

Strategic: Diversify with alternatives

Diversify with alternatives

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Why? 1) A broadening stock rally and high return dispersion provide a rich environment for hedge fund alpha right now. 2) Hedge funds can offer more diversified sources of return, helping to limit the impact of unexpected sell-offs. 3) Private real estate and infrastructure can diversify long-term income sources, while offering exposure to structural trends like electrification.



Source: Pexels

Video: [Diversify with alternatives](#)

Hedge funds

The environment of high return dispersion—a key driver of hedge fund returns—remains in place and should support performance in 2026. A broadening stock rally away from prior tech leaders can offer a richer opportunity set for managers to generate market-beating returns (alpha). We believe that equity market neutral strategies can enhance portfolios due to their ability to generate returns in both rising and falling markets, while limiting directional exposure. We also see appeal in global macro and multi-strategy funds.

Global macro tends to benefit in periods of high uncertainty and volatility, including heightened geopolitical risk. Indeed, from 1997 to November 2025, discretionary macro traders posted an average annualized performance of 7.0%, based on the BarclayHedge Global Macro Index, with a volatility of 5.5%. This performance is comparable with that of equities but with less than half of the volatility. The maximum drawdown over this period is the lowest of all hedge fund strategies at 8.1%, and markedly lower than the maximum drawdown of developed market equities (MSCI World) at 54% over the past two decades. This supports global macro funds' role as a portfolio diversifier.

We believe multi-strategy funds can benefit from their flexibility to position around economic trends and risks like persistent inflation, trade tensions, or debt sustainability concerns.

Meanwhile, margin pressure and widening dispersion are increasingly driving corporate actions, consolidation, and a richer deal landscape. This combination of circumstances tends to be constructive for merger arbitrage strategies.

Private equity

While private equity's returns of around 8% through to the end of the third quarter last year (Cambridge Associates data) underperformed public benchmarks, we do see signs of better times ahead. For example, dealmaking has strengthened: 2025 US private equity deal value grew 36% year over year based on PitchBook data, driven by robust activity in health care and technology. The return of megadeals and several large exits has helped support overall volumes.

Raising fresh capital remains challenging and timelines are extended—especially for smaller funds—but the outlook on increasing exits and a more favorable macroeconomic environment is supportive of new capital flows in the coming quarters.

Attractive valuations, renewed deal activity, and a constructive macro backdrop in terms of robust US growth and lower US interest rates all support a positive view on private equity overall. We continue to favor value-oriented, middle-market buyout strategies as well as secondaries, which are likely to be less impacted by volatility in the software sector. Select European and Asian assets are also increasingly attractive for diversification.

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While investor concerns have recently risen on the impact of AI disruption on software-as-a-service (SaaS) firms, including unlisted companies in private equity vehicles, widespread AI-led disruption, in our view, is likely a long-tail risk. Mission-critical, enterprise-facing SaaS vendors with proprietary data remain favorably positioned. We favor broad diversification to fully capture opportunities across the AI value chain. We also recommend investors prioritize thorough due diligence and seek partnership with managers who: 1) possess deep domain expertise, 2) demonstrate selective deal sourcing, 3) have experience with complex transactions and 4) align strategies with investors' long-term objectives and risk tolerances.

Select direct lending

Private credit headlines highlight the need for quality and selectivity. While direct lending remains relatively small compared to broader credit markets, and risks to overall financial stability appear moderate, investors should recognize that the market is not uniform.

Fundraising momentum slowed last year, with capital raised about 15% below the prior year's pace. Investors shifted allocations toward Europe, which now accounts for half of new fundraising. The market remains highly selective, with consolidation favoring established managers and larger funds.

Lending activity has also moderated, with volumes and deal count down year over year, despite a pickup in M&A. Direct lenders continue to dominate LBO (leveraged buyouts) financing, supporting over 80% of deals, especially in less-cyclical sectors like healthcare. However, competition with the syndicated loan market has intensified, particularly for large, high-quality transactions.

Risks are rising, especially among lower-middle-market borrowers and loans originated in 2021/22, which have seen higher defaults and non-accruals. The use of "bad payment-in-kind" features (those added after a loan has closed) is concentrated in smaller companies, and 2021/22 vintages account for a high share of foreclosures. Defaults rose to 2.46% in the fourth quarter, but overall credit metrics, so far, remain broadly stable.

The software sector faces increased scrutiny due to AI disruption, leading to sell-offs in software high-yield bonds and leveraged loans. While fundamentals for large, mission-critical SaaS firms remain solid for now—supported by continued EBITDA growth and low default rates—AI-driven risks and refinancing challenges are growing for weaker legacy software vendors.

In Europe, volumes reached a record EUR 41 billion based on Lincoln and Morningstar data, with most deals sponsor-backed and focused on software, healthcare, business services, and increasingly, defense. Defaults have edged higher, and the share of distressed loans is at its highest since

2023.

Looking ahead, returns are likely to moderate further in 2026 as spreads remain tight, further anticipated US rate cuts materialize, and default rates normalize.

For those considering direct lending, robust positioning is key: Regularly review liquidity needs, prioritize quality, and exercise selectivity in manager and deal choice. Diversification across private market strategies may help manage risk, but investors must be prepared to tolerate illiquidity and limited transparency in both good and more challenging market conditions.

Private real estate and infrastructure

Infrastructure assets are well positioned to deliver resilient, inflation-protected returns. Their monopolistic characteristics, high

barriers to entry, and robust cost passthrough mechanisms make them effective hedges against economic volatility and inflation—qualities that are increasingly valuable in today's environment.

Market conditions are favorable for investors amid attractive valuations and solid fundamentals. Recent fundraising

momentum is strong—the year to the third quarter of 2025 saw infrastructure fundraising surpassed the prior year's total, with core-plus and digital infrastructure strategies leading the way. Powerful secular trends in digitization, decarbonization, and deglobalization are set to further accelerate capital flows into the sector.

Infrastructure-linked assets returned 9.4% in the first three quarters of 2025 and have averaged 11% annually over the past 10 years (Cambridge Associates). While we expect appealing returns going forward, we advocate selectivity and discipline. Investors who focus on diversified, core/core-plus assets that generate returns chiefly from income in non-cyclical sectors—prioritizing predictable, inflation-linked cash flows—are best positioned to capture attractive, risk-adjusted returns while supporting the essential modernization of the global economy.

In global direct real estate, net asset values have stabilized since late 2024, and investment activity is accelerating. We now expect sustained growth, especially in sectors with tight supply, strong rental growth, and minimal capital expenditure.

We estimate that transaction volumes ended 2025 up roughly 20%, to around USD 850bn. We anticipate further growth in 2026 as financing and opportunity costs decline. Looking ahead, we expect total returns to be primarily driven by income, with a smaller contribution from capital gains as rental growth continues but at a slower pace.

Diversify with alternatives

We favor core/core-plus strategies. Our preferred sectors include logistics, data centers, and living sectors offering the most robust fundamentals and attractive risk-adjusted returns.

Alternatives carry unique risks that investors must be aware of before investing, including limited transparency, potentially high fees, and illiquidity.

Non-traditional asset classes are alternative investments that include hedge funds, private equity, private credit, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. **An investment in an alternative investment fund is speculative and involves significant risks.**

Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment 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 an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- **Hedge Fund Risk:** There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, "junk bonds," derivatives, distressed securities, non-U.S. securities and illiquid investments.
- **Managed Futures:** There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- **Real Estate:** There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
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- **Private Credit:** There are risks specifically associated with investing in private credit. This could include losses stemming from defaults on loans, which in significant adverse circumstances could result in a substantial loss of investment.
- **Foreign Exchange/Currency Risk:** Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer's "home" currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.

Global asset class preferences definitions

The asset class preferences provide high-level guidance to make investment decisions. The preferences reflect the collective judgement of the members of the House View meeting, primarily based on assessments of expected total returns on liquid and commonly known indices, House View scenarios, and analyst convictions over the next 12 months. Note that the tactical asset allocation (TAA) positioning of our different investment strategies may differ from these views due to factors including portfolio construction, concentration, and borrowing constraints.

Attractive: We consider this asset class to be attractive. Consider opportunities in this asset class.

Neutral: We do not expect outsized returns or losses. Hold longer-term exposure.

Unattractive: We consider this asset class to be unattractive. Consider alternative opportunities

Note: For equities, we have a five-tier rating system with two additional preferences

Most Attractive: We consider this asset class to be among the most attractive. Investors should seek opportunities to add exposure.

Least Attractive: We consider this asset class to be among the least attractive. Seek more favorable alternatives opportunities.

When equities are included with the other asset classes in the three-tier rating system, we collapse "Most Attractive" with "Attractive" and "Least Attractive" with "Unattractive."

Appendix

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