The case for Hedge Funds in the current market environment

October 2023

For Professional Clients only.

This is a marketing communication.
Please refer to the Private Placement Memorandum or Prospectus before making any final investment decisions.

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.

Further information on the potential risks can be found in the Key Investor Information Document (KID) and/or the Prospectus or Offering Memorandum.

The story so far

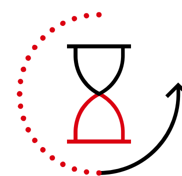
- **Higher interest rates** (rising to 5.25% in the U.S. at the time of writing) in response to the elevated inflationary environment have temporarily increased investor interest in leaving allocations in cash yielding instruments.
- U.S. deposit rates of near 5% p.a. mean investors receive a 5% return when holding for the full year. Put another way, this is equivalent to c. **40bps per month.**

With cash at 5%, why allocate to Hedge Funds?

- We would argue that a balanced and diversified hedge fund portfolio should, in the current environment, be generating more than 40bps per month on average, and therefore should be preferred to a cash allocation for investors.
- In theory there is no upper bound to hedge fund returns, meaning there is potential for hedge funds to offer significantly greater returns compared to cash.

Where do we go from here?

- We are cognisant of the fact that we are at or/near peak rates with consensus leaning towards significant rate cuts next year (with HSBC pricing in 75bps in US rates cuts in 2024). As such, the c. 40bps per month is essentially the upper bound that investors can expect. Investors are likely to receive less than 5% if holding for one year as rates are cut during that time as banks are likely to reduce their offered deposit rates.
- HSBC Asset Management considers three macroeconomic scenarios as being most likely over the coming months. Rate cuts are expected in two of them. We believe that a diversified portfolio of hedge funds, unlike cash or cash equivalents, are uniquely positioned to perform across all three possibilities:

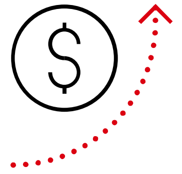
SUSTAINED HIGH RATES	RATE CUTS EXPECTED	
1. INFLATION CRISIS Persistent inflation pressures from strong labour demand and a constrained supply side 	**2. CHOPPY MARKETS** Tighter financial conditions induces global recession 	**3. SOFT-ISH LANDING** Rapid supply-side improvements, balance sheet support, confidence holds up 

Source: HSBC, Bloomberg, as of 31 July 2023.

Past performance does not predict future returns. Diversification does not ensure a profit or protect against a loss. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way, HSBC Alternative Investments Limited accepts no liability for any failure to meet such forecast, projection or target. The costs/ returns may increase or decrease as a result of currency and exchange rate fluctuations. For illustrative purposes only and does not constitute any investment recommendation in the above mentioned strategies.

Scenario 1: Inflation Crisis

Key features



- **Persistent inflation** pressures from strong labour demand and a constrained supply side
- Central banks **raise interest rates** further, maintaining higher rates for a sustained period
- Consequently, developed markets experience **economic drawdowns** amid strong recessionary pressures
- Cash and **defensive assets perform well**, while credit **spreads widen** and equities struggle

Hedge fund opportunities

- Any hedge fund strategy that has **market neutral** characteristics where the short book is largely financing the long book will benefit from its substantial cash pile earning interest.
- A strategy entering positions using margin such as **CTA**s via futures will again benefit from its high allocation to cash earning interest.
- Strategies such as **CTAs and Discretionary Macro** benefit from a broadened opportunity set when there are falls in asset values associated with higher interest rates.
- **Event-driven managers** with the flexibility to redeploy capital dynamically across the different parts of the capital structure as well as across geographies are particularly well suited to take advantage of the opportunity set. In particular, strategies targeting stressed and distressed investments would benefit

Source: HSBC, Bloomberg, as of October 2023.

Past performance does not predict future returns. Diversification does not ensure a profit or protect against a loss. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way, HSBC Alternative Investments Limited accepts no liability for any failure to meet such forecast, projection or target. The costs/ returns may increase or decrease as a result of currency and exchange rate fluctuations. For illustrative purposes only and does not constitute any investment recommendation in the above mentioned strategies.

Scenario 2: Choppy Markets

Key features

- Tighter financial conditions induces **global recession**
- Central banks **lower rates** in 2024 in response to recession and fiscal tightening
- Equities have an uncertain outlook, potential for **volatility spikes**
- Short duration bonds and highly rated **instruments with carry continue to perform well**

Hedge fund opportunities

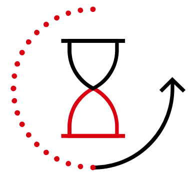
- Greater activity and dispersion in the fixed income and credit space will benefit **alternative credit** managers seeking alpha over what could be achieved by cash alone.
- **Structured credit** remains interesting as robust levels of loss adjusted yield and solid collateral make for an attractive opportunity set. Floating rate debt and interest rate hedges have limited portfolio duration and helped offset losses from rising rates to date, and are supported by strong carry.
- **CTA managers** should benefit from heightened market dispersion and volatility, delivering diversified alpha across the market cycle.
- Fixed income volatility, macro-economic and geopolitical uncertainty should also benefit **Macro** strategies

Source: HSBC, as of October 2023.

Past performance does not predict future returns. Diversification does not ensure a profit or protect against a loss. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way, HSBC Alternative Investments Limited accepts no liability for any failure to meet such forecast, projection or target. The costs/ returns may increase or decrease as a result of currency and exchange rate fluctuations. For illustrative purposes only and does not constitute any investment recommendation in the above mentioned strategies.

Scenario 3: Soft-ish Landing

Key features



- Rapid supply-side improvements, balance sheet support, confidence holds up
- Central banks **loosen monetary policy** in Q1 2024
- Any developed markets economic and profit **recessions are very mild**
- Reduced pressure on profits and multiples amid lower discount rates cause **equities to rally** (particularly growth and cyclical stocks)
- **Bond yields compressed** and credit spreads tighten

Hedge fund opportunities

- In the **Equity Long/Short** sector, long-biased strategies in particular would benefit from decreases in the discount factor. This comes at a time where we expect retail investors to shift out of money market funds due to lower potential returns, and return back to 'Risk on' equity investments. This potential for growing market enthusiasm will benefit Equity Long/Short managers.
- Following a lacklustre first half of the year in IPO and M&A activity, a lower cost of capital offers these managers a greater opportunity set to derive alpha from. **Event Driven** credit trades should also benefit due to marking to market as interest rates fall.

Source: HSBC, Bloomberg, as of October 2023.

Past performance does not predict future returns. Diversification does not ensure a profit or protect against a loss. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way, HSBC Alternative Investments Limited accepts no liability for any failure to meet such forecast, projection or target. The costs/ returns may increase or decrease as a result of currency and exchange rate fluctuations. For illustrative purposes only and does not constitute any investment recommendation in the above mentioned strategies.

In summary

- Investors who have enjoyed strong cash returns this year nevertheless face an **uncertain path** over the coming months
- Our analysis expects the **majority of hedge fund strategies to find fertile opportunities** for returns across the various possible scenarios ahead.
- The central case is that **rates will fall** over the coming months, meaning cash will no longer be as attractive on a relative basis. As rates fall, CTA, Macro, Equity Long/Short and Credit Long/Short funds stand to benefit from opportunities which will lead to them outperforming cash in the medium term
- Should we see a further pick up in inflation and continued further rate hikes, **dispersion and volatility supports alpha generation** across a range of strategies
- Overall, we see **significant scope for hedge funds to offer greater returns relative to cash / fixed income** for the foreseeable future

Source: HSBC, Bloomberg, as of October 2023.

Past performance does not predict future returns. Diversification does not ensure a profit or protect against a loss. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way, HSBC Alternative Investments Limited accepts no liability for any failure to meet such forecast, projection or target. The costs/ returns may increase or decrease as a result of currency and exchange rate fluctuations. For illustrative purposes only and does not constitute any investment recommendation in the above mentioned strategies.

For Professional Clients and intermediaries within countries and territories set out below; and for Institutional Investors and Financial Advisors in Canada and the US. This document should not be distributed to or relied upon by Retail clients/investors.

The value of investments and the income from them can go down as well as up and investors may not get back the amount originally invested. The capital invested in the fund can increase or decrease and is not guaranteed. The performance figures contained in this document relate to past performance, which should not be seen as an indication of future returns. Future returns will depend, inter alia, on market conditions, fund manager's skill, fund risk level and fees. Where overseas investments are held the rate of currency exchange may cause the value of such investments to go down as well as up. Investments in emerging markets are by their nature higher risk and potentially more volatile than those inherent in some established markets. Economies in Emerging Markets generally are heavily dependent upon international trade and, accordingly, have been and may continue to be affected adversely by trade barriers, exchange controls, managed adjustments in relative currency values and other protectionist measures imposed or negotiated by the countries and territories with which they trade. These economies also have been and may continue to be affected adversely by economic conditions in the countries and territories in which they trade. Mutual fund investments are subject to market risks, read all scheme related documents carefully.

The contents of this document may not be reproduced or further distributed to any person or entity, whether in whole or in part, for any purpose. All non-authorised reproduction or use of this document will be the responsibility of the user and may lead to legal proceedings. The material contained in this document is for general information purposes only and does not constitute advice or a recommendation to buy or sell investments. Some of the statements contained in this document may be considered forward looking statements which provide current expectations or forecasts of future events. Such forward looking statements are not guarantees of future performance or events and involve risks and uncertainties. Actual results may differ materially from those described in such forward-looking statements as a result of various factors. We do not undertake any obligation to update the forward-looking statements contained herein, or to update the reasons why actual results could differ from those projected in the forward-looking statements. This document has no contractual value and is not by any means intended as a solicitation, nor a recommendation for the purchase or sale of any financial instrument in any jurisdiction in which such an offer is not lawful. The views and opinions expressed herein are those of HSBC Asset Management at the time of preparation, and are subject to change at any time. These views may not necessarily indicate current portfolios' composition. Individual portfolios managed by HSBC Asset Management primarily reflect individual clients' objectives, risk preferences, time horizon, and market liquidity. Foreign and emerging markets. Investments in foreign markets involve risks such as currency rate fluctuations, potential differences in accounting and taxation policies, as well as possible political, economic, and market risks. These risks are heightened for investments in emerging markets which are also subject to greater illiquidity and volatility than developed foreign markets. This commentary is for information purposes only. It is a marketing communication and does not constitute investment advice or a recommendation to any reader of this content to buy or sell investments nor should it be regarded as investment research. It has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of its dissemination. This document is not contractually binding nor are we required to provide this to you by any legislative provision.

All data from HSBC Asset Management unless otherwise specified. Any third party information has been obtained from sources we believe to be reliable, but which we have not independently verified.

HSBC Asset Management is the brand name for the asset management business of HSBC Group, which includes the investment activities provided through our local regulated entities. HSBC Asset Management is a group of companies in many countries and territories throughout the world that are engaged in investment advisory and fund management activities, which are ultimately owned by HSBC Holdings Plc. (HSBC Group). The above communication is distributed by the following entities:

- In Argentina by HSBC Global Asset Management Argentina S.A., Sociedad Gerente de Fondos Comunes de Inversión, Agente de administración de productos de inversión colectiva de FCI N° 1;
- In Australia, this document is issued by HSBC Bank Australia Limited ABN 48 006 434 162, AFSL 232595, for HSBC Global Asset Management (Hong Kong) Limited ARBN 132 834 149 and HSBC Global Asset Management (UK) Limited ARBN 633 929 718. This document is for institutional investors only, and is not available for distribution to retail clients (as defined under the Corporations Act). HSBC Global Asset Management (Hong Kong) Limited and HSBC Global Asset Management (UK) Limited are exempt from the requirement to hold an Australian financial services license under the Corporations Act in respect of the financial services they provide. HSBC Global Asset Management (Hong Kong) Limited is regulated by the Securities and Futures Commission of Hong Kong under the Hong Kong laws, which differ from Australian laws. HSBC Global Asset Management (UK) Limited is regulated by the Financial Conduct Authority of the United Kingdom and, for the avoidance of doubt, includes the Financial Services Authority of the United Kingdom as it was previously known before 1 April 2013, under the laws of the United Kingdom, which differ from Australian laws;
- in Bermuda by HSBC Global Asset Management (Bermuda) Limited, of 37 Front Street, Hamilton, Bermuda which is licensed to conduct investment business by the Bermuda Monetary Authority;
- in Canada by HSBC Global Asset Management (Canada) Limited which provides its services as a dealer in all provinces of Canada except Prince Edward Island and also provides services in Northwest Territories. HSBC Global Asset Management (Canada) Limited provides its services as an advisor in all provinces of Canada except Prince Edward Island;
- in Chile: Operations by HSBC's headquarters or other offices of this bank located abroad are not subject to Chilean inspections or regulations and are not covered by warranty of the Chilean state. Further information may be obtained about the state guarantee to deposits at your bank or on www.sbif.cl;
- in Colombia: HSBC Bank USA NA has an authorized representative by the Superintendencia Financiera de Colombia (SFC) whereby its activities conform to the General Legal Financial System. SFC has not reviewed the information provided to the investor. This document is for the exclusive use of institutional investors in Colombia and is not for public distribution;

- in Finland, Norway, Denmark and Sweden by HSBC Global Asset Management (France), a Portfolio Management Company authorised by the French regulatory authority AMF (no. GP99026) and through the Stockholm branch of HSBC Global Asset Management (France), regulated by the Swedish Financial Supervisory Authority (Finansinspektionen);
- in France, Belgium, Netherlands, Luxembourg, Portugal, Greece by HSBC Global Asset Management (France), a Portfolio Management Company authorised by the French regulatory authority AMF (no. GP99026);
- in Germany by HSBC Global Asset Management (Deutschland) GmbH which is regulated by BaFin (German clients) respective by the Austrian Financial Market Supervision FMA (Austrian clients);
- in Hong Kong by HSBC Global Asset Management (Hong Kong) Limited, which is regulated by the Securities and Futures Commission. This document has not been reviewed by the Securities and Futures Commission;
- in India by HSBC Asset Management (India) Pvt Ltd. which is regulated by the Securities and Exchange Board of India;
- In Israel, HSBC Bank plc (Israel Branch) is regulated by the Bank of Israel. This document is only directed in Israel to qualified investors (under the Investment advice, Investment marketing and Investment portfolio management law-1995) of the Israeli Branch of HBEU for their own use only and is not intended for distribution;
- in Italy and Spain by HSBC Global Asset Management (France), a Portfolio Management Company authorised by the French regulatory authority AMF (no. GP99026) and through the Italian and Spanish branches of HSBC Global Asset Management (France), regulated respectively by Banca d'Italia and Commissione Nazionale per le Società e la Borsa (Consob) in Italy, and the Comisión Nacional del Mercado de Valores (CNMV) in Spain;
- in Mexico by HSBC Global Asset Management (Mexico), SA de CV, Sociedad Operadora de Fondos de Inversión, Grupo Financiero HSBC which is regulated by Comisión Nacional Bancaria y de Valores;
- in the United Arab Emirates, Qatar, Bahrain & Kuwait by HSBC Bank Middle East Limited which are regulated by relevant local Central Banks for the purpose of this promotion and lead regulated by the Dubai Financial Services Authority.
- in Oman by HSBC Bank Oman S.A.O.G regulated by Central Bank of Oman and Capital Market Authority of Oman;
- in Peru: HSBC Bank USA NA has an authorized representative by the Superintendencia de Banca y Seguros in Perú whereby its activities conform to the General Legal Financial System - Law No. 26702. Funds have not been registered before the Superintendencia del Mercado de Valores (SMV) and are being placed by means of a private offer. SMV has not reviewed the information provided to the investor. This document is for the exclusive use of institutional investors in Perú and is not for public distribution;
- in Singapore by HSBC Global Asset Management (Singapore) Limited, which is regulated by the Monetary Authority of Singapore;
- in Switzerland by HSBC Global Asset Management (Switzerland) AG. This document is intended for professional investor use only. For opting in and opting out according to FinSA, please refer to our website at https://www.assetmanagement.hsbc.ch/ if you wish to change your client categorization, please inform us. HSBC Global Asset Management (Switzerland) AG having its registered office at Gartenstrasse 26, PO Box, CH-8002 Zurich has a licence as an asset manager of collective investment schemes and as a representative of foreign collective investment schemes. Disputes regarding legal claims between the Client and HSBC Global Asset Management (Switzerland) AG can be settled by an ombudsman in mediation proceedings. HSBC Global Asset Management (Switzerland) AG is affiliated to the ombudsman FINOS having its registered address at Talstrasse 20, 8001 Zurich. There are general risks associated with financial instruments, please refer to the Swiss Banking Association ("SBA") Brochure "Risks Involved in Trading in Financial Instruments";
- in Taiwan by HSBC Global Asset Management (Taiwan) Limited which is regulated by the Financial Supervisory Commission R.O.C. (Taiwan);
- in the UK by HSBC Global Asset Management (UK) Limited, which is authorised and regulated by the Financial Conduct Authority;
- and in the US by HSBC Global Asset Management (USA) Inc. which is an investment adviser registered with the US Securities and Exchange Commission.

NOT FDIC INSURED ◆ NO BANK GUARANTEE ◆ MAY LOSE VALUE

Copyright © HSBC Global Asset Management Limited 2023. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, on any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of HSBC Global Asset Management Limited.

XB 2933/ EXP30APR2024