Beyond Bonds: Why Hedge Funds can deserve an allocation in portfolios

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HSBC Asset Management

Investors in hedge funds should bear in mind that these products can be highly speculative and may not be suitable for all clients.

The value of investments and any income from them can go down as well as up and investors may not get back the amount originally invested. Past performance does not predict future returns. The return may increase or decrease as a result of currency fluctuations.

There are several key issues that one should consider before making an investment into hedge funds. The risks specific to this type of investment may include, but are not limited to:

Regulation

The hedge fund industry is lightly regulated, with the majority of funds domiciled in offshore jurisdictions. Hedge funds are generally classified as "unregulated" and are not typically subject to the same levels of scrutiny and protection as a traditional investment fund. A thorough due diligence process can mitigate these concerns.

Gating

In event that redemptions requests on a particular dealing date are much higher than the normal level and full satisfaction would jeopardise the longer term portfolio balance, a gate or partial execution of redemption requests may be implemented generally on a pro-rata basis.

Side pocket

There may be instances when certain assets in a fund portfolio could become less liquid and the fund manager may segregate these illiquid positions from the main portfolio into a side pocket (or a separate vehicle).

Suspension of redemption

Suspension of redemption is a temporary halt in exiting the fund during a given redemption window. This is a stronger measure than gating because there is no dealing for the fund. This is generally used under special circumstances such as when liquidity conditions have markedly deteriorated in a short period of time or when there are heavy asset outflow such as the loss of a core investor.

Access

Hedge funds operate larger investment minima than traditional investment funds. Investors are often unable to access a hedge fund unless they were willing to invest US$500,000 to US$2million.

Liquidity

Hedge funds typically have much longer dealing cycles than traditional investment funds. Depending on the strategy being utilised, a hedge fund may only allow subscriptions and redemptions on a monthly or quarterly basis. Furthermore, some hedge funds have long lock-up periods, where an investor is not permitted to redeem from the hedge fund unless a period of 6 months, a year or even 2 years has passed. Some may allow a redemption before the lock-up period is over, but the investor would have to pay a hefty penalty to be able to do this.

Transparency

Many hedge fund managers are wary of regularly publishing their positions in the belief that this will remove any advantage that they have over their peers. This can pose a problem to the investor, as he or she cannot be certain to which stocks, geographies, markets or even strategies he or she will be exposed to when investing in the hedge fund. However, trusted investors who have built strong relationships with the hedge funds can access this information for the majority of funds, enabling thorough monitoring of the investment.

Manager failure

Over time, a number of hedge funds will close or fail, due to weak performance or operational difficulties. An investor must take this into consideration before making an investment, seeking professional advice to help minimise the risk of investing in a fund that is likely to fail.

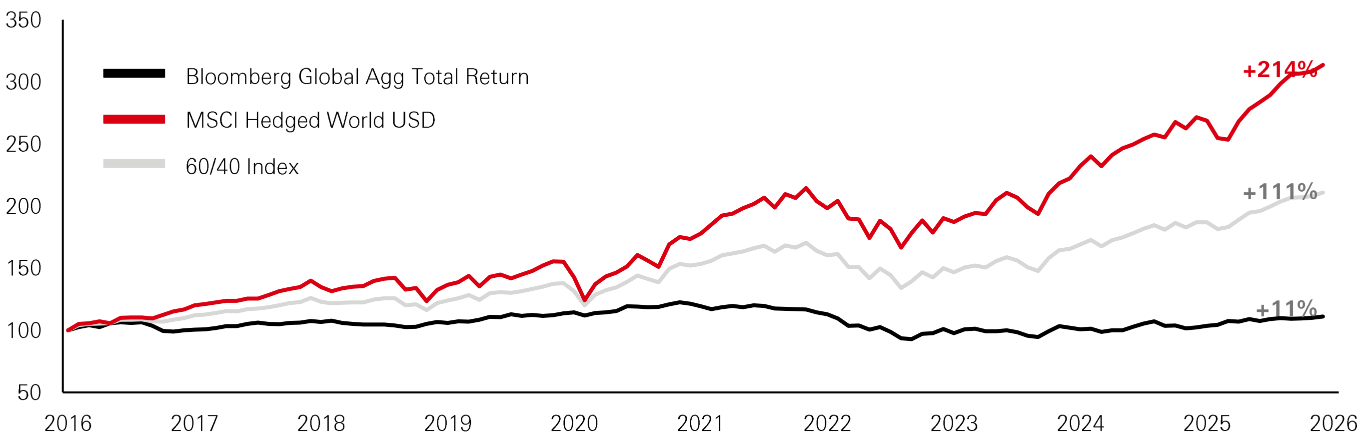
Alternatives

There are additional risks associated with specific alternative investments within the portfolios; these investments may be less readily realisable than others and it may therefore be difficult to sell in a timely manner at a reasonable price or to obtain reliable information about their value; there may also be greater potential for significant price movements.

An unfavourable period for fixed income

Investors over the past few years have had to grapple with elevated geopolitical challenges and uncertainty both over the direction and level of interest rates across the globe. While equity markets have attained record highs, albeit buffeted by the occasional bouts of volatility the same cannot be said for fixed income markets. From the Pleasantville of near-zero rates for much of the 2010s, to the shock of sharply rising rates in the early 2020's, the current monetary policy cycle has proven to be more opaque than many investors have been used to. This lack of clarity we have seen for much of the last three years on the path for interest rates has further stagnated the performance of an asset class, which had already spectacularly lost its status as the "safe" asset in global balanced portfolios during 2022. Despite hopes that the latest cycle of easing would raise returns, what has become clear as time moved on is the stickiness of inflation, evoking further uncertainty over the path of central bank policy – uncertainty that we continue to foresee. This has culminated in a lengthy period of period of underperformance from the asset class.

Fig 1: Major Index Performance (since February 2016)[1]

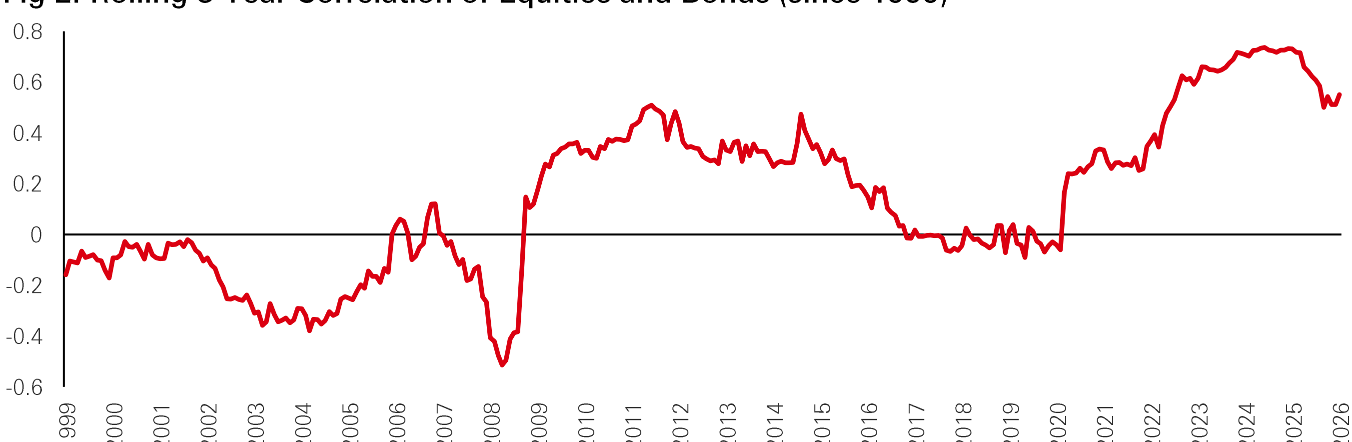


We understand the traditional role that fixed income allocations serve within wider portfolios. Income generation aside, capital preservation is a classical characteristic of the asset class. Common finance literature would argue fixed income is 'safer' when compared to other asset classes, given the nature of its construct. This should result in lower volatility and reduced downside risk. In contrast, what we have witnessed is a period of extended drawdowns and elevated volatility.

Another key characteristic of investment in fixed income more broadly is the diversification benefits it brings to portfolios. Traditionally, it is thought bonds operate with a low or negative correlation to equities. However, when looking at Fig. 2, we see a different story. Particularly in recent times, we see an increasing trend of positive equity and fixed income correlation. It suggests that the traditional role as a diversifier that broad fixed income allocations play in traditional portfolios is open to discussion.

In short, we would argue that fixed income may no longer fulfil its role in portfolio allocation under the current market regime - and that hedge funds can play that part instead.

Fig 2: Rolling 3 Year Correlation of Equities and Bonds (since 1999)[2]



For illustrative purposes only. Past performance does not predict future returns. The return may increase or decrease as a result of currency fluctuations. Diversification does not ensure a profit or protect against loss.

1. Source: HSBC Alternative Investments Limited, Bloomberg. As at January 2026. Performance period February 2016 – January 2026. 60/40 Index is represented by 60% allocation to MSCI Hedged World USD & 40% allocation to Bloomberg Global Aggregate Total Return Index.
2. HSBC Alternative Investments Limited, Bloomberg. As at January 2026. 3 year rolling correlation between the MSCI Hedged World USD Index and the Bloomberg Global Aggregate Total Return Index for the period May 1996 to January 2026.

With fixed income allocations potentially no longer meeting the needs of investors, it is fair for allocators to seek exposure in alternative asset classes that can. Hedge funds could provide the 'lost' characteristics of fixed income which investors are looking for as part of their wider portfolio construct.

Reward for your risk

Whilst fixed income as an asset class is typically considered a less risky bet that can diversify portfolios, it is interesting to see the results when you compare the risk-adjusted returns and overall volatility profile of fixed income to that of a hedge fund index. One might expect hedge funds to operate at a much higher volatility level relative to fixed income given their exposure to a broad range of asset classes. However, as shown in Fig 3, this is not the case.

In fact, hedge funds have offered investors a marginally lower volatility profile, combined with a significantly better return profile. Over the last ten years, investors in fixed income will not only have seen their nominal returns flat line but have done so at a greater volatility compared to an allocation to hedge funds. Given the frequent constraints around risk budgeting in portfolio management, it is integral that investors are seeking to maximise their return generation per unit of risk. Hedge funds have achieved this, and, if history is anything to go by, are arguably more likely to do so going forward compared to fixed income.

Fig 3: 10y annualised volatility[3]
HFRI Fund Weighted Index, Bloomberg Global Agg

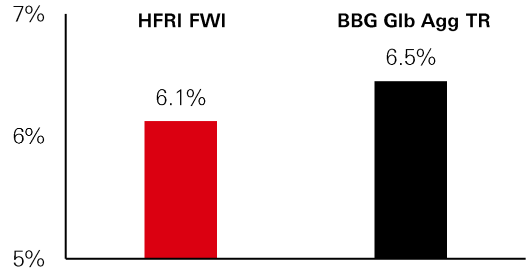
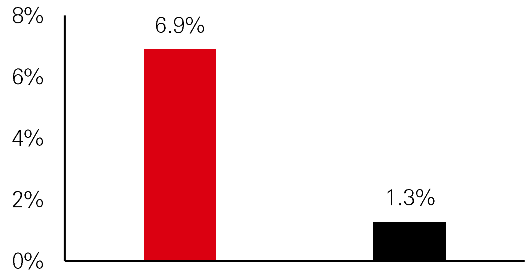
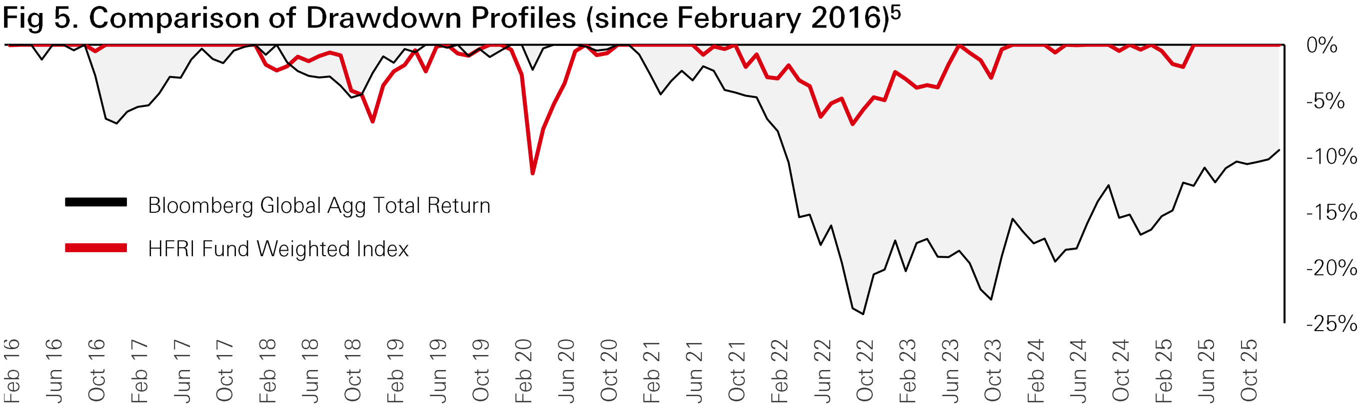


Fig 4: 10y annualised return[4]
HFRI Fund Weighted Index, Bloomberg Global Agg



The diversification of portfolios when comparing fixed income allocations to those of hedge funds also gives investors food for thought, especially when it comes to downside protection.

Fig 5. Comparison of Drawdown Profiles (since February 2016)[5]



	Bloomberg Global Agg Total Return	HFRI Fund Weighted Index
Maximum Drawdown	-24.2%	**-11.6%**
Month Occurred	October 2022	March 2020
Recovery Period	N/A	**8 Months**

Looking over the last ten years, one can see hedge funds experience a lower maximum drawdown and have the shortest recovery period. Compared to global equities and a traditional 60/40 portfolio, hedge funds have experienced significantly fewer drawdowns, and (where they occur) these drawdowns are ameliorated over a much shorter period of time. When you compare hedge funds to just fixed income over the same period, the results are even more apparent.

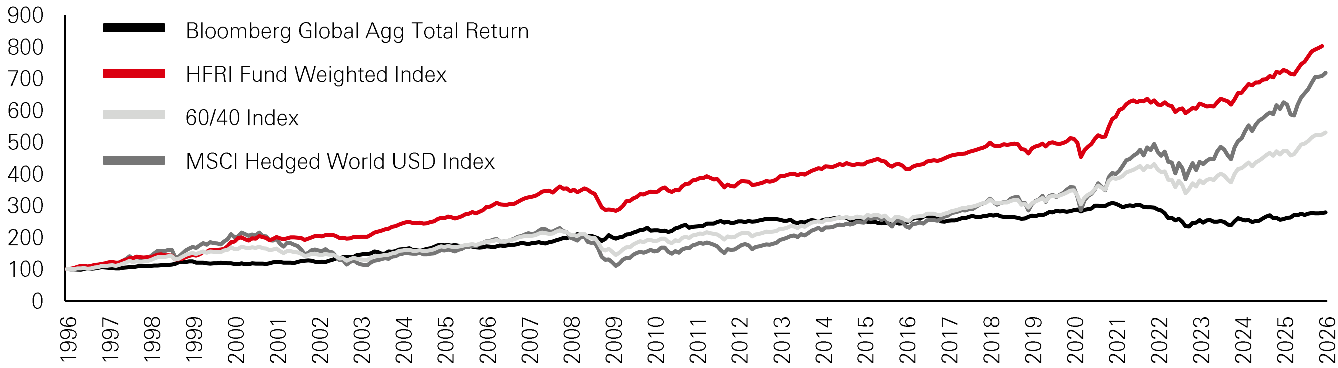
Past performance does not predict future returns. There is no guarantee that the fund objectives or target returns will be achieved. The return may increase or decrease as a result of currency fluctuations. Diversification does not ensure a profit or protect against loss.

3. & 4. & 5. Source: HSBC Alternative Investments Limited, Bloomberg, HFRI Inc. As at January 2026. Performance period February 2016 to January 2026 of the HFRI FWI is the HFRI Fund Weighted Index and the Bloomberg Global Aggregate Total Return Index. There is no guarantee the trend illustrated by the charts above will continue.

The longer-term story

Extending the time horizon reviewed, the case for investors having an allocation to hedge funds is even more pronounced. This is evidenced in the performance of a hedge fund index in excess of indices for equities, fixed income, and that of a traditional 60/40 portfolio.

Fig 6. Return Profile (since 1996)[6]



	MSCI Hedged World USD Index	60/40 Index	Bloomberg Global Agg Total Return	HFRI Fund Weighted Index
Annualised Return	6.8%	5.7%	3.5%	**7.3%**
Annualised Volatility	14.2%	9.2%	5.8%	6.7%
Return / Risk	0.5	0.6	0.6	**1.1**
Max. Drawdown	-51.9%	-33.0%	-24.2%	**-21.4%**

Drivers of Hedge Fund Performance

Diversification of Strategy

- Hedge funds expand beyond traditional investments, utilizing derivatives, commodities, and bespoke products.
- They offer access to niche markets and innovative strategies not available through conventional vehicles.
- This diversification broadens investment opportunities and enhances portfolio diversification

Alpha Driven Returns

- Hedge funds target alpha, generating returns beyond market averages through skill and insight.
- They leverage proprietary techniques, such as algorithms, to identify undervalued stocks.
- This approach offers potential for superior risk adjusted returns compared to traditional strategies.

Correlation Benefits

- Hedge funds provide correlation benefits by employing uncorrelated return strategies.
- They invest in emerging strategies and complex derivatives to reduce portfolio volatility.
- Diversification through hedge funds mitigates risk and enhances risk-adjusted returns.

Risk Management

- Risk management is embedded in hedge fund processes, using techniques like stress testing.
- They employ hedging strategies to protect against adverse market movements.
- Proactive risk management ensures navigation of complex environments and investor capital protection.

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Wide opportunity set for hedge fund managers

Looking forward we continue to see a fertile environment for hedge fund managers to deliver strong risk-adjusted returns uncorrelated to the wider market.

Dispersion in markets grows

Scope for return generation increases

- The broadening out of equity markets has elevated dispersion, which can drive idiosyncratic alpha on both the long and short side.
- This is of particular benefit to **Equity Long/Short** and **Market Neutral** managers.

Monetary policy uncertainty creating opportunity

Policy moves fuel strategy potential

- Central banks remain focused on balancing inflation and labour markets.
- Shifting central bank policies create trading opportunities for hedge funds, especially **Macro** and **Credit** managers

Geopolitical shifts unlock new avenues

Rising geopolitical tensions continue

- Government intervention drives price dislocations for managers to exploit.
- Uncertainty creates opportunities in commodities and debt markets, particularly benefitting **Macro** and **Managed Futures** strategies

Corporate activity back with a vengeance

2025 a strong year for M&A volumes

- 2025 saw the revival of M&A and restructurings which has provided fertile ground for **Event Driven** and **Credit** strategies
- Price dislocations should aid managers in extracting alpha.

Conclusion

With recent performance in mind, and prevailing uncertainties across the global economy, the future path for fixed income returns appears unclear. An extended period of elevated rates is market consensus as inflationary pressures refuse to go away in an environment of overt fiscal laxity.

Not all hope is lost though. In our view the drivers of hedge fund performance place them in a unique position to capitalise on wider market uncertainty and possess many of the characteristics that investors have traditionally prized in fixed income. In summary, we would argue that a well managed, hedge fund portfolio should represent a key allocation within investors' wider portfolios.

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