THE SIGNIFICANCE OF HEDGE FUNDS IN YOUR PORTFOLIO

"Navigating Uncertainty" is a dynamic finance series designed to demystify the complexities of hedge funds. We provide clarity on intricate concepts, ensuring accessibility to readers of all backgrounds.

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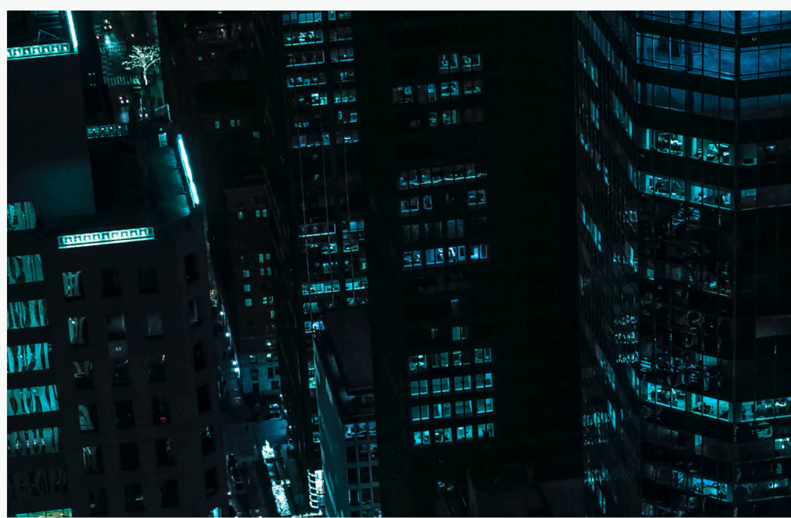

WHAT ARE THE BENEFITS OF HEDGE FUNDS AS PART OF AN INVESTMENT PORTFOLIO?

Breaking this down to a few key points, we'll start with diversification. The accepted wisdom is to diversify within both underlying instruments and asset classes. However, the end investor typically has access to equities and bonds, and the only real diversifier they could add to a portfolio is property.

Hedge funds add an additional class that is entirely uncorrelated to those other asset classes. On that basis, through its inclusion, even before discussing additional potential returns, hedge funds would reduce the volatility of the overall portfolio by being added to your portfolio of traditional asset classes.

Moving on to downside protection, three tools available to hedge fund managers that are not typically found in other funds are shorting, derivatives, and flexibility. Hedge funds are typically not correlated to the broader markets or other asset classes because of these tools. Essentially, these tools allow the hedge fund manager to create returns in sideways, upward, and downward trending markets.

Hedge funds are often accused of not capturing the full market upside. However, the flip side to this argument is that by avoiding the downturns, hedge funds create a situation where capturing all of the upturns is not necessary.

It's the old fairy tale of the tortoise and the hare. In simple arithmetic, if you avoid a 50% drawdown, you don't need to add 100% performance to get back to zero. If you could have limited that drawdown to, say, 10%, you only need to achieve an 11% return to get back to square one.

WHAT DO SUPERIOR RISK-ADJUSTED RETURNS ENABLE AN INVESTOR TO DO ON A PORTFOLIO LEVEL?

Risk-adjusted returns have become an overused term, often pushed by hedge fund managers without proper context. What have superior risk-adjusted returns really enabled any investor to do on a portfolio level?

Ultimately, if we can utilise the asymmetric payoff or the downside protection from one portion of the portfolio, it actually ends up freeing up risk budgets across the rest of the portfolio.

So, instead of focusing purely on the downside protection that a hedge fund can bring, this actually enables the investor to assume more risk in the balance of the portfolio and ultimately generate a superior return over time without assuming more risk overall.

WHAT ARE ASYMMETRICAL RETURNS?

Asymmetrical returns are returns that are not symmetrical. Typically an asset class has a market exposure of one to the underlying instruments in that asset class. Whereas hedge funds try to capture the upside without capturing the totality of the downside.

The typical aim for a hedge fund manager is to capture two- thirds of the upside and one - third of the downside. That is what we mean when we talk about asymmetry of returns.

DO SPECIALISED STRATEGIES AND HEDGE FUNDS FALL INTO THE SAME INVESTMENT CATEGORY?

Hedge funds are not generically comparable, even within the same categories. It is important to understand each individual hedge fund, the tools it utilises, and the role it is designed to play in the investor's ultimate portfolio.

WHAT IS THE DIFFERENCE BETWEEN A HEDGE FUND AND A TRADITIONAL UNIT TRUST?

In terms of demonstrating what hedge funds can do for your portfolio, our findings since hedge funds became available to the investor in 2015 show significant benefits.

If we take a typical 70:30 moderate aggressive portfolio, with 70% allocated to equity and 30% allocated to bonds, and compare that return series to the same portfolio with proportionate allocation of 20% of capital to a well-constructed hedge fund portfolio, the hedge fund or the portfolio that included hedge funds outperformed the standard 70:30 portfolio.

Additionally, it returned a less volatile return series, resulting in fewer sleepless nights compared to the traditional portfolio.