Asset Management

HSBC Alternatives Insights

The role of alternatives in a new investment playbook

August 2023

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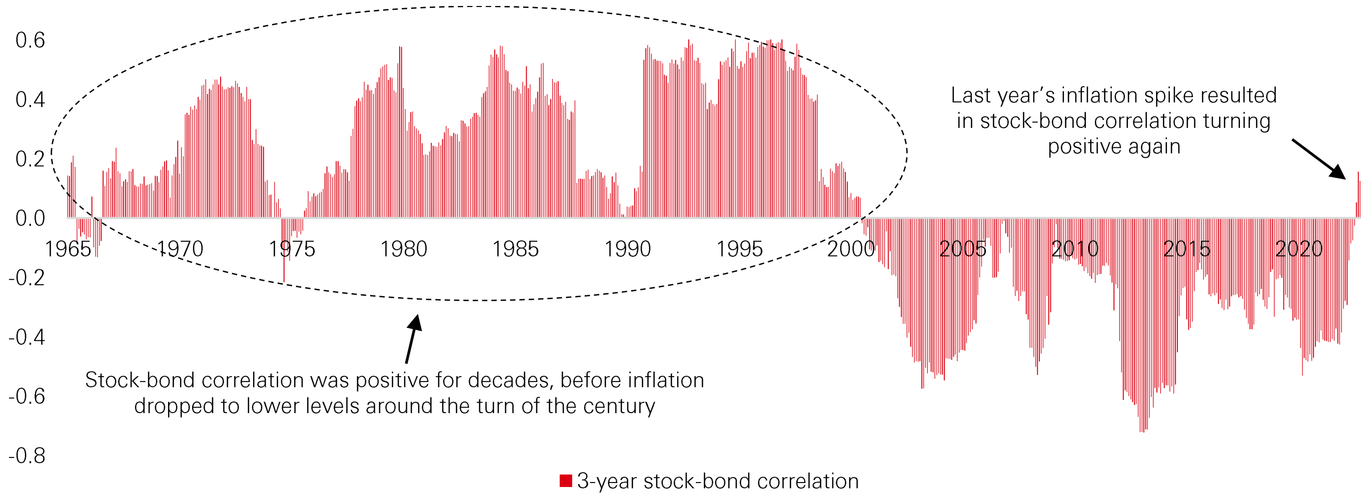
Key Investment Risks

Risk Considerations. There is no assurance that a portfolio will achieve its investment objective or will work under all market conditions. The value of investments may go down as well as up and you may not get back the amount originally invested. Portfolios may be subject to certain additional risks, which should be considered carefully along with their investment objectives and fees.

- **Illiquidity:** An investment in alternatives is a long term illiquid investment. By their nature, the alternatives' investments will not generally be exchange traded. These investments will be illiquid.
- **Long term horizon:** Investors should expect to be locked-in for the full term of the investment
- **Economic conditions:** The economic cycle and prevailing interest rates will impact the attractiveness of the underlying investments. Economic activity and sentiment also impacts the performance of underlying companies, and will have a direct bearing on the ability of companies to keep up with interest and principal repayments.
- **Valuation:** These investments may have no or a limited liquid market, and other investments including those in respect of loans and securities of private companies, may be based on estimates which cannot be marked to market until sale. The valuation of the underlying investments is therefore inherently opaque.
- **Strategy Risk:** Investments into alternatives may, among other risks, be negatively affected by adverse regulatory developments or reform, credit risk and counterparty risk. The credit market bears idiosyncratic risks such as borrower fraud, borrower bankruptcy, prepayment risk, security enforceability risk, subordination risk and lender liability risk.
- **Investor's Capital At Risk:** Investors may lose the entirety of invested capital

Following extraordinary returns across multiple asset classes in 2021, the market climate since 2022 has become daunting to many investors as they have been faced with a series of stress tests ranging from high inflation to central bank policy tightening in response. With higher inflation and interest rates, listed stocks and bonds have become positively correlated for the first time since the turn of the century, and both turned negative in 2022.

Stock-bond correlation through history[1]

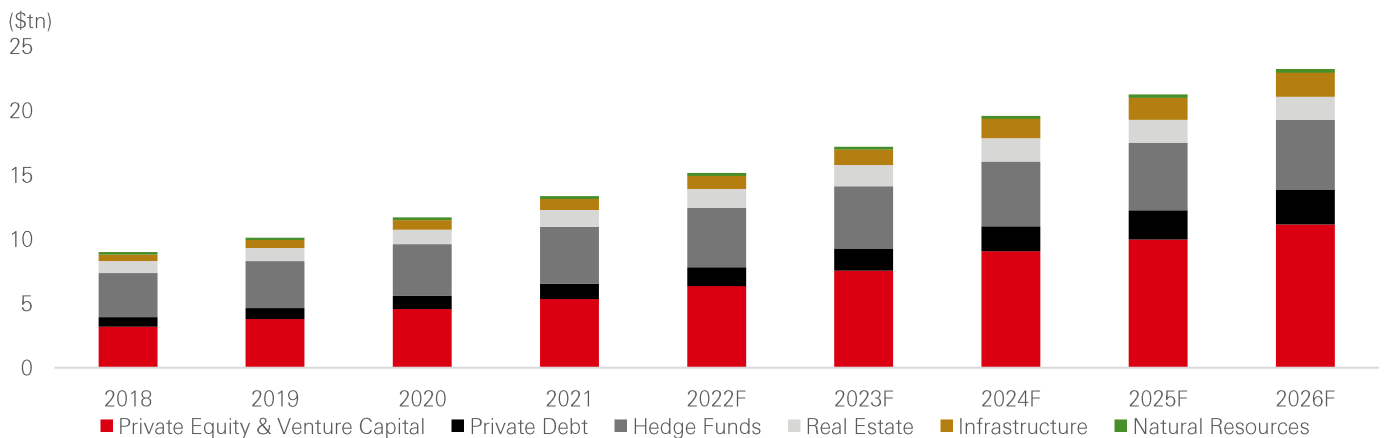


1. Source: HSBC Asset Management, Macrobond, December 2022.

This regime shift has led investors to look for "new diversifiers". As the name suggests, alternatives offer exposure to investments with different drivers of returns and thus useful diversification benefits. Additionally, certain alternative assets that generate real cash flows offer additional appeal amidst an environment in which inflation remains stubborn.

The term 'alternatives' encompasses a wide spectrum of sub-segments, including infrastructure equity, private equity, venture capital, infrastructure debt, private debt and hedge funds. Per the chart below, their appeal supports projections for investment to grow significantly in the coming years. Aside from their typically low correlations with traditional markets, these alternative investments have a number of specific features for investors to consider before allocating to them within portfolios.

Alternative assets under management and forecast[2]



2. Source: Preqin forecasts, as of March 2021 ("F" denotes forecasted figure).

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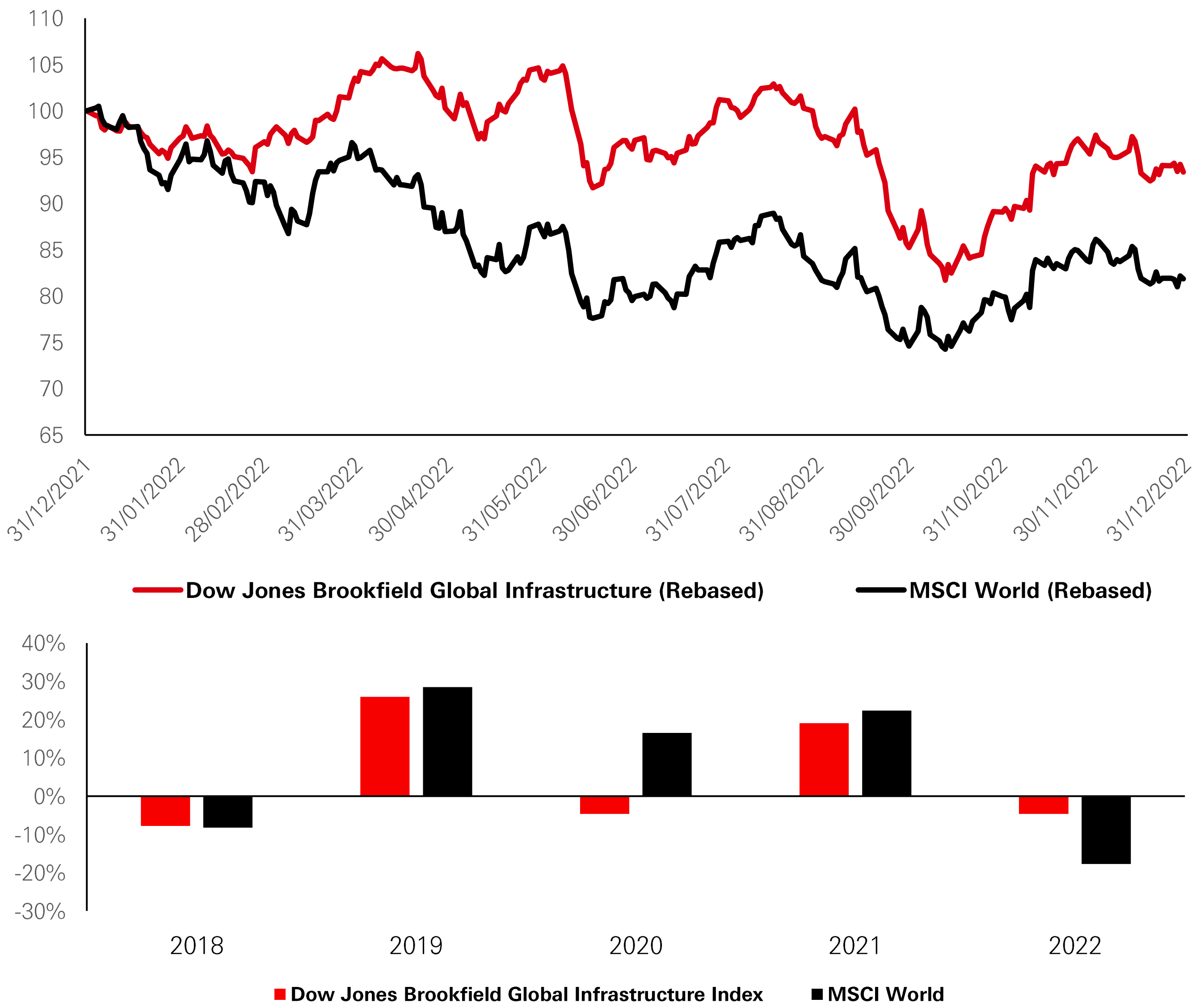
Source: HSBC Asset Management as of June 2023

Infrastructure assets are tangible assets which, through the nature of the cash flows generated, come with an inflation-linked return profile. That's because infrastructure companies can typically pass on rising costs through price adjustments, to varying extents depending on sectors and jurisdictions. For instance, utility assets often operate with government-regulated pricing mechanisms or long-dated contracts that are embedded with explicit links to inflation measures. This results in top line revenues that are inflation-hedged. Even if the contracts are not explicitly linked to inflation, many infrastructure assets operate in industries with high barriers to entry and enjoy a dominant market position. Through their pricing power they are able to maintain a reasonable return on equity. On top of that, infrastructure assets that produce commodities such as energy, a key driver of inflation, have thrived in 2022.

Nevertheless, the term "infrastructure" encompasses a very broad range of assets. An active approach is important in order to select investments that actually share the desired economic and risk/return characteristics. As the precise implications of inflation vary across different sectors and geographies, we believe that an active, bottom-up investment process focusing on quality and value can provide an infrastructure equity portfolio with the defensive qualities needed to offer valuable diversification in today's environment of higher inflation and recession fears.

Infrastructure equity outperformed global equity in 2022 amidst rising inflation[3]



3. Source: S&P Dow Jones, MSCI, as of 31 December 2022. Indices are expressed in USD net total returns. All data rebased to 100 as of 31 December 2022.

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Source: HSBC Asset Management as of June 2023

The long-term approach of private equity investments makes short-term volatility less of a concern. Not being publicly listed means that volatility is also less visible, with mark-to-market valuations often quarterly. More importantly, as part of this long-term approach investors gain exposure to early-stage companies at the heart of key long-term trends, particularly within venture capital.

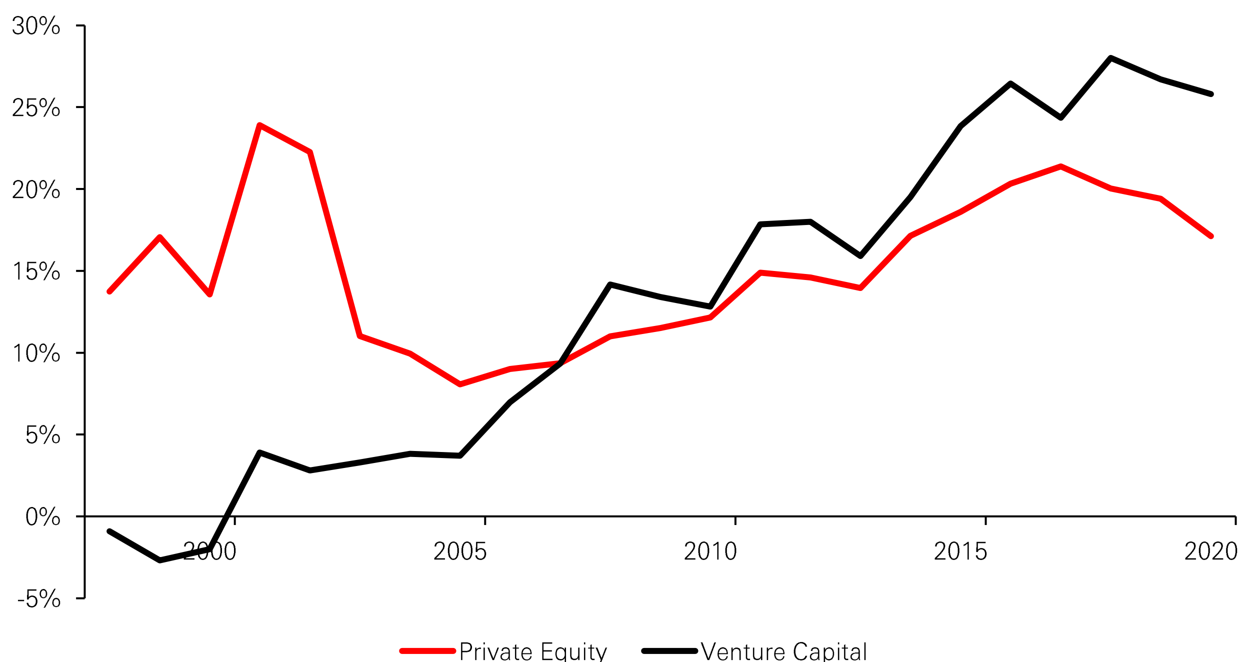
Of course, these unlisted assets are also less liquid. Investors are typically required to lock up their capital commitments during the fund term to allow portfolio companies to grow and unlock their potential value over time. Accordingly, investors are generally compensated with an illiquidity premium, or discount in asset pricing, supporting return potential.

As it has for public stocks, the risk-off market sentiment since 2022 has inevitably weighed on valuations and the exit opportunities for private equity, including IPOs, buyouts and mergers. However, private equity and venture capital funds may potentially help investors navigate these swings in valuations since portfolio investments are naturally diversified across different points of entry over an investment period of around three to five years. Annual vintage programs offer further diversification as investors can commit to successor funds across multiple vintage years (which refers to the year in which a private equity fund made its first investment). Valuation adjustments made on the back of the prevailing bearish sentiment may also provide opportunities for recently launched or upcoming new funds to selectively make investments at relatively appealing valuations.

Historically, we have seen the median private equity fund delivering positive net internal rates of return for all vintages since 1980, and the same has been broadly true for venture capital funds - demonstrating their resilience amidst market disturbances ranging from the Global Financial Crisis to the COVID-19 shock.[4]

Historical resilience of private equity and venture capital funds[4]

Private Equity and Venture Capital Median Net IRR (%) by Vintage Year



4. Source: Pitchbook as of 30 September 2022. Private Equity / Venture Capital in all regions are calculated using data for over 14,000 Private Equity funds / 24,000 Venture Capital funds of vintages between 1998 and 2020 with performance as of 30 September 2022 and include liquidated funds. All returns are net of management fees, expenses and carry. The chart does not illustrate funds raised in 2021 or later as these are likely to be in their initial investment period and therefore returns are not representative of their expected long-term performance.

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Source: HSBC Asset Management as of June 2023

We believe in the importance of a selective investment process in this challenging market environment. With late-stage private equity, we favour companies with market leading positions in defensive or secular growth sectors in order to improve portfolio resilience through steady corporate profitability amidst rising costs, rather than passively waiting for valuation expansion to return. In venture capital, we have seen companies at early funding rounds enjoying more resilient investment demand, particularly given the significant dry powder available. Their valuations have remained relatively grounded and therefore provide more future room for long-term valuation expansion. Early-stage ventures also offer more potential exit options such as trade sales, acquisition, secondary sales, future funding rounds, and so on – making them less impacted by the recent slowdown in IPO activities.

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Source: HSBC Asset Management as of June 2023

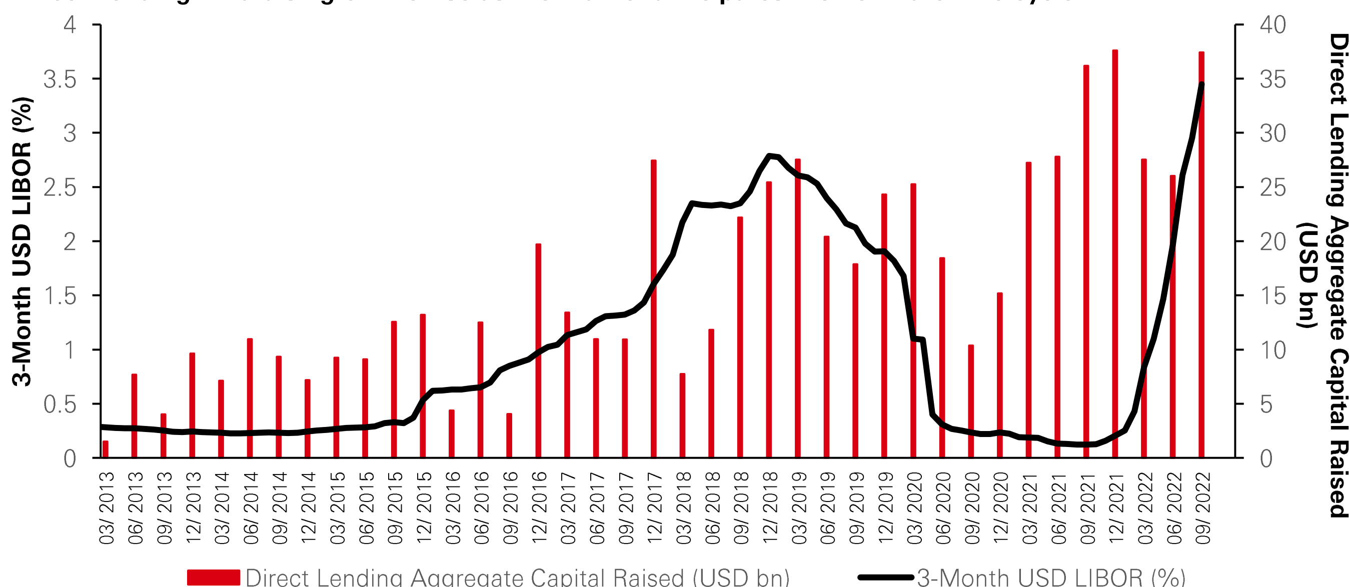
With monetary policies tightening across major economies as central banks attempt to fight against rising inflation, mainstream fixed rate government and corporate bonds have been vulnerable to the steep increase in yields, devaluing their traditional role as portfolio diversifiers. However, floating rate debt investments can offer some protection since valuations are less affected by interest rates. Interest on floating rate debt is based on a base rate plus a spread (which may, in some cases, be adjusted over time via step-up mechanisms). The base rate is generally reset every 1, 3 or 6 months, and therefore will increase in line with the rising interest rate environment. As a result, floating rate loans, due to their regular reset of the base rate applied, and typically shorter maturity, tend to have smaller exposure to interest rate risk and inflation compared to fixed rate bonds.

Where can investors find these floating rate loans? In the infrastructure space, greenfield loans, originated during the construction phase of infrastructure projects, are more often floating rate loans with five-to-seven-year maturity schedules. Brownfield loans, on the other hand, originated during the operational phase, are more often fixed rate debt, which is usually externally rated and investment grade. From a credit quality point of view, the majority of higher-yielding or unrated infrastructure debt is floating rate, while the investment grade space comprises a mix of fixed and floating rate structures.

In addition to infrastructure debt, private debt, such as direct lending to mid-market companies, also typically adopts a floating rate structure. Private equity constitutes the vast majority of direct lending transactions in regions such as Europe, so private debt deployment is underpinned by the dynamics in the private equity space. The loans are generally used to support private equity sponsors in their leveraged buyouts and subsequent bolt-on acquisitions, growth capital projects, re-financing and re-capitalization. As private equity sponsors seek to develop their portfolio assets through these projects, they will typically seek to fund follow-on financing opportunities first with their existing lenders. Therefore, we believe that direct lending asset managers with large incumbent portfolios are likely to enjoy a more resilient market for deployment of funds. Furthermore, as the economic environment becomes more challenging, leveraged loans backed by private equity sponsors can enjoy an additional source of follow-on capital for growth and liquidity when needed.

With the market currently facing a confidence shock, direct lending asset managers may also be able to negotiate higher loan margins and a greater level of protection through covenants when agreeing terms with borrowers. While admittedly, borrowers would be faced with an increasing cost of borrowing as market interest rates rise, we believe that more protected senior segments would be less vulnerable. Also, adopting a disciplined credit underwriting process that focuses on high quality deals with low leverage, strong covenant protection and attractive pricing will give rise to a more resilient portfolio.

Direct Lending fundraising on the rise as the market anticipates the next rate hike cycle[5]



5. Source: Preqin, aggregate capital raised across Direct Lending strategies, as of 30 September 2022. European Central Bank, US Dollar 3-month British Bankers` Association (BBA) LIBOR - Historical close, average of observations through period, as of 30 September 2022.

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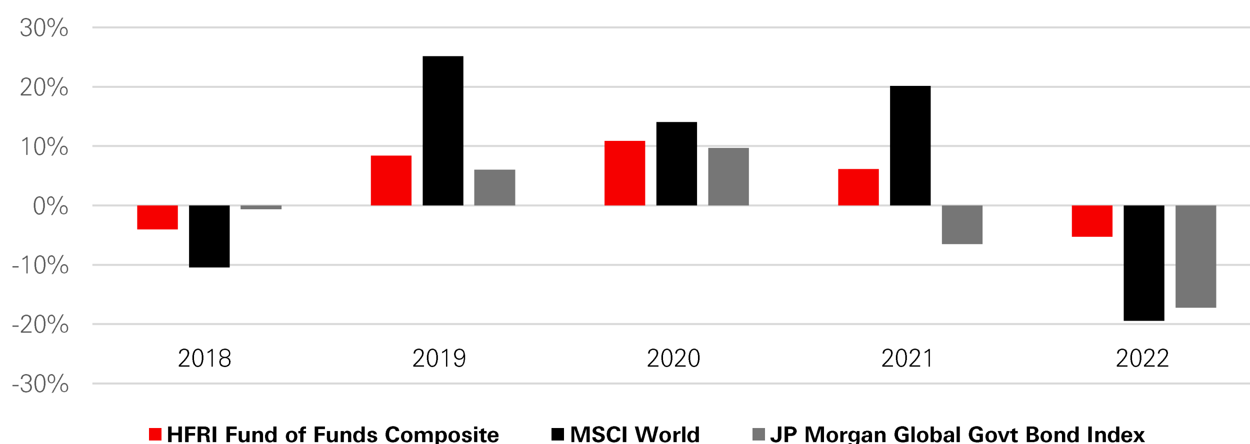
Common misconceptions around hedge funds include that they are inherently very risky or consistently underperform equity markets. In fact, hedge funds can have a significant part to play in capital preservation and portfolio diversification thanks to reduced downturns compared to the broader equity markets and low correlations with traditional asset classes.

Traditional funds are typically designed to track or benchmark against traditional markets, hence their returns and volatilities are usually similar to the underlying markets, within a limited range of tracking error. In contrast, most hedge funds have an absolute return profile; thus their performance is not designed to be directly related to the direction of traditional markets. In other words, they are able to benefit not only from rising prices, but also from falling prices through short selling. Hence, they may seek to take advantage of both "risk-on" and "risk-off" strategies to smooth out market volatility.

In general, hedge funds tend to capture a reasonable portion of the upside when equity markets are performing strongly, and to outperform equities during periods of market downturns, as was the case in the 2018 taper tantrum, 2020 COVID shock, and 2022. As rising yields have challenged the valuations of both traditional equity and fixed income assets in 2022, resulting in their returns becoming increasingly correlated, we have now seen hedge funds outperforming both global stocks and bonds.[6]

Index performance during market downturns[6]



6. Source: Bloomberg, as of 31 December 2022. The MSCI World Index hedged in USD is used as the proxy for global equities, the HFRI Fund of Funds Composite Index for hedge funds, and the JP Morgan Global Government Bond Index unhedged in USD for global bonds. Hedge funds exhibited smaller drawdowns than global equities during market downturns.

The hedge fund universe comprises a wide array of strategies involving different asset classes and risk/return characteristics. For instance, equity strategies that take both long and short positions may help to smooth out a portfolio's return streams by reducing drawdowns, especially amidst severe market turmoil. Equity market neutral strategies are in many ways similar to long/short strategies, but they have an even stronger emphasis on eliminating net exposure to overall market risk, and hence performed well in 2022. Event-driven strategies focus on corporate events such as M&As, takeovers, restructuring, dividends, buybacks, spinoffs, and IPOs. Thus, they provide the potential to generate idiosyncratic returns which are largely catalyst-driven and uncorrelated to the direction of equity markets.

Last year we saw managed futures and macro strategies shine. This is in particular due to many of their long/short exposures to commodities, currencies, short-term interest rate futures and sovereign bonds having benefited from strong trends such as soaring commodity prices, a strengthening US dollar and rising interest rates. Thanks to their flexible trading styles and broad asset class universe, they are often able to benefit from market dislocations with limited correlation to other asset classes. Given the wide variety of hedge fund strategies available, global multi-strategy funds of hedge funds may provide investors with instant diversification and more dynamic allocation across managers and strategies, along with access to high-quality managers and funds through extensive investment and operational due diligence processes.

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Key Takeaways

As economic and market conditions remain challenging and listed stocks and bonds are now more correlated, investors are seeking new ways to achieve their risk/return objectives and portfolio diversification. In alternative assets, we can find a number of important characteristics that could assist in this regard, including low correlations with traditional equity and fixed income assets, low sensitivity to market shocks, and insulation from rate hikes and inflation. While the illiquid nature and generally higher risk profile of alternative assets mean that they are not suitable for all investors' portfolios, we see them as not just a tool to navigate through short-term market volatility, but much more importantly, as part of investors' long-term allocations in order to capture portfolio benefits consistently and adapt to the structural and thematic changes that will take place over the next decade in the new economic and market environment.

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