April 20, 2020

Tactical Hedge Fund Allocation

***Seeking Security and Opportunity During Times of Uncertainty** (1 of 2)*

In uncertain times, like we're experiencing today, humans look for one of two things: security or opportunity. Since most allocators are human, seeking out security or opportunity can be a crucial decision when making investments.

If hedge funds are an important part of your portfolio, then tactically shifting your asset allocation toward hedge funds can provide enhanced security through diversification. Or it can create unique opportunities, by allocating to managers that are taking advantage of the current market environment.

When we talk about **security**, what we're really talking about is the diversification provided by hedge fund investments. However, since hedge funds are complex investments, quickly adding new managers is not in the cards for most allocators.

So how do we access the diversification we're looking for?

A great place to start might be with a broad-based investable hedge fund index that provides access to the risk/return profile of the overall hedge fund universe. Investing in indices reduces the manager risks associated with allocating to single hedge funds, along with the burdensome and costly due diligence process of underwriting multiple managers.

Ultimately, what we're looking for in this environment is access and speed. Increasing your exposure to hedge fund strategies has never been easier.

Another way allocators handle uncertainty is to look for **opportunities** caused by that very uncertainty. When looking through the lens of tactical allocation, this might look like a larger bet on one or two specialty managers that can execute on a specific attractive opportunity set.

However, unless you already have a predetermined lineup of funds, this process could take from six months to a year or more to properly underwrite and make your first allocation. Put another way, the **opportunity** has most likely passed you by.

A tale of two outcomes: COVID-19

If you pay attention to the financial media, as most of us do, you see two main theories for where the economy is going in the coming months.

The first, which I believe to be wishful thinking, is once the government gives the all clear, the economy will go back to normal relatively quickly. The other, however, is a grim scenario, which predicts the world descending into a depression that could take a decade or more to recover.

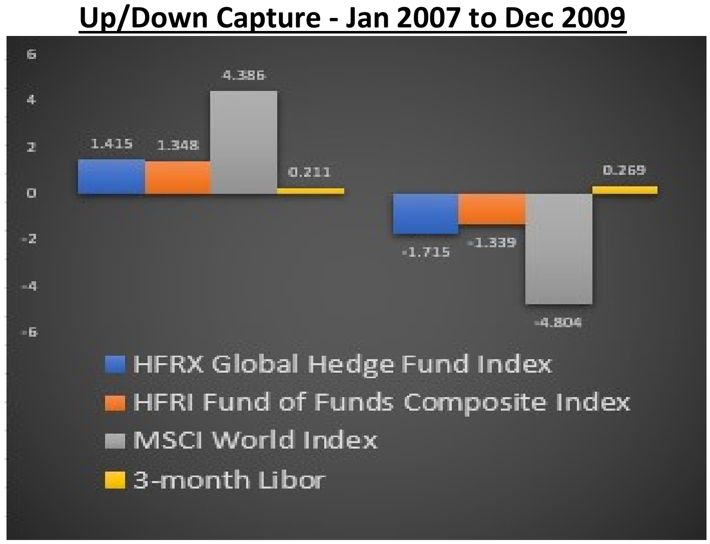
I would guess that the outcome lies somewhere in the middle, but the range of possible outcomes is still wide and relatively unclear. This puts us right back to where we started – Are you searching for security through diversification? For opportunity? Or maybe, for a bit of both.

Diversification

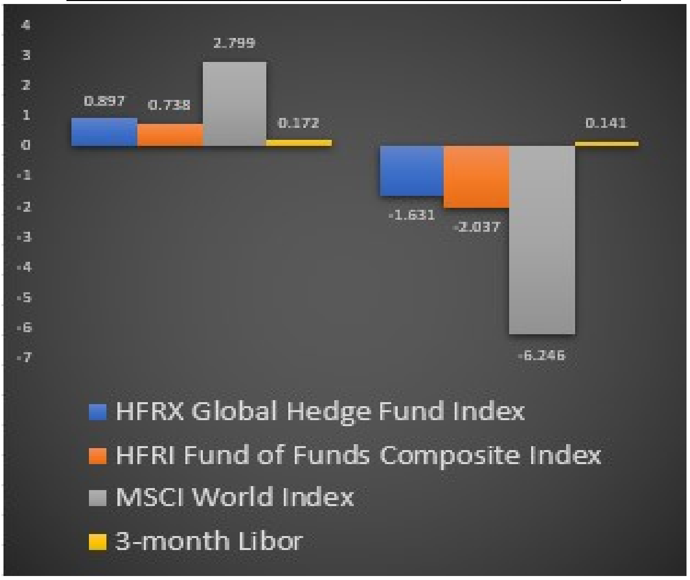
As I mentioned earlier a broad-based investable hedge fund index could be a solution when tactically allocating to hedge funds. At HFR, we have numerous investable versions of our indices that serve several needs.

While I cannot say for sure how an index may perform in the future, I can show you the downside protection provided by the HFRX Global Index during the global financial crisis and over the past several months of uncertainty caused by COVID-19.

Up/Down Capture - Jan 2007 to Dec 2009



Up/Down Capture - Jun 2019 to Mar 2020



Source: Hedge Fund Research, Inc.

Imagine what it might look like to tactically supplement your hedge fund portfolio. What could that mean for your returns? What could it mean for your peace of mind? Are you willing to possibly give up a little on the upside for downside protection during uncertainty?

NEXT TIME: Opportunistic Manager Selection
Stay tuned for the next edition of ***Tactical Hedge Fund Allocation***, which will cover tactically allocating to managers to take advantage of attractive market dislocations

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The HFRX Global Hedge Fund Index is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset weighted based on the distribution of assets in the hedge fund industry. The MSCI World Index is a free float-adjusted market capitalization index that is designed to measure global developed market equity performance. The 3 month US dollar LIBOR interest rate is the interest rate at which a panel of selected banks borrow US dollar funds from one another with a maturity of three months. The HFRI Fund of Funds Composite sets forth the performance of Hedge Fund Research, Inc.'s hedge fund index, an equally weighted performance summary of over 800 constituent fund of funds.

Indices are not investable themselves, and thus do not include the deduction of fees and other expenses associated with an investment in a fund. When reviewing the performance of any fund to a broad-based index, investors should consider the material differences between indices and funds. Index information is provided merely as an indication of the performance of various capital markets. The performance and tax consequences of an investment in the securities represented by an Index, on the one hand, and an investment in the fund, on the other hand, are materially different.

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