CIO expects positive returns for the major asset classes in 2024, investors can consider a range of strategies to smooth portfolio returns and mitigate drawdowns. (UBS)

Protecting against risks is getting more affordable

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Investors have recently become less interested in shielding portfolios against threats. Demand for hedges that pay out in the event of equity declines as large as 30% has fallen to its lowest level since March, when concerns were mounting over the health of the US financial system, based on data compiled by Bloomberg.

This comes amid buoyant sentiment over stocks, with the S&P 500 now trading less than 5% below its all-time high struck at the start of 2022. Bloomberg also cited data from EPFR Global showing the largest two-week inflows into equity exchange-traded funds since around the time of this market peak. Inflows for November are on track to be the second best of the year, according to Bloomberg.

Meanwhile, investors appear to be less concerned by other risks, including the threat of an escalation of the Israel-Hamas war. The price of Brent crude oil has fallen below USD 80 a barrel and is now around 17% below the high point for the year from late September, suggesting investors are less worried about the potential for the war to disrupt energy supplies.

But while we expect a positive outlook for major asset classes over the coming year, risks remain and hedging opportunities look attractive:

Protecting portfolios against equity market sell-offs has become more affordable. The price of hedging against a market decline of around 10%has retreated to its lowest level since data started being compiled in 2013 from Bloomberg. Meanwhile, the VIX index of implied US stock volatility, a popular gauge of fear in markets, is trading at 13.3 at present, well below its average of close to 20 since the 1990s. Low implied volatility, combined with higher bond yields, improves the terms of structured investments with capital preservation features. These make for appealing conditions in terms of downside protection versus upside participation.

Investors worried about the potential market impact of further escalation in the Israel-Hamas or Russia-Ukraine wars can consider hedging portfolios through oil market investments or energy stocks. Our base case is that the threat from both military conflicts will be contained. However, these wars remain fluid and risk scenarios could still materialize. Investors with a high risk tolerance can consider adding exposure via longer-dated Brent contracts, or selling the risk of Brent prices falling. The price of Brent is now below the level prior to the Hamas attack on Israel in early October.

Continued economic uncertainty makes macro funds an attractive hedge and diversifier heading into 2024. Our view is that this week's release of the personal consumption expenditures index, the Federal Reserve's favorite measure of inflation, will confirm the fading of price pressures and add to optimism that a peak in rates has already been reached. However, data setbacks remain possible over the coming months. Against this backdrop, macro hedge funds can take advantage of volatility generated by shifts in the economic landscape, central bank policies, and market conditions.

Meanwhile, multi-strategy funds, which combine various hedge fund approaches, are also a potentially attractive way to diversify portfolios. These funds are typically highly diversified, reallocate dynamically, and exercise advanced risk management strategies. Investors should be aware of the risks inherent in alternative investments like hedge funds. These include liquidity risk, the use of gearing, and limited disclosure requirements.

So, while we expect positive returns for the major asset classes in 2024, investors can consider a range of strategies to smooth portfolio returns and mitigate drawdowns.

Main contributors - Solita Marcelli, Mark Haefele, Christopher Swann, Vincent Heaney, Moritz Vontobel, Dominic Schnider, Jennifer Stahmer

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