20 March 2026, 08:59 UTC
Chief Investment Office GWM
Investment Research

Hedge market risks

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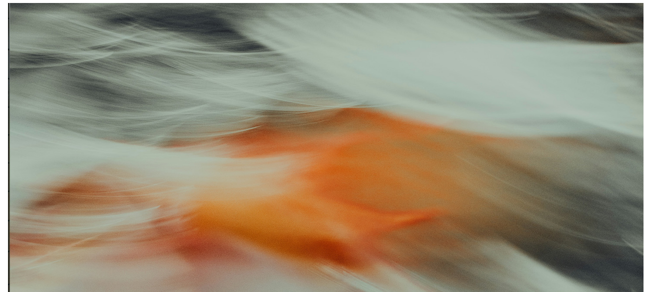
- **Why?** 1) Diversifying across regions, sectors, and asset classes is the most effective long-term hedge against market shocks, such as oil-supply shocks, AI disappointments, or emerging credit stresses. 2) A modest gold allocation can enhance diversification and help buffer portfolios against geopolitical turbulence or systemic risks through the cycle. 3) Adding government bonds can provide stability, as they tend to rally during periods of risk-off sentiment.
- **Why now?** 1) Building a liquidity strategy allows investors to meet obligations without being forced to sell assets in adverse market conditions. 2) We recommend holding enough liquidity to cover up to five years of expected withdrawals, since bear markets can take time to recover. 3) Replacing some direct equity positions with capital preservation strategies can help limit losses while still allowing some participation in a market rebound.



Volatility and geopolitical risks offer investors the opportunity to diversify, hedge, and lock in gains through quality bonds, gold, and structured strategies.
Source: Geronimo Giqueaux_Unsplash

Video: Hedge market risks: Review your goals

Get asset allocation right, including quality bonds and alternatives

A diversified asset allocation is one of the best ways to manage market risks, in our view. Government bond markets have been volatile since the conflict began, reflecting concerns about inflation, rate hikes, and fiscal risks. Yet, quality bonds retain their role as portfolio diversifiers, in our view, especially if recession fears begin to rise. We favor medium-duration bonds. An allocation to hedge funds may also help mitigate drawdowns and smooth returns, particularly as cross-asset volatility increases.

Substitute direct equity exposure for capital preservation strategies

Trading geopolitics has historically been a recipe for disappointment. Rather than taking bold directional views, we recommend that investors concerned about downside risks consider capital preservation strategies that offer participation in market upside while potentially limiting some downside risk. In particular, investors should consider using these in areas that have held up well, but which are cyclical, expensive, or susceptible to a prolonged energy shock.

Consider currency hedges

The near-term outlook for the US dollar is likely one of strength amid higher energy prices, but its structural headwinds remain, including the US twin deficits and heavy global allocations to USD assets. Aligning portfolio currencies with liabilities and spending plans may help investors reduce the risk of potentially large currency swings undermining financial goals. According to the latest Global Investment Returns Yearbook, currency risk on average added around 6 percentage points to total portfolio risk. To manage this, investors may want to consider balanced portfolios hedged into their desired currencies, shifting investment grade fixed income holdings into under-allocated currencies, currency hedging overseas equity

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exposures, or using derivatives such as currency forwards, options, and structured solutions. These instruments, however, introduce additional risks, such as leverage and margin calls.

Appendix

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.
- **Private Equity:** There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- **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

Risk information
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