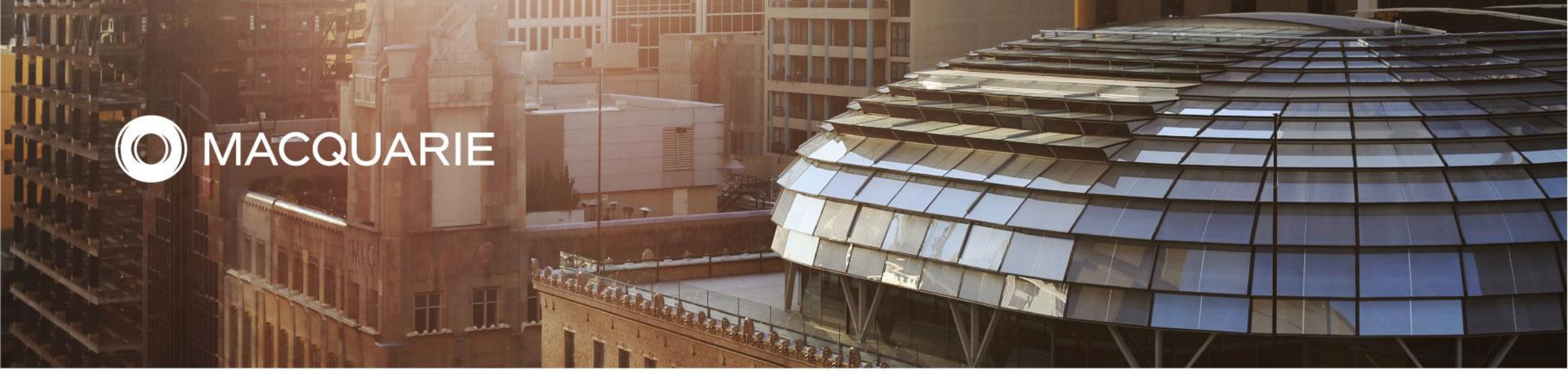



# Investment Strategy Update #118

## Alternatives: Hedge funds – Three preferred strategies for volatile times

- We are overweight alternatives which offer diversification, downside protection and the potential for superior risk-adjusted returns. For new money, we prefer an allocation to hedge funds, which are well-placed to deliver superior risk-adjusted returns given their flexible investment strategies.

- In times of high economic and financial market uncertainty, we believe diversification provides the best protection for portfolios. While diversification across asset classes remains important, diversification via alternative investment strategies is a very effective tool for portfolios as well. Hedge funds have delivered year-to-date, with the HFRI Fund Weighted Index outperforming global equity and bond markets by ~11% and ~7%, respectively (and the top hedge fund strategy, macro, outperforming global equity and bond markets by ~29% and ~26%, respectively).

- Our preferred hedge fund strategies are:

  - **Multi-strategy funds for diversification**, offering potential for a more steady, less volatile return profile, while low correlation within its strategies as well as to other asset classes provide an additional layer of diversification.

  - **Macro strategies for downside risk protection**, via leveraging market inefficiencies caused by broader macro events (e.g., geopolitical uncertainty, central bank policy pivots) to generate alpha while hedging against downside risks.

  - **Equity market neutral for maximising risk-adjusted returns,** through targeting a zero net market exposure with returns driven by the quality of manager stock selection.

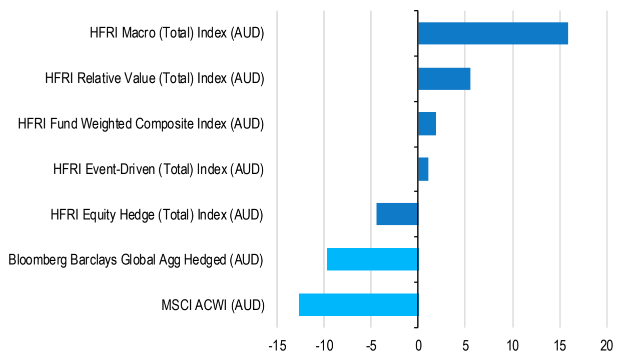
In our recent Investment Strategy Updates (please see the back of this note) we highlighted that financial markets are likely to remain highly volatile and at risk of further weakness. Against this backdrop, we think ensuring portfolios are diversified across asset classes and investment strategies provides the best protection to total portfolio returns. We are overweight alternative and real assets for diversification, downside protection and defensive yields.

## Hedge funds are proving their value

We believe hedge funds are well-positioned to deliver positive returns and provide downside protection to overall portfolios. Empirically, hedge funds have demonstrated their ability to provide less correlated returns, with the HFRI Fund Weighted Index delivering ~0.4% during the month of August, outperforming both global equities (-4%) and global bonds (-3%) as they struggled to digest a worsening outlook for inflation and economic growth. Likewise, hedge funds have also provided stable returns amid the market turmoil year-to-date, with the HFRI Fund Weighted Index outperforming global equity and bond markets by ~11% and ~7%, respectively (and the top hedge fund strategy, macro, outperforming global equity and bond markets by ~29% and ~26%, respectively).

### Hedge funds have delivered less correlated returns YTD

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




Source: Factset, HFRI, MWM Research, September 2022

## Our preferred strategies for the current environment

Our preferred hedge fund strategies amidst an ongoing volatile environment include:

Characteristics of hedge fund strategies

| Strategy type | Return: Growth | Return: Income | Risk: Tail risk hedge | Risk: Volatility | Risk: Low correlation to equities |
|---|---|---|---|---|---|
| Multi-strategy | ✓ | × | ✓ | ✓ | ✓ |
| Macro | ✓ | × | ✓ | ✓ | ✓ |
| Market Neutral | ✓ | × | × | ✓ | ✓ |
| Equity long/short | ✓ | × | × | × | × |

Source: MWM Research, September 2022

### 1. Multi-strategy: For diversification

We like multi-strategy funds because relative to other growth assets/investment strategies they are expected to deliver a steadier and less volatile return profile. By investing across a range of alpha opportunities (e.g., relative value, event driven, equity long/short, systematic trend following), managers have the flexibility to capitalise on the most appropriate strategy for a given market backdrop and thereby minimising the risk to the overall fund by excluding strategies that are less favourable. Multi-strategies also add a further layer of diversification given the low correlation between each individual strategy sleeve. While they may take some market risk, and have some correlation to equity markets, they tend to have a lower beta compared to more directional hedge funds.

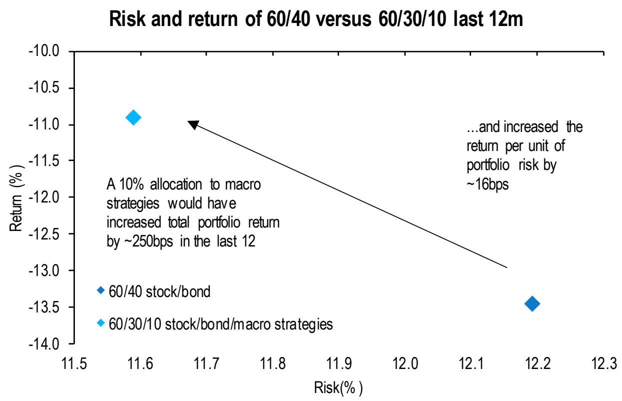
Multi-strategies have historically outperformed public equities during market downturns


Source: Factset, HFRI, MWM Research, September 2022

### 2. Macro: For protection against rising macro risks

Unlike many of their equity peers, macro strategies are generally directionless, with the ability to generate returns irrespective of market direction. Rather than detracting from performance, periods of elevated volatility have historically enabled macro managers to generate positive alpha by exploiting broad market moves across various asset classes to deliver less correlated returns. For example, an investor that included a 10% allocation to market neutral strategies over the last 12 months would have increased their total portfolio return by 250bps and risk-adjusted return by ~16bps.

Including macro strategies improves the risk-adjusted return of an overall portfolio

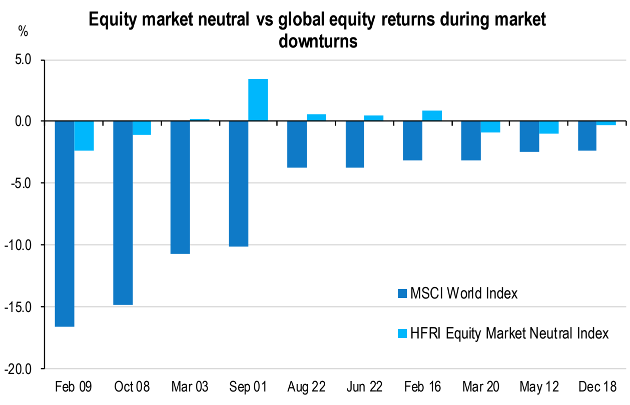



Source: Factset, HFRI, MWM Research, September 2022

### 3. Equity market neutral: For maximising risk-adjusted returns

Equity market neutral strategies benefit in the current environment where market direction is unpredictable given the strategy's focus on risk management through targeting a net beta exposure of zero. Even in cases of extreme divergence across sector performance, as seen in 1H22, market neutral strategies (HFRI Equity Market Neutral Index) were able to outperform global equities by ~21% (MSCI World NR). Market neutral strategies offer valuable downside protection during market downturns by dampening volatility and drawdown participation when incorporated within a diversified portfolio however, may lag the broader equity market during a strong market rallies, it can. Historically across the ten worst yearly returns since 2000, equity market neutral strategies have outperformed global equity markets by an average of ~13%.

Market neutral limits the exposure to broad market beta




Source: Factset, HFRI, MWM Research, September 2022

**Types of hedge fund strategies**

1. **Multi-strategy funds:** Combines multiple low and/or uncorrelated strategies together to deliver returns through the market cycle. Underlying strategies can include:

    - Equity long/short (long and short positions in stocks).
    - Event-driven (capturing arbitrage opportunities around corporate events or capital structures).
    - Arbitrage/relative value (capturing mispricing across assets).
    - Systematic trend following (using quantitative analysis to capture trends in markets to generate returns).

    Managers deliver alpha by identifying which strategy should be overweight or underweight against the current market backdrop in order to maximise risk-adjusted returns.

2. **Macro funds:** Aims to generate risk-adjusted returns through the market cycle, by taking advantage of market inefficiencies caused by broad macro events (e.g. monetary policy errors, geopolitical events, divergent business cycles). These periods generally lead to higher market volatility, greater uncertainty, lower liquidity and/or exacerbate investor biases across asset markets (equity, bond, currency, commodity), with macro managers seeking to identify these dislocations while hedging out the risks (e.g. rising rates, higher inflation, equity/bond market volatility).

3. **Equity long/short**: Aims to maximise market returns with less risk by taking active long positions which are offset by a number of short positions. By doing so, the strategy aims to limited beta exposure (market risk), with returns that are less correlated to broader equity market movements relative to traditional long-only equity funds. Returns of a fund are predominantly driven by the quality of stock selection.

    **Equity market neutral** is a type of long/short fund and tend to exhibit the lowest correlation with the broader equity market by targeting a zero net beta exposure.

*Our recent Investment Strategy Updates:*

- *#114: Downside economic growth risks intensify*
- *#115: Fixed income – Credit: Not yet priced for ongoing uncertainty*
- *#116: Emerging Markets – Too early to go back in*
- *#117: Australian equities: Headwinds are set to intensify*

**Macquarie WM Investment Strategy Team**

The report was finalised on 13 October 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

The analyst(s) responsible for the preparation of this research receives compensation based on overall revenues of Macquarie Group Limited (ABN 94 122 169 279 AFSL 318062) ("MGL") and its related entities (the "Macquarie Group", "MGL", "We" or "Us"). No part of the compensation of the analyst(s) was, is or will be directly or indirectly related to the inclusion of specific recommendations or views in this research.

This research has been issued and is distributed in Australia by Macquarie Equities Limited (ABN 41 002 574 923 AFSL 237504) ("MEL" or "We"), a Participant of the ASX. MEL is not an authorised deposit-taking institution for the purposes of the Banking Act 1959 (Cth), and MEL's obligations do not represent deposits or other liabilities of Macquarie Bank Limited (ABN 46 008 583 542). Macquarie Bank Limited does not guarantee or otherwise provide assurance in respect of the obligations of MEL.

This research contains general advice and does not take account of your objectives, financial situation or needs. Before acting on this general advice, you should consider if it is appropriate for you. We recommend you obtain financial, legal and taxation advice before making any financial investment decision. Past performance is not a reliable indicator of future performance. You should consider all factors and risks before making a decision. Please refer to MEL's Financial Services Guide (FSG) for more information at https://www.macquarie.com.au/advisers/financial-services-guide.html.

This research has been prepared for the use of the clients of the Macquarie Group and must not be copied, either in whole or in part, or distributed to any other person. If you are not the intended recipient, you must not use or disclose this research in any way. If you received it in error, please tell us immediately by return e -mail and delete the document. We do not guarantee the integrity of any links, e-mails or attached files and are not responsible for any changes made to them by any other person. Nothing in this research shall be construed as a solicitation to buy or sell any security or product, or to engage in or refrain from engaging in any transaction. This research is based on information obtained from sources believed to be reliable, but We do not make any representation or warranty that it is accurate, complete or up to date. We accept no obligation to correct or update the information or opinions in it. Opinions expressed are subject to change without notice. We accept no liability whatsoever for any direct, indirect, consequential or other loss arising from any use of this research and/or further communication in relation to this research. The Macquarie Group produces a variety of research products, recommendations contained in one type of research product may differ from recommendations contained in other types of research.

The Macquarie Group has established and implemented a conflicts policy at group level, which may be revised and updated from time to time, pursuant to regulatory requirements, which sets out how we must seek to identify and manage all material conflicts of interest. The Macquarie Group, its officers and employees may have conflicting roles in the financial products referred to in this research and, as such, may affect transactions which are not consistent with the recommendations (if any) in this research. The Macquarie Group may receive fees, brokerage or commissions for acting in those capacities and the reader should assume that this is the case. The Macquarie Group's employees or officers may provide oral or written opinions to its clients which are contrary to the opinions expressed in this research.

Important disclosure information regarding the subject companies covered in this report is available at macquarie.com/disclosures.