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Hedge funds can help with a tricky start to 2025

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After a relatively strong year for risk assets, we continue to view equities as attractive. However, we are also aware of a potential increase in risk aversion early in 2025 as the incoming Trump administration in the US unveils its economic policies. Hedge funds are uniquely suited to weathering periods of volatility amid high equity valuations. In particular, we think investors should focus on strategies like low net equity, global macro, and multi-strategy funds as these can enhance portfolio resilience and improve risk-adjusted returns.

Risk assets enjoyed a strong 2024 as US economic growth turned out to be more resilient than feared while the Federal Reserve pivoted to cutting interest rates. Over 2024, the MSCI ACWI rose almost 18%, the S&P 500 climbed 23%, and the MSCI Asia ex-Japan was up over 14%. With US GDP growth likely to remain robust in 2025, and the Fed likely to cut rates, investors may be tempted to position for a risk-on environment as we begin 2025.

While we still view equities as Attractive, we would still stress that December 2024 provided us with ample reminder that risks persist. Between a surprisingly hawkish Fed statement, and the near shutdown of the US government, the S&P 500 fell as much as 3.7%, and the equity market volatility index (VIX) spiked from under 14 to almost 28 before settling down around 16. The near shutdown of the US government in particular highlights how the incoming Trump administration's unconventional approach to governance has the potential to be highly disruptive, both for policy formulation and the economy as a whole. This poses a significant risk to financial markets and risk assets, and portfolio returns in turn.

In such an environment, it is imperative that investors maintain well-diversified and balanced portfolios. In addition, investors should also ensure that their portfolios include the optimal allocation to hedge funds, which are particularly well-suited to weathering the potential near-term volatility for the following reasons. However, investors should note though that hedge funds can carry unique risks, including partial illiquidity, leverage, complexity, and high return dispersion among managers.

Hedge funds have a good track record in volatile periods. Historically, hedge funds have improved portfolio returns during periods of high equity valuations by diversifying equity risk while stabilizing portfolios in market selloffs. The incoming Trump administration could usher in fiscal policies that could end up compounding the ongoing Fed easing, and inadvertently tightening the correlation between equities and fixed income. However, should inflation concerns resurface and lead to fears of a much tighter monetary policy, hedge funds can provide uncorrelated returns across major asset classes, thereby enhancing portfolio resilience.

Low net-long/short equity strategies remain a key preference. These strategies are well-positioned to capitalize on market dispersion while mitigating directionality and selloffs, effectively complementing traditional equity betas. The potential for elevated market volatility from geopolitical developments and the new US administration's economic plans could generate alpha opportunities for those adept at building longs and shorts into portfolios.

Macro funds and multi-strategy platforms are essential diversifiers of portfolios. Macro funds can help portfolios navigate macroeconomic shifts. These funds have historically been able to capitalize on divergent global cycles and central bank policies, while also providing strong diversification during periods of elevated market volatility. Multi-strategy platforms bring a flexible approach and ability to shift between different investment strategies based on evolving market dynamics. These platforms thus offer a comprehensive solution for managing risk, and generate returns across various scenarios.

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