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NEW MARKET REGIME FAVOURS ALTERNATIVES

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Asset Management | Marketing Communication

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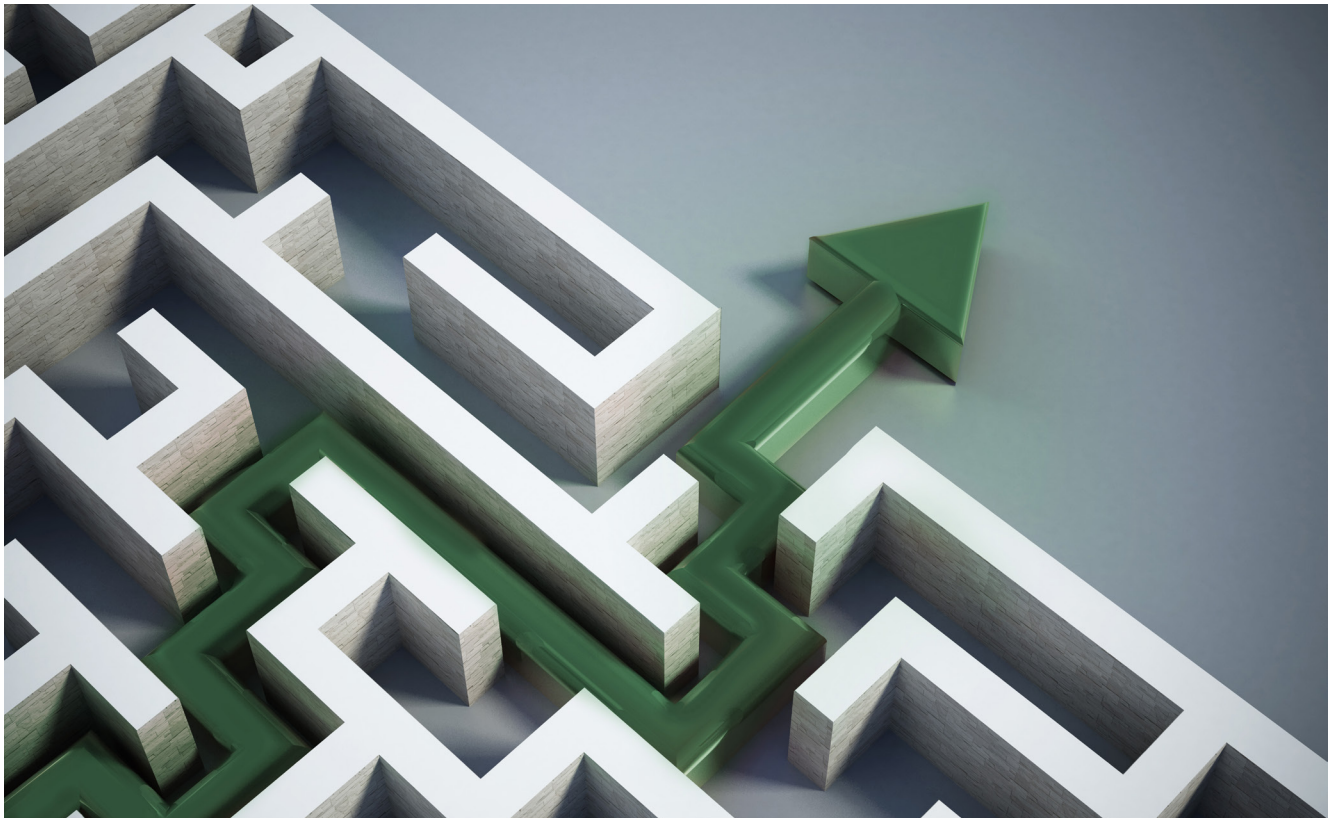
Key points

- *2021 appears to have been the turning point for a 30-year period of disinflationary global trends which led to elevated asset prices and suppressed volatility. Going forward, financial assets will need to reprice, but at levels that are unpredictable. What investors can be certain of is that the path to terminal value will be more volatile than during the past 10 years.*
- *In this new market regime, the previously successful portfolio asset mix (60/40 equities/ bonds) is unlikely to perform as well. As a result, investors should look to find alternatives to add to their current portfolio allocation.*
- *One area to re-examine is liquid alternatives, such as hedge funds, but how they are included will be crucial in order to generate attractive portfolio performances.*



Evolution of the industry

"Alternative investments", i.e. hedge funds, is a very broad term and to grasp what this industry is about, it is worth taking a step back to look at its origins, its evolution, the various strategies that have emerged and how they have fared in different market environments.

The origins of the industry are generally believed to date back to the late 1940s, with the first partnership that invested in a portfolio of both long stocks and a basket of short stocks to cover certain market and factor risks of the long portfolio. In short, hedge funds have been in existence for many decades.

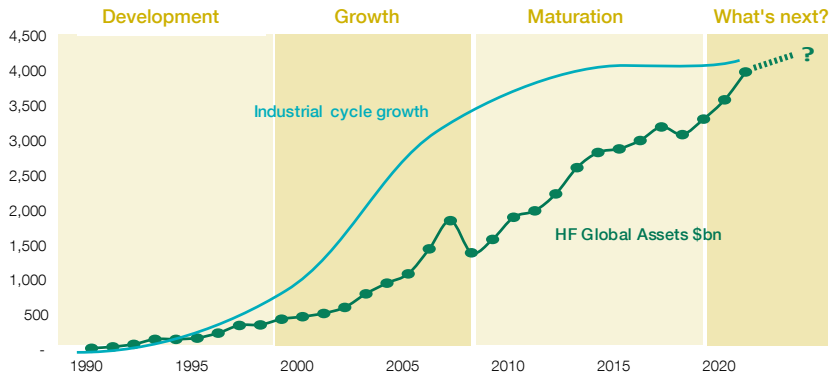
The 1970s and 1980s saw the emergence of some legendary firms in strategies such as global macro and long/short equity, some of which still exist today. It also saw the birth of funds of hedge funds – the possibility to invest in a group of hedge funds though one single vehicle. The 1990s saw a real boom in the industry with the emergence of multiple new strategies, such as arbitrage and relative value, and an explosion in the number of funds. It also saw the creation of hedge fund benchmarks, such as Hedge Fund Research (HFR) and Credit Suisse/ Tremont indices.

Growth continued in the early 2000s. As global stock markets fell by around 45% between 2000 and 2002, hedge fund strategies managed, on average, to post positive returns. This feature caught the eye of institutional investors, which started to make significant investments in hedge funds between 2003 and 2008. This development allowed the industry, which until then had been mostly invested in by private high net worth clients, to become more mainstream and to be included in the asset allocations of a broader group of investors.

After this classic sequence of development and growth came a phase of maturation, starting in 2009.

Many aspects of the industry that may have been true in its early days and remain as a perception for some market participants, have changed today. The emergence of regulated structures, such as alternative UCITS, have democratised access to hedge funds, with lower minimum investments, better liquidity, greater transparency, and cheaper fees. Even unregulated funds have had to adapt, providing generally much better transparency than in the past.

Hedge Fund Industry Cycle



Sources: HFM Global Review – Autumn 2019, Eurekahedge, Hedge Fund Research, Statista.com

Strategy definitions

LONG/SHORT EQUITY: Identify and invest in companies perceived as being the best, based on proprietary criteria, while "shorting" the ones that are considered the worst or hedging with indices.

EVENT DRIVEN: Identify the impact of a non-recurring corporate event on a company valuation. Events can range from mergers to bankruptcies. Investments can be made before, during or after the event.

GLOBAL MACRO: Analyse macro-economic conditions in order to identify various trends or mispricing on a global scale and in a wide range of instruments and/ or assets. Funds can use a discretionary or systematic approach.

RELATIVE VALUE: Assess pricing inefficiencies between financial instruments that are related, with the expectation that such instruments will converge toward a defined fair value.

Performance in different environments

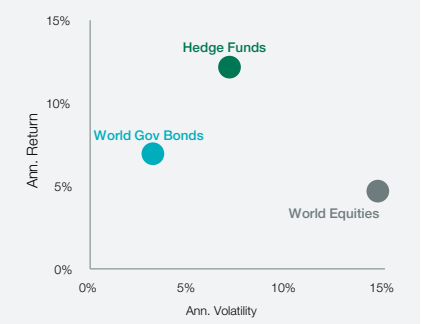
Alternative strategies have, on aggregate, limited sensitivity to traditional markets, such as equities and bonds. The best environments for these strategies are markets which are driven by fundamentals, where there is real price discrimination between securities, companies and sectors, as well as reasonable volatility. Some strategies also tend to benefit from large dislocations.

In contrast, markets with compressed volatility, large central bank and government interventions, and persistently low interest rates, as has been seen in several years since 2008, do not provide an attractive opportunity set for alternative strategies.

As mentioned above, the burst of the dot-com bubble, followed by the recession of 2001–2002, allowed these strategies to benefit from the gradual repricing of markets and generate positive returns, while equity markets lost 45% of their value. Even in 2007 & 2008, alternatives were performing quite well until the collapse of Lehman Brothers, which brought chaos to markets, which ground to a halt for several months.

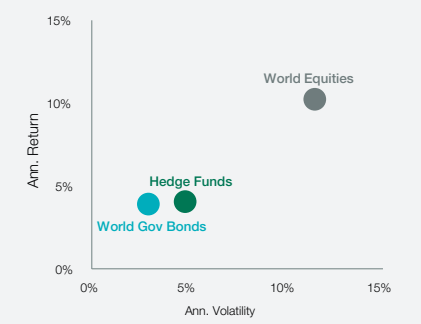
THE ANALYSIS OF PAST RETURNS CAN BE SPLIT INTO THREE PERIODS:

1) 1990–2009
The golden years



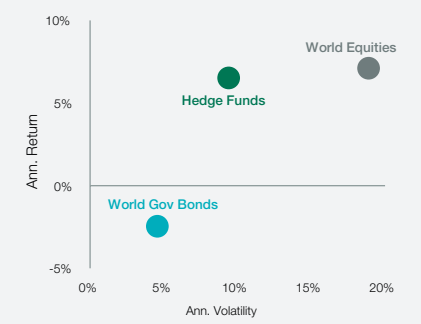
During this period, alternatives materially outperformed equity and fixed-income markets, with reasonable volatility and drawdowns. The risk/reward and diversification benefits were very attractive.

2) 2010–2019
The underperformance years



This timespan coincided with a period of continuous central bank intervention, which suppressed market volatility and dispersion. As a result, alternative strategies underperformed equities and performed in line with government bonds. They provided some diversification benefits, but the risk/reward was relatively unattractive.

3) 2020 and beyond
Time to reconsider

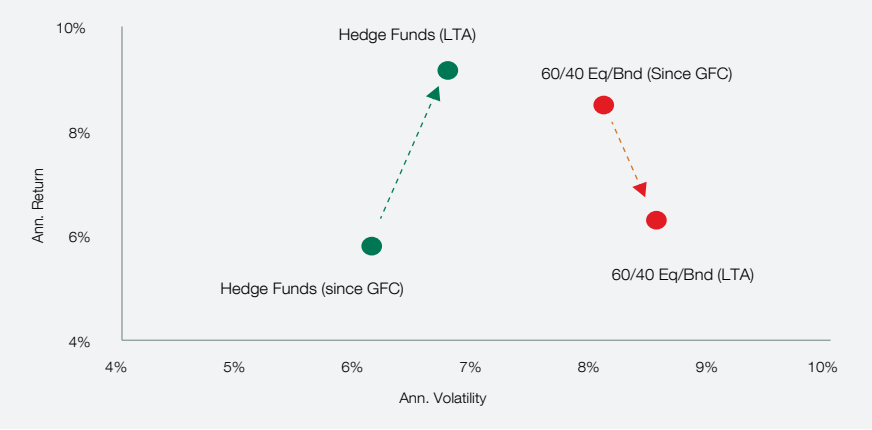


With the changes we have seen in macroeconomic and financial conditions over the last two or so years, markets have been more favourable for alternatives. They are once again showing attractive risk/reward profiles and strong diversification benefits compared with traditional assets.

Sources: UBP, Bloomberg Finance, LP, HFR. Data as at 31 August 2022. HFRI Fund Weighted Composite Index represents the hedge funds data. MSCI World Total Return (USD hedged) represents world equity data. Citigroup WGBI (USD hedged) represent the world government bond data. Past performance is not a guide to current or future results.

WILL PERFORMANCES REVERT BACK TO THEIR HISTORICAL AVERAGES?

Another way of looking at this is to compare the performance of hedge funds with a 60/40 equities/bond portfolio since the GFC* and over the long term. As the chart on the right shows, conditions since the GFC have been particularly favourable for traditional asset classes compared with their long-term averages, despite the drawdown we have seen so far in 2022. In contrast, as mentioned above, hedge funds have underperformed their historical averages. If these trends were to revert, the attractiveness of hedge funds compared with traditional asset classes would increase significantly.



*Global Financial Crisis

Sources: UBP, Bloomberg Finance, LP, HFR. LTA data from January 1990 to August 2022. "Since GFC" data from March 2009 to August 2022. HFRI Fund Weighted Composite Index represents the hedge fund data. A pro-forma calculation of 60% MSCI World Total Return (USD hedged) and 40% Citigroup WGBI (USD hedged) represent the 60/40 equity/bond. LTA: long-term average. Past performance is not a guide to current or future results.

The opportunity set in today's markets

We have entered a new market regime, characterised by higher rates & inflation, the end of quantitative easing and elevated market volatility. In this context, several alternative strategies are seeing an improved opportunity set that should help them deliver attractive returns. The many challenges facing investors today, such as geopolitical instability, the general trend away from globalisation and higher levels of inflation, could last for some time. These uncertainties could have a pronounced short-term impact on asset prices and should be considered by investors in their asset allocation decisions.

In terms of the opportunity set for alternative strategies, the selection of strategies and managers remain key. Each broad strategy can be broken down by investment style.

In long/short equity, less directional/ low net exposure managers should be favoured, but at some point, investors should rotate into more directional sector specialists. As fundamentals generally drive share prices in the long term, these managers should be well positioned to generate attractive returns.

For diversifying strategies, macro and commodities should continue to present an above-average opportunity set. These strategies are supported by a number of tailwinds, including higher front-end rates, central bank policies determined by economic fundamentals, commodity pricing set by supply-side constraints, higher levels of volatility, and equity market noise.

In fixed income, the sell-off across credit markets is beginning to produce some attractive long opportunities. The environment is also improving for corporate credit managers, which are able to generate alpha on both the long and short sides of portfolios. Default rates may not necessarily increase substantially from here, but dispersion, spread widening and volatility all provide a fertile opportunity set. This increased volatility and dispersion should also favour relative-value strategies.

One investment approach that has attracted the most talent and growth of the industry over the past years is multi-strategy funds. Multi-strategy funds are those that allocate to more than one alternative strategy or portfolio manager (PM) to a single vehicle. They have benefited from structural trends to attract talented PM teams: the closure of investment banks' proprietary trading desks, more regulation, and higher operational and financial burdens have led PMs to opt for this solution instead of setting up their own structures. These funds have generated attractive and robust performances as a group, even through the recent market volatility, outperforming the overall hedge fund industry. The ability of these funds to source talent, provide well-diversified exposure and strong risk management, has been the main factor for their success. In contrast, these structures tend to have higher total expense ratios (TER) and generally less attractive dealing terms. However, we believe these negatives are more than compensated for by the attractiveness of the approach, and that current markets should allow multi-strategy funds to continue to perform well.

Added value in a client portfolio

At UBP, we are solution-driven. This means that we have a high degree of flexibility in building alternative allocations for clients by focusing on clients' needs. The two variables to be considered are:

Investment format – liquidity, regulation aspects, costs. Less constrained investors should benefit from a broader set of strategies and thus have higher expected returns, given the illiquidity premium some strategies benefit from and the fact that some high-alpha-producing strategies are not replicable in UCITS. Despite this, the alternative UCITS offering has expanded significantly in recent years, both in terms of the number of funds and their quality. For cost-sensitive investors, certain strategies are accessible in a simpler and less expensive format. However, the most sophisticated and highest-value-added strategies are only available in their original, more expensive format.

Investment profile – performance objective, volatility budget and market sensitivities. This depends on the investor's profile and risk tolerance.

Hedge fund strategies offer a broad range of profiles, from very conservative to very aggressive, high market sensitivity to low market sensitivity.

One of the key elements for investors to consider is to determine which role the investment plays in portfolio allocation. Looking at the role in a client portfolio, we believe there are three categories into which alternatives can be split:

ASYMMETRIC EQUITY

- More conservative way to invest in equities
- Benefit from higher stock dispersion
- Outperformance in both falling and directionless markets

As the name suggests, this approach offers the possibility of staying invested in equities but with a more conservative approach. The level of sensitivity to markets depends on an investor's risk appetite. It benefits from high stock dispersion and should outperform both falling and directionless markets.

This approach includes long/short equity strategies.

In current markets, managers that are able to avoid too much sector and factor risk should outperform, given the strong rotations we have seen in recent months.

FIXED-INCOME ALTERNATIVES

- Replace bond allocations with similar risk/return patterns
- Outperformance in rising rate environments
- Protect against higher rate or credit spread volatility

The objective of this approach is to generate returns that offer a similar risk/return profile to traditional fixed income but with different performance drivers. These strategies should provide outperformance in a rising interest rate environment and protect against higher rate & credit spread volatility. This profile is quite conservative and typically includes strategies such as relative value and credit arbitrage.

DIVERSIFIER

- Outperformance when markets sell off
- Differentiated sources of returns
- Today, generally positioned to benefit from higher rates

This approach looks to provide differentiated sources of returns compared with equities and bonds, with very limited sensitivity to both asset classes. In general, this approach outperforms during market sell-offs. Interest rate volatility, dispersion and strong market trends are also favourable for diversifiers. These strategies tend to offer the lowest correlation to traditional assets but with higher volatility than the fixed-income alternatives approach. Strategies typically included here are global macro, systematic and other actively traded strategies.

Available solutions

As mentioned in the introduction, the alternatives industry offers a wide range of investment strategies and vehicles: from liquid and regulated to unconstrained, single-manager or multi-manager, commingled and customised. The chosen approach depends on an investor's risk-return objective, level of sophistication, liquidity, and cost requirements. When discussing investment strategies with investors, we believe in the complementarity that alternative investments bring in the context of a global portfolio. In order to achieve the best results, a full analysis of the client's portfolio can determine the factors they are exposed to, and target the most appropriate approach, strategies and individual funds. In short, strategy and fund selection are key.

CONCLUSION

Alternative strategies have been in existence for several decades and the industry, which has gone through various cycles, has evolved and matured. The emergence of regulated funds, greater transparency, improved liquidity and more attractive fees are the consequences of this evolution. Today, a broad range of investment strategies and formats that can play different roles in a client portfolio are available to investors.

We believe that the global economy and financial markets are moving into a challenging environment that will be more sustained. As a result, investors must prepare themselves for returns from traditional assets, such as equities and bonds, to revert to their long-term, risk-adjusted historical ranges. To offset this compression of returns and increase in volatility, alternatives should form a significant proportion of any portfolio's asset mix.

Finding the right approach when building an alternatives portfolio requires multiple levels of analysis. At UBP, we have been providing our clients with alternative solutions for over 30 years and have continuously invested in people and infrastructure. Our philosophy is to build client-focused solutions for private and institutional clients, structured in an innovative and efficient way.

We think of ourselves as our clients' partner, seeking to deliver on common objectives that we set together. To achieve this, we aim to find the most appropriate vehicle, either by investing in an existing fund structure, or by building a bespoke investment solution.

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