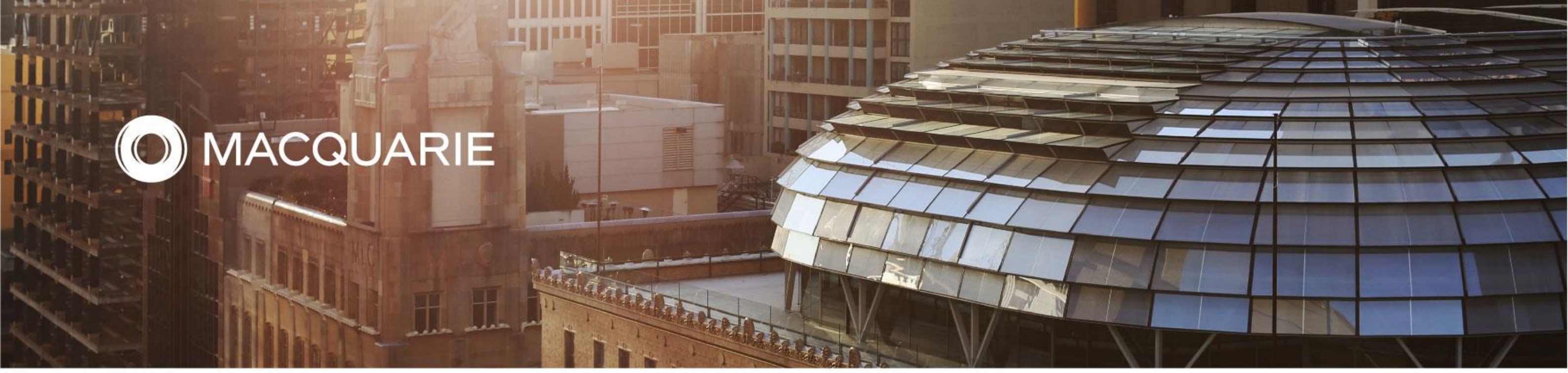


Investment Strategy Update #112

Hedge Funds: Offering diversification and downside risk protection

- We are tactically overweight alternative assets, which have the potential to deliver returns that are less correlated / uncorrelated to traditional assets as well as provide opportunities to enhance long term returns.

- Within alternatives, we have a tactical preference for hedge funds over private equity against a backdrop of ongoing volatility and uncertainty (see our *2H22 Outlook*), with hedge funds able to deploy strategies (e.g. shorting) that can capitalise on falling markets and/or have low beta, which generate returns that are independent of market direction.

- Hedge funds can use volatility to deliver alpha by turning the resulting market dislocations into trading opportunities. This was seen in 1H22, with the hedge fund composite index outperforming global equity and bond markets by ~7-11% and the top performing hedge fund strategy (macro) outperforming global equities by more than 22%.

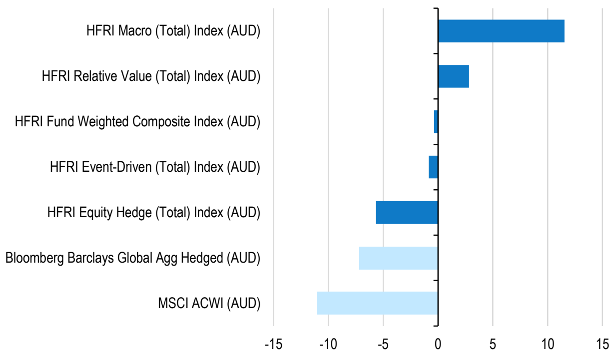
- Hedge funds have also demonstrated their ability to deliver diversification and downside protection year to date, with a 60/30/10 (stock/bond/hedge fund) portfolio having outperformed a 60/40 (stock/bond) portfolio by ~210bps during 1H22 and with lower volatility, resulting in an increase in the risk-adjusted return by ~35bps.

- Our preferred hedge fund strategies to be able to deliver risk-adjusted returns amid a volatile backdrop are: **equity hedge funds** (long/short), which should benefit from an improved environment for shorting and stock selection versus long only equities, **macro strategies** which have the flexibility to position for changing macro conditions (and have been the best performing strategy YTD) and **multi-strategy funds** for diversification to traditional assets (equities/bonds).

Turning volatility into opportunity

The word unprecedented has become synonymous with 1H22 as financial markets experienced a rare confluence of factors: high inflation, tightening rates and positive equity / bond correlations. This period has emphasised the role of diversification in portfolios, with hedge funds having delivered exactly as required - providing a source of uncorrelated returns that have also protected investors against the downside. The HFRI Fund Weighted Composite Index outperformed global equity and bond markets by ~7-11% YTD, with the top performing strategy (macro) outperforming global equities by more than 22%. Hedge funds have the potential to deliver uncorrelated returns during public market downturns.

Hedge funds vs traditional assets performance, YTD July-22 (%)



Source: HFRI, MWM Research, August 2022

For a balanced investor, we recommend a strategic allocation of ~15% to Alternatives. We have been overweight to Alternative assets since June 2020 given the ultra-low level of bond yields meant that the diversification to risk assets from bonds was limited. In March 2022, we moved overweight hedge funds relative to private equity. Hedge funds are able to take advantage of opportunities when volatility is elevated and market prices/conditions are changing rapidly.

Within a balanced portfolio, we would allocate up to 9% to hedge funds, however we would recommend diversifying across at least 3 different types of strategies to mitigate short-term manager performance risk. Diversification and uncorrelated return streams do not mean that hedge funds can't deliver negative returns from time to time. Additionally, the focus on non-traditional sources of return means that hedge fund exposures rarely overlap.

We believe hedge funds provide benefits to portfolios because:

#1 Diversification of returns

Exposure to diversified sources of return provided by hedge funds can improve the overall (risk-adjusted) returns of a balanced portfolio. We estimate that a balanced portfolio with 60/30/10 (stock/bond/hedge fund) would have delivered a return of -11% during 1H22 versus -13% for a 60/40 (stock/bond) portfolio, with lower volatility (3.8% for a 60/30/10 versus 4% for a 60/40). This improved risk-adjusted returns by around ~35bps.

Hedge fund strategies such as macro and multi-strategy funds have historically had low correlation with other asset classes (equities, fixed income, commodities) and as such provide an opportunity for diversifying portfolio returns. These strategies generate returns via idiosyncratic (or 'stock specific') risk or through taking a view on broader macro themes and/or changing macro regimes, compared to traditional assets, whose returns are typically dominated by changes in broad market factors such as equity market beta, interest rates and / or credit risk.

Select hedge fund strategies have exhibited low correlation to traditional assets

Hedge fund / public market correlations based on quarterly returns (2008-2021)

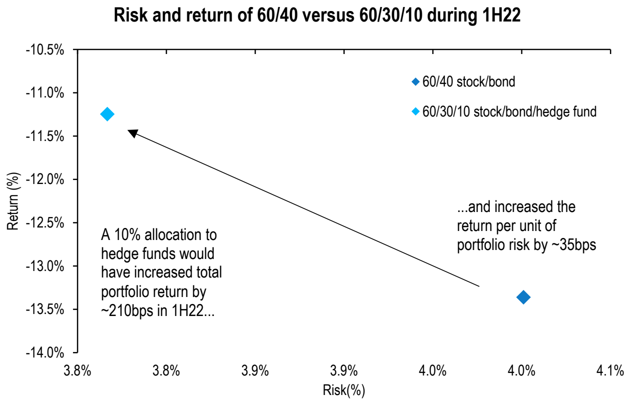
	Global Bonds	Global Equities	Macro	Equity L/S	Relative Value
Global Bonds	1.0				
Global Equities	0.3	1.0			
Macro	0.3	0.4	1.0		
Equity L/S	0.2	0.9	0.5	1.0	
Relative Value	0.2	0.9	0.4	0.9	1.0

Source: MSCI, Bloomberg, HFRI, JPMAM, July 2022

#2 Downside risk protection

Hedge funds aim to deliver absolute risk-adjusted returns through the market cycle by employing risk management techniques that "hedge out" (or minimise) the risk of the underlying assets, such as through targeting an explicit risk (volatility) budget or actively hedging out risks such as market risk, interest rate risk, and volatility. As such, hedge funds are a way to optimise the expected level of return at a given level of risk within an allocation, which in turn improves overall portfolio volatility and the risk-adjusted return profile of the portfolio. This becomes critical in the event of a market drawdown; by participating less in the initial drawdown, portfolios have a shorter time to recovery. For example, we estimate that a 60/40 portfolio will need to return ~13% to recover from the drawdowns incurred YTD versus a 60/30/10 portfolio, which will have to recover ~11% to get back to its previous peak.

Including Alternative strategies improves risk and return profiles of portfolios

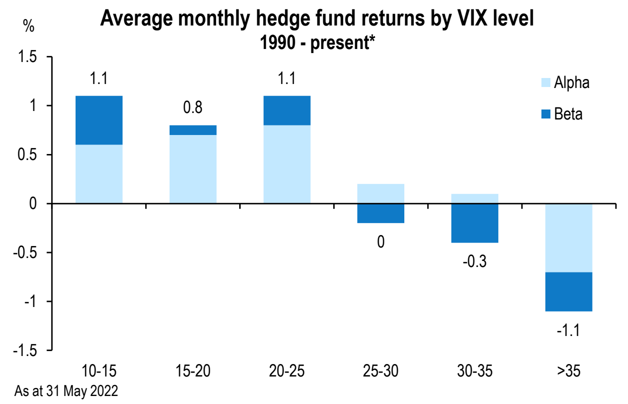


Source: Factset, HFRI, MWM Research, August 2022

#3 Alpha generation

Elevated volatility provides opportunities for hedge fund managers to generate alpha. Select strategies such as macro and multi-strategy hedge funds are nimble and flexible enough to reposition portfolios to take advantage of the resulting dislocations across asset classes and benefit from more persistent stock / sector dispersions.

Elevated volatility has historically provided alpha generation opportunities for hedge fund strategies



Source: HFRI, JPMAM, MWM Research, July 2022

Common misconceptions about hedge funds

There are some common misconceptions surrounding hedge funds that appear to largely be a hangover from the GFC. Some of the most common reasons for avoiding hedge funds we hear are:

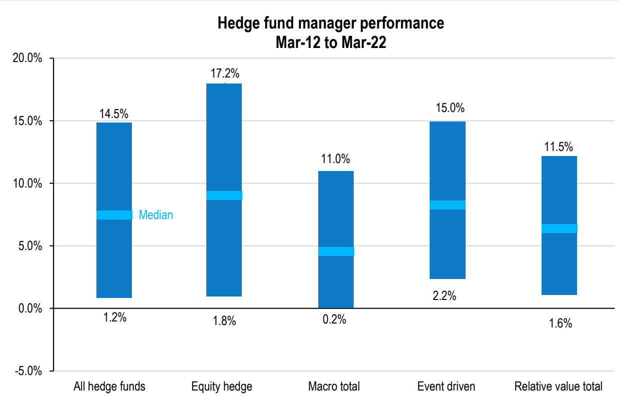
1. **High fees:** It is true that hedge funds are more expensive than a traditional long only equity strategy, however the fees are only high if the manager is delivering market returns and consequently, the allocation is not performing the role required in the overall portfolio. We look for strategies that can demonstrate true differentiated returns (low beta) and can offer real diversification (low correlation to other asset classes).

2. **Lack of transparency:** Historically, hedge fund managers have been known to offer little transparency to protect proprietary ideas. However, expectations for transparency across the industry have evolved. We maintain ongoing dialogue and information from managers as well as access to holdings and/or risk factors of the portfolio.

3. **Performance delivery:** We measure a hedge fund's performance success by a strategy's ability to provide downside protection, diversification, and alpha. We expect to see performance that can deliver alpha through the market cycle, with return driven by stock selection/macro positions rather than market beta / broader market direction.

However, manager selection is crucial to ensure the fund chosen performs the role that is intended within a portfolio, whether it is downside risk protection, alpha generation and/or diversification. Performance dispersion between hedge fund managers has historically been very wide – with performance between top and bottom quartile hedge fund managers diverging almost 14% over the last decade.

Significant return dispersion exist between top and bottom hedge fund managers



Source: PivotalPath, JPMAM, July 2022

Our preferred funds

Hedge funds are our preferred allocation within alternatives due to the potential for strong alpha generation, low correlation to traditional asset classes and a focus on downside protection to deliver risk-adjusted returns. We prefer the following hedge fund strategies:

- **Equity long/short strategies:** These strategies aim to create alpha via a manager's skill at stock picking and involve buying (or going long) stocks that the manager expects to appreciate and sell (or go short) positions that are anticipated to decrease in value. Both long and short positions within a portfolio are expected to deliver outperformance, while minimising exposure to the overall equity market.

- **Macro strategies:** These strategies apply an opportunistic approach that aims to generate returns from market swings caused by geopolitical and/or macroeconomic events. Macro strategies seek to maximise returns during periods of higher market volatility and lower liquidity. They often have a lower-beta equity exposure and an idiosyncratic return profile. A shift in policy regime (such as the environment investors are in now) creates market opportunities for macro managers with a tactical and nimble approach.

- **Multi-strategy funds:** These funds combine multiple uncorrelated strategies together (e.g. equity market neutral, equity and credit arbitrage, event driven and relative value strategies) in order to deliver returns through the market cycle. Managers accomplish this by identifying which strategy should be overweight or underweight against the current market backdrop in order to maximise risk-adjusted returns. Whereas single strategy funds may be limited in their scope of investment opportunities, the benefit of multi-strategy funds is in their flexibility to capitalise on the best strategy for a given market and having the option of minimising single strategy risk to reduce the risk of the overall fund.

Macquarie WM Investment Strategy Team

The report was finalised on 22 August 2022.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return

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