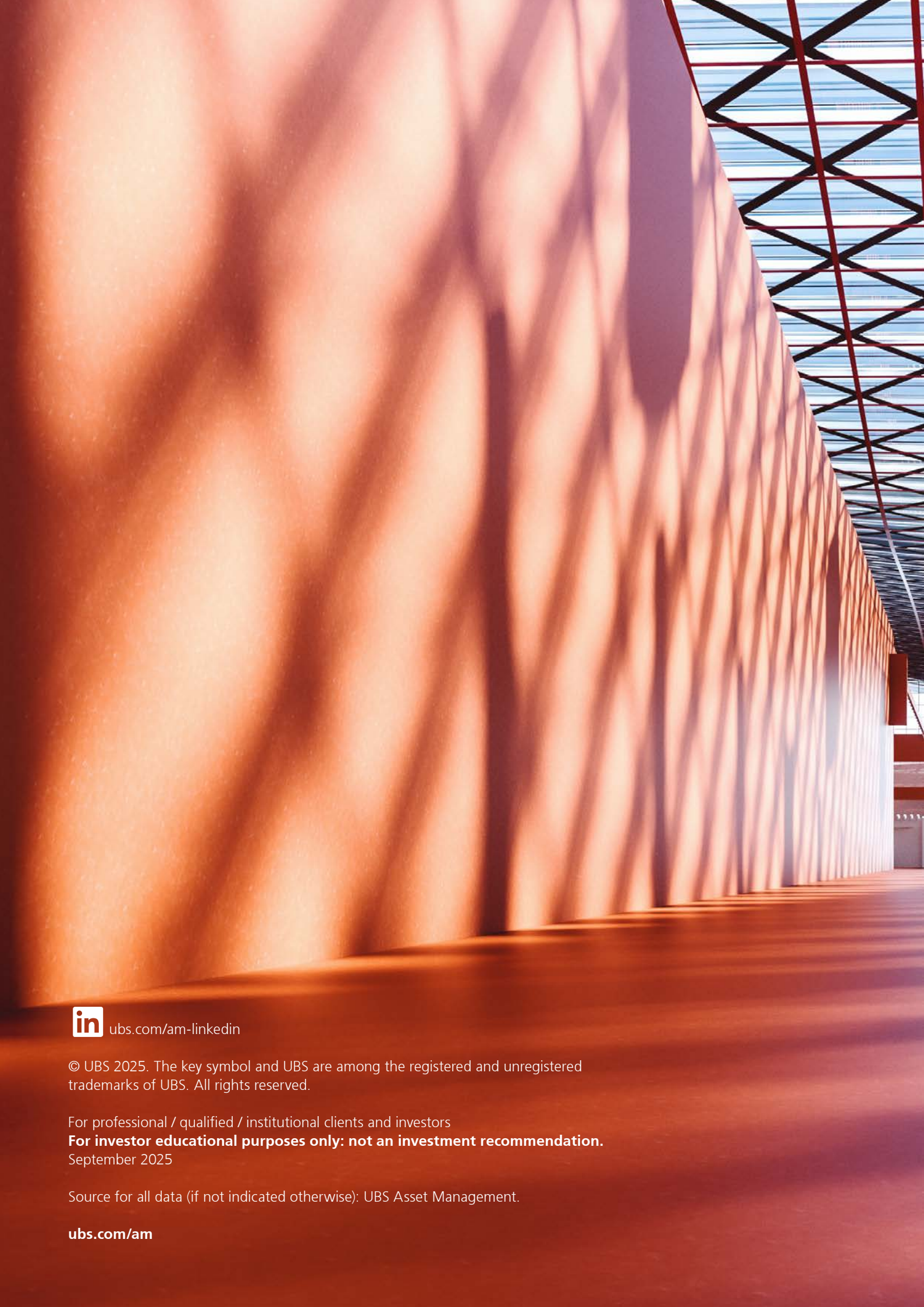

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