The hedge fund industry has grown significantly, and there are now around 8,000 funds in existence with close to USD 4tr in assets under management. (UBS)

What are hedge funds and what can they add to portfolios?

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Hedge funds can do well in periods of market stress, with a long history of outperformance when equity markets are falling. But investors must also accept lower levels of liquidity, along with less transparency. The UBS Chief Investment Office (CIO) explores what these funds are, what varieties they come in, and what they can add to portfolios.

What are hedge funds?

Hedge funds first gained public attention during the 1990s, with top managers occasionally becoming highly influential in markets—including when George Soros' Quantum Fund contributed to the UK's forced exit from a managed currency scheme with its European partners. But hedge funds long pre-dated this rise to prominence. Investor Alfred Winslow Jones is often credited with establishing the first hedge fund as far back as 1949. Jones was the first to combine long and short positions in stocks he believed to be undervalued or overvalued in order to reduce his exposure to general stock market movements and primarily focus on his stock picking skills. And to enhance his returns, he added leverage.

The approach—now referred to as "traditional long/short equity"—was widely emulated after Jones outperformed long-only investors by double digits for several years. At that time, hedge funds were niche products, only available to a select few. Since then, however, the industry has grown significantly, and there are now around 8,000 funds in existence with close to USD 4tr in assets under management.

Given hedge funds come in such a wide variety of shapes and sizes it is reasonable to ask what they have in common.

- First, hedge funds are actively managed investment pools, which means that a portfolio manager will be taking active bets, swiftly adjusting the exposures of the fund based on the current market environment and opportunity set.

- Second, hedge funds also offer greater flexibility than traditional investments in offering such features as short positions, leverage, or the use of derivative instruments.
- Third, while many active managers are tasked with investing in a particular national equity market or sector, certain hedge fund strategies allow managers to seek opportunities across various asset classes and financial instruments.
- Fourth, hedge funds generally aim to generate asymmetric returns. The idea here is to create portfolios that are not optimized for higher returns, but higher risk-adjusted returns where the odds of winning are higher than the odds of losing. Their goal is to produce a superior compounding of capital.
- Fifth, hedge funds usually charge a management and performance fee, which can be seen as the cost of generating this type of risk/return profile.
- Finally, many strategies may limit the ability of investor to exit the fund in a hurry, restricting withdrawals to once a quarter—or even less frequently for strategies that require patient capital to execute their strategies.

What can hedge funds add to portfolios?

The main goal of hedge fund managers is to generate alpha. To do so, hedge funds draw on some of the most talented professionals in the investment world, from high profile traders or portfolio managers to skilled research and data scientists. Specialized knowledge, resources, infrastructure, or skill sets are typically required to implement these strategies. As a result, hedge fund managers use their unique skills to invest in areas and ways that are less popular among other investors. Hedge funds have had periods where overall returns were eclipsed by soaring stock markets. But, over a longer horizon the hedge fund industry overall has shown its value. Looking at the HFRI Fund Weighted Index over the past 24 years, hedge funds delivered net-of-fees returns of 7%, with a volatility of 7%. This is similar to the performance of global equities, but with less than half of the volatility.

Hedge fund managers' approach to risk-taking and trading is also quite different to their long-only counterparts. Hedge funds are more likely to accept complexity risk, illiquidity risk, and event risk than long-only investors. If the market offers compensation for accepting these risks, then hedge fund managers may be more likely to earn excess returns. For example, hedge funds that invest in convertible bonds or capital-structure arbitrage are allocating assets to more complex securities and often reap the rewards for the efforts they take to understand and operate in these domains.

Diversification is also a key advantage for investors. With a range of strategies on offer, investors can achieve returns that are less closely linked to the forces that drive movements in the broader stock or bond markets. Select HF strategies called diversifiers have the potential to dampen portfolio volatility and drawdowns, while still generating positive returns in the long run. In times of equity selloffs, they can also stabilize the performance for traditional portfolio allocations, such as the 60/40 equity/bond mix.

Finally, hedge funds can do well in periods of market stress, with a long history of outperformance when equity markets are falling or choppy. Indeed, certain hedge fund strategies are specifically designed to flourish in bear markets or periods of high volatility.

For more on hedge funds, see the full report CIO tutorial: What are hedge funds and what can they add to portfolios? 13 December 2022.

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