Hedge market risks

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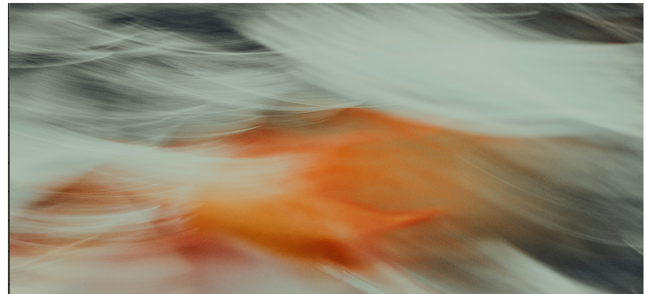
- **Why?** 1) Diversifying across regions, sectors, and asset classes is the most effective long-term hedge against market shocks, such as oil-supply shocks, AI disappointments, or emerging credit stresses. 2) Adding government bonds can provide portfolio stability, as they tend to rally during periods of risk-off sentiment. 3) Capital preservation strategies can offer participation in market upside while potentially limiting some downside risk.
- **Why now?** 1) Global equities have set record highs at a time when the Strait of Hormuz is still closed, AI competition is intensifying, and fiscal deficits remain elevated. 2) Such conditions of relative calm can be used by investors to add hedges and manage portfolio risks from a position of strength. 3) This includes locking in yields on short- and medium-duration government bonds, or by replacing linear equity exposure with strategies offering a degree of downside protection. The goal is to reduce the risk of large drawdowns while maintaining participation in potential rebounds.



Investors can use a period of low volatility to consider adding hedges to help limit drawdowns. 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 yields in USD, EUR, and GBP have risen significantly to account for higher oil prices. This reflects the potential for tighter central bank policy, including from the European Central Bank, and delays to rate cuts by the Fed. But we believe markets have moved too far in pricing more hawkish monetary policy, and we expect such worries to subside in the event of a diplomatic solution to the Middle East conflict, which remains our base case. Although yields may be volatile and longer-duration bonds bear elevated fiscal and inflation risks, we believe the risk-reward for short- to medium-term quality bonds remains appealing. And we believe quality bonds will retain their role as portfolio diversifiers, especially if recession fears begin to rise. We favor short- to medium-maturity bonds in general. For investors still concerned about the longer-term inflationary outlook and seeking a less correlated asset, an allocation to US inflation-linked bonds (TIPS) may be preferred to nominal bonds for those investors. 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

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cyclical, expensive, or susceptible to a prolonged energy shock.

Capital preservation notes can be customized for tenor, loss avoidance, and participation, allowing investors to tailor the degree of capital preservation and participation in market gains. Variants such as "bearish notes" and "twin-win" strategies can offer flexibility for different market views. The predefined loss limits can help investors stay invested during downturns, reducing the temptation to sell and lock in losses.

The sharp move higher in many governments' shorter-dated bonds could make zero-coupon bonds cheaper, increasing the capital available for options and thus participation in market gains. However, investors must also monitor implied volatility, as higher option prices can reduce participation rates.

Build a liquidity strategy

Liquidity planning is a key consideration for private investors, especially those who depend on their assets to fund their lifestyle. An effective liquidity strategy should be designed to allow investors to meet their spending needs without being forced to sell investments during unfavorable market conditions. This liquidity reserve is intended as a complement to a core allocation in a globally diversified portfolio.

Tier I (everyday cash, up to 12 months) To provide access to funds for daily living expenses, and any unforeseen short-term needs. Most investors will have reasonable visibility of their spending needs over the next year and should size this allocation accordingly. Investment instruments over this horizon should prioritize capital safety and liquidity, offering peace of mind and financial stability. Tier II (core liquidity, 1-3 years) To cover planned expenses over the next one to three years—including larger purchases, tax payments, or anticipated lifestyle costs. Investments over this horizon should aim to deliver positive real returns by balancing modest yield enhancement with low risk, serving as a buffer to avoid liquidating long-term assets during periods of market volatility. Tier III (investment cash, 3-5 years) To set aside wealth for potential medium-term needs—including possible health care costs or major life events, or to replenish everyday cash or core liquidity. By accepting moderate risk and reduced liquidity, "investment cash" can target positive real returns and help safeguard against having to sell down core portfolio holdings during drawdowns. This supports long-term financial sustainability and helps weather market downturns.

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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