The return of hedge funds

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Interest in hedge funds has surged following last year's equity and bond market downturn which has prompted asset owners to look for new sources of diversification.

It comes as many of the diverse strategies in the liquid alternatives sector once again begin to outperform following a relatively poor decade against traditional asset classes.

"There's an enormous amount of interest in the hedge fund space and I think there is some scepticism about the returns from conventional assets," David Elms, Head of Diversified Alternatives, Janus Henderson, said. "To some extent, that's the normal impact of recent performance in 2022."

Katie Petering, Head of Strategy – Multi Asset Strategy and Solutions, BlackRock, said another driver was the diversification benefits of bonds and equities breaking down amid a rising rate environment.

"There's been a seismic shift in correlations, which have broken down, and it has changed the landscape," she said. "We're seeing a lot of people come to us and ask, 'what's the impact of inflation or structurally higher rates on hedge funds as an asset class?'"

This new environment has created more opportunities for hedge fund managers whose target investment return remained benchmarked to a higher cash rate.

"A higher rate environment and a more volatile environment actually generates an environment where you can have rich alpha generation in various sub strategies," she said.

The benefits of diversification

Michiel Swaak, Head of Alternatives, Frontier Advisors, said the performance of hedge fund strategies varied with changing market environments year-on-year, which is one reason to diversify across multiple strategies.

While the S&P 500 had performed strongly over the year to date, there had been three extended periods when it delivered no real return (1929-1958, 1968-1992, 2000-2015).

"We have some real diversification benefits that you can get from adding some alternative hedge fund strategies to your traditional stock and bond portfolio," Swaak said.

Petering said the BlackRock macro research team's capital market assumptions for hedge fund returns was currently higher than for US equities. Diversified strategies, such as multi-manager, multi-strategy, and global macro, were attracting the bulk of inflows compared to single strategies such as long-short equities.

She said asset owners considering investing in hedge funds needed to consider how much beta (equity or bond market) they wanted in their portfolios and to define their return and volatility expectations.

Elms said Janus Henderson always preferred to target positive-sum situations rather than zero-sum, which relied entirely on skill. For example, banks have become less active in risk capital markets but still offer their retail clients structured products that rely on derivatives. Funds involved in providing this service to banks are more likely to generate healthy returns.

"The good thing about this trade is that you have a good idea where the value is coming from. Unfortunately, it's the retail buyers of structured products and that makes it much easier to believe that you're in a positive sum game, and that you have a positive expected return from the strategy."