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Hedge Funds: Siren Songs versus Unvarnished Facts

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Hedge funds promise “attractive uncorrelated returns” that are intended to enhance the diversification of a traditional portfolio. But do these promises stand up to close scrutiny?

Hedge funds are frequently marketed on the grounds that they are a “source of genuine diversification”. Particularly after the poor experience of mixed equity-and-bond portfolios in 2022, hedge funds are considered appealing because they are said to deliver uncorrelated returns and to be more effective at diversifying a conventional portfolio. Let us examine these claims one by one.

The year 2022 really was an unfortunate coincidence of negative returns for equities and – owing to rising interest rates – the worst year on record for Swiss franc bonds. As a result, Pictet’s pension fund index with a 40% equity allocation (Pictet LPP 40, 2000 index family) produced a return of –14.8%, and –15.7% with a 60% equity allocation. While 2022 was not quite as bad as 2008 during the financial crisis, when the index returns were –17.3% and –26.6% respectively, it was nonetheless extremely painful for many investors.

Hedge funds deliver meagre returns

For long-term investment success, however, it is not any individual year that matters, but rather the long-term interplay between the various assets. Let us therefore first take a look at the risks and returns of different asset classes:

It is striking to note that, over a period of almost twenty years, hedge funds have produced an average negative return of –0.8% per annum. With currency hedging against the Swiss franc, this figure is –0.1%. This is even lower than the modest annual return of 1.7% delivered by Swiss franc bonds; and yet hedge funds carry significantly higher risks. In addition to the higher risks of price fluctuations (volatility), their worst-performing year, at –28.2%, was also worse than that of bonds, at –12.1%. Furthermore, the number of negative years for hedge funds has been twice as high over this twenty-year period.

It follows, therefore, that hedge funds trail significantly behind equities in terms of return and behind bonds in terms of risk. Might their advantages, then, lie in the context of a portfolio?

In a conventional mixed portfolio, risk is dominated by the equity allocation and by any real estate investments. Diversifying these risks requires investments that behave differently – in other words, investments whose values do not rise or fall at the same time. This is measured using the correlation coefficient – a value of 1 indicates that the investments fluctuate perfectly in parallel, while a value of 0 indicates that they are completely independent. Hedge funds have an average correlation of 0.7 with equities and real estate, which is considerably higher than their correlation of 0.33 with bonds. Bonds are therefore, on average over the years, an important and more effective diversifier – although

Return in Swiss francs over almost twenty years (January 2007 to June 2026)

Asset class	Foreign equities	Swiss equities	Swiss franc bonds	Swiss real estate	Hedge Funds	Hedge Funds (currency-hedged)	Private Equity	Gold
Index	MSCI Welt	SPI	SBI	KGAST, WUPIX-A/F	HFRX Global	HFRX Global (CHF hedged)	LPX Direct Listed PE	ZKB Gold
Return p.a.	6.4%	5.6%	1.7%	6.1%	–0.8%	–0.1%	–0.7%	7.7%
Volatility p.a.	17.8%	16.1%	4.4%	5.2%	9.3%	8%	25.5%	17%
Worst year	–43.7%	–34%	–12.1%	–3.7%	–28.2%	–24.2%	–66.5%	–30.1%
Best year	28%	30.6%	7.4%	16.5%	13.5%	12.7%	43.1%	43.5%
Number of negative years	4	6	5	3	10	7	8	7

Source: Bloomberg, www.hfr.com

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this did not work in the year 2022, as we have seen above.

Gold shows low correlation with equities

Gold also has a low correlation of 0.25 with the other real assets and, according to the table, delivers an attractive return as well. Gold is therefore a sensible addition to the portfolio. It should be noted at this point, however, that while gold has enjoyed two exceptionally strong decades, its average annual return over several decades was only half as high! Caution is therefore warranted against overly optimistic conclusions when it comes to adding gold to a portfolio.

So what does this actually look like in practice, in terms of a concrete asset allocation? To illustrate this, two portfolios are calculated: one with a 40% equity allocation (Portfolio A) and one with a 50% equity allocation (Portfolio B; see the table below). The first thing to note is that Portfolio A has roughly the same volatility as currency-hedged hedge funds; yet its annualised return is 4.5 percentage points higher (+4.4% versus –0.1%). The other performance measures, such as the worst and best years and the number of negative years, are also better for Portfolio A.

Portfolio B, meanwhile, has the same volatility as non-currency-hedged hedge funds; yet its average annual return exceeds that of hedge funds by a substantial 5.7 percentage points (+4.9% versus –0.8%). Here too, the other performance measures of Portfolio B are superior. In this comparison, conventional mixed portfolios outperform hedge funds in every respect.

Hedge funds do not improve a portfolio

If we now examine whether adding a 10% hedge fund allocation to Portfolio B improves diversification – that is, an allocation of 10% hedge funds and 90% of Portfolio B – we find that this marketing promise cannot be fulfilled: While the return falls by more than half a percentage point, from 4.9% to 4.3% per annum, volatility remains almost unchanged. What is more, the return in the worst year deteriorates by one percentage point, and the number of years with negative returns rises.

If one instead turns to another alternative investment – private equity – for diversification purposes, this too fails to bring any improvement – quite the opposite, in fact! Only the addition of gold has helped over this almost twenty-year period. That said, the caveat mentioned above regarding the return on gold in a very long-term context still stands.

Why do hedge funds hold such appeal?

This raises the further question of why, despite these facts, marketing in favour of hedge funds nonetheless seems to pay off. Consider a foundation with assets of CHF 50 million. If it invests through a traditional,

Return-risk characteristics of portfolios

Portfolio type	Traditional portfolios		Portfolios with an allocation to alternative investments		
Portfolio	Portfolio A: 40% equities*	Portfolio B: 50% equities**	90% Portfolio B, 10% hedge funds	90% Portfolio B, 10% private equity	90% Portfolio B, 10% gold
Return p.a.	4.4%	4.9%	4.3%	4.5%	5.3%
Volatility p.a.	7.9%	9.3%	9.2%	10.7%	8.9%
Worst year	–13.6%	–17.9%	–18.9%	–22.8%	–16.4%
Best year	15.1%	17.7%	16.6%	19.2%	17.6%
Number of negative years	3	4	5	5	3

*Composition: 40% equities (split equally between Switzerland and abroad), 45% Swiss franc bonds, 15% Swiss property
**Composition: 50% equities (split equally between Switzerland and abroad), 35% Swiss franc bonds, 15% Swiss property

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actively managed mixed-asset mandate, the management costs likely amount to around 0.3%. After twenty years, the assets will have grown, net of costs, to around CHF 122 million.

If a 10% hedge fund allocation is added to the traditional mixed portfolio by way of a specialist fund-of-funds mandate, the question arises as to how much this specialist mandate costs. The cost ratio for hedge funds is likely to be at least ten times higher than that of traditional investments; a plausibility check via an AI query confirms this: "The economically relevant total burden of a hedge fund is therefore often not 2%, but – depending on the performance achieved – more likely 3 to 5% p.a. or more."

The costs of the underlying funds should already be reflected in the hedge fund return as shown in the first table, so only the fund-of-funds cost layer needs to be taken into account here. 1.5% is assumed for this purpose. The final asset value comes to around CHF 113 million – CHF 9 million less than with the traditional portfolio! Of this difference, CHF 1.2 million flows to the fund-of-funds provider, with the remainder resulting from the underperformance, which is partly attributable to the high costs of the sub-funds.

Owing to poor performance and costs, the specialist fund-of-funds mandate shrinks from an initial CHF 5 million to CHF 3.2 million by the end of the term, meaning that it no longer accounts for 10% of total assets, as it did initially, but only just under 3%. If annual rebalancing takes place so that the specialist fund-of-funds mandate always accounts for 10% of the foundation's total investments, funds are continuously reallocated from the better-performing portion of the portfolio to the weaker-performing portion.

This further exacerbates the situation at the end of the period: the final asset value then amounts to only CHF 107 million, while the total cost amount for the fund-of-funds layer nearly doubles to CHF 2.2 million. In this case, the foundation ends up with almost CHF 15 million – or 12% – less in final assets than it would have had by investing in traditional assets.

What drives investors?

The providers' motivation for marketing is now clear: Even small allocations promise high revenue potential. But what drives investors? For new investments, it may be belief in high promised returns or a misunderstanding of diversification. Where a hedge fund allocation already exists, hardly any of those involved has an incentive to prepare a transparent, net-of-costs return history.

Why is this? Firstly, in an institutional setting, those responsible for investments are likely to have changed three or four times over a twenty-year period. Secondly, if the investment returns are unsatisfactory, someone has to take responsibility. It is worth recalling Molière's wise words: 'We are responsible not only for what we do, but also for what we fail to do.'

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