CIO thinks hedge funds are powerful tools for managing risk and diversifying sources of return. (UBS)

Do hedge funds make portfolios more or less risky?

04 January 2024, 3:40 pm CET, written by UBS Editorial Team

Hedge funds are seen as too risky by some. Investors must be able to bear certain risks not always experienced in stocks and bonds. But adding hedge funds to a portfolio can reduce risks to overall wealth.

Hedge funds can help smooth portfolio returns, add diversification, and grant access to parts of the market that are often off limits to many investors. Certain hedge fund strategies are also well-placed to outperform in market downturns. We see the best current opportunities in macro, multi-strategy, and credit funds.

Hedge funds come with a range of potential pitfalls, which need to understood and managed.

- Hedge fund strategies that invest in illiquid assets, such as distressed debt, can limit investors' access to their money in a fund for 1–3 years.
- Hedge funds often don't share details of their strategy, making funds less transparent to investors.
- Complexity is an additional risk, with some strategies using more exotic instruments that individual investors may not understand.

But savvy hedge fund investing can smooth returns and add new sources of return.

- Some strategies, like macro funds, can make money even in falling markets, dampening swings in portfolios.
- Hedge funds can add sources of return beyond public bonds and stocks, while manager skill can help beat major indexes (or"generate alpha").
- Holding a collection of hedge fund approaches—including multi-strategy funds—can help investors avoid over-concentration and achieve diversification.

So, we think the asset class can play a positive role in portfolios, both now and in the years to come.

- With 2024 likely a year of elevated economic and political uncertainty, macro and multi-strategy funds are well-placed to exploit shifting market conditions.
- Elevated debt levels and interest rates above pre-pandemic levels create opportunities for credit funds that take advantage of mispricing between stronger and weaker borrowers.

Did you Know ?

- The ease of selling a hedge fund (its liquidity) depends on how the manager invests. Funds working with more liquid securities can make it easier for investors to withdraw their capital. This is often the case with Commodity Trading Advisors, who tend to invest in deep futures markets. By contrast, distressed debt funds or event driven funds—which operate in less liquid instruments—require investors to tie up capital for longer.
- Select hedge fund strategies can outperform in hostile market conditions. Between 2000 and 2002, the bursting of the "dot com bubble" led to falls of 47% for the MSCI All Country World Index. Yet, equity market neutral funds lost just 0.4% and merger arbitrage 0.8%.
- The 20% addition of equity hedge fund substitutes to a 60/40 portfolio lowered portfolio swings with little change in returns between 2000 and 2022. This smoothing can result in swifter compounding of returns and higher wealth over long time horizons.

Investment view

Within hedge funds, we particularly like specialist credit hedge fund strategies. Discretionary macro funds and multi-strategy funds have proven resilient during crisis periods. Investors should understand the inherent risks of hedge funds, including illiquidity, lack of transparency, and use of leverage.

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Original report - **Do hedge funds make portfolios more or less risky?, 3 January 2024.**