

Portfolio Diversification through Hedge Fund

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As we go into 2024, investors continue to be faced with many uncertainties, whether it comes from geopolitics or the macroeconomic environment. As proven in past years and especially in 2022 and 2023, allocating part of an investment portfolio to hedge funds help improve the risk/return profile of the portfolio through diversification. Throughout the past year, we have been asked how hedge funds are expected to perform in a higher rate environment. Historical data of over 2 decades suggests that, on average, hedge fund excess returns have risen in tandem with interest rates. The main underlying reason of this observably strong relationship is that hedge funds benefit directly from the increase in short-term rates due to their high cash balances. Take equity long/short managers as an example. By being long a stock and short another one, the manager is long cash. His return will be driven by the interest he makes on the cash balance plus the relative value he can extract from his long short position. Higher interest rate environments are in addition often associated with heightened volatility that in turn creates greater alpha opportunities. Markets will continue to worry about cyclical, interest rate and geopolitical risks, and nimble hedge funds are expected to continue to take advantage of market volatility. For all those reasons, we maintain our overweight on hedge funds for Q1 2024 and recommend a 12.5% allocation to hedge funds in a medium risk portfolio. Within hedge fund strategies, we continue to have a positive view on the operating environment for Multi-Strat and Multi-PM managers looking ahead through 2024. By allocating to such managers, investors benefit from diversification of risks and returns across strategies, and diversification of portfolio managers' investment skills. Such multi-PM managers usually have several dozens of portfolio managers and analysts, investing within a very tightly controlled risk environment. We also retain our positive outlook for the macro strategies. The ability of macro managers to operate with full flexibility during these uncertain times should serve the strategy well during 2024. It was the strategy contributing to the strongest returns during the last quarter,

with the opportunity set expanding into emerging market themes over the period.
In addition, as 2020 demonstrated,
managers in this sector
can generate outsized returns under a falling rate environment.
We would expect to see a greater proportion of returns emanating from directional rates positioning in
2024
compared to 2023.