Asset Risk | Consulting

Monthly macro focus

June 2026

The return of hedge funds

Macro focus

The return of hedge funds

> *Back once again. The renegade master of ill-behaved returns.*

Hedge funds have spent much of the past decade out of favour. That made sense in a world of zero rates and rising equity markets.

That world has changed. With equity valuations stretched and macro conditions less forgiving, the case for genuinely diversified and, at times, ill-behaved returns looks stronger than it has for years.

A cycle turns

The hindsight fund is always in the top quartile.

The advent of quantitative easing following the financial crisis and its expansion in response to the Covid-19 pandemic meant that from roughly 2009 to the end of 2021, in hindsight, investing was unusually simple. Interest rates sat near zero, inflation was muted and liquidity was abundant. In that environment, a traditional 60/40 portfolio delivered more than 9% per year over this period with equities dominating outcomes.

This backdrop had two consequences:

- diversification looked unnecessary
- complexity looked expensive

Hedge funds, with higher fees and more nuanced return drivers, lagged headline equity indices and drifted out of favour. That critique was not entirely wrong.

Over recent years, hedge funds have delivered around 10 to 12% annual returns, versus materially higher equity market gains in a strong bull run. However, this analysis is a little too simplistic.

It judged a diversifying asset on how it behaved in a period when diversification was, in hindsight, not needed.

In 2008, Warren Buffett bet $1m that a low cost S&P 500 index fund would beat a diversified portfolio of hedge funds over 10 years. Ted Seides took the other side. By 2017 the index fund had returned about 7% a year, versus roughly 2% to 3% for the hedge funds (after fees). The bet became a shorthand for hedge fund underperformance in a post-crisis bull market.

A regime shift

There has been a change. We have moved from a period of cheap capital to one where:

- inflation has returned
- interest rates are structurally higher
- macro volatility has increased

Hedge fund returns tend to be closely linked to the opportunity set created by dispersion, volatility and the cost of capital.

Two broad empirical patterns stand out:

1. Higher rates support hedge fund returns.
Across long data sets, hedge fund excess returns have tended to rise alongside interest rates. This is partly mechanical, through higher cash returns and short rebates, and partly behavioural, through greater opportunity to exploit mispricing.

2. Performance improves in tougher markets.
Since 1990, hedge funds have outperformed equities and traditional portfolios during periods of above average inflation and more normal rate regimes.

A simple way to frame this is that hedge funds do not require markets to rise to generate returns. They require markets to move, disagree or break.

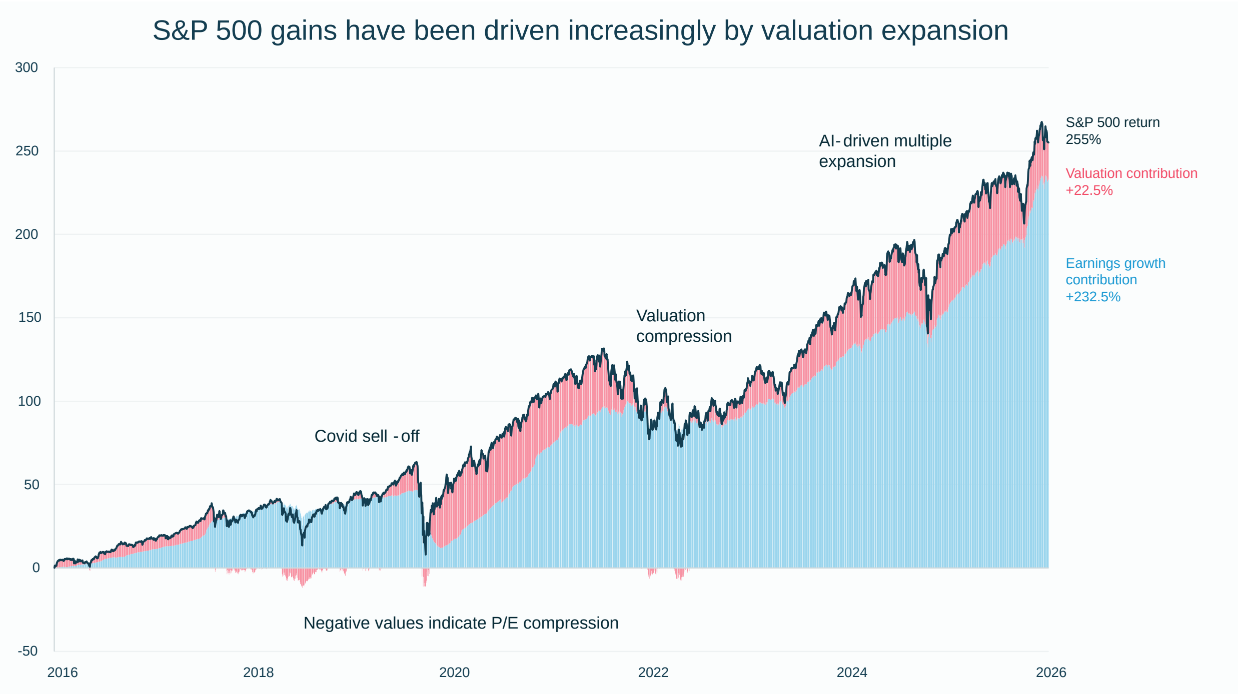
Equity valuations

Another major change has been in equity valuations. The starting multiple for equities now is much more demanding than it has been in the recent past.

Market returns can be decomposed into earnings growth and multiple expansion. There are question marks about the sustainability of both.

This chart decomposes S&P 500 returns into earnings growth (blue bars) and changes in valuation multiples (orange bars), showing how much each has contributed to overall market performance (white line).

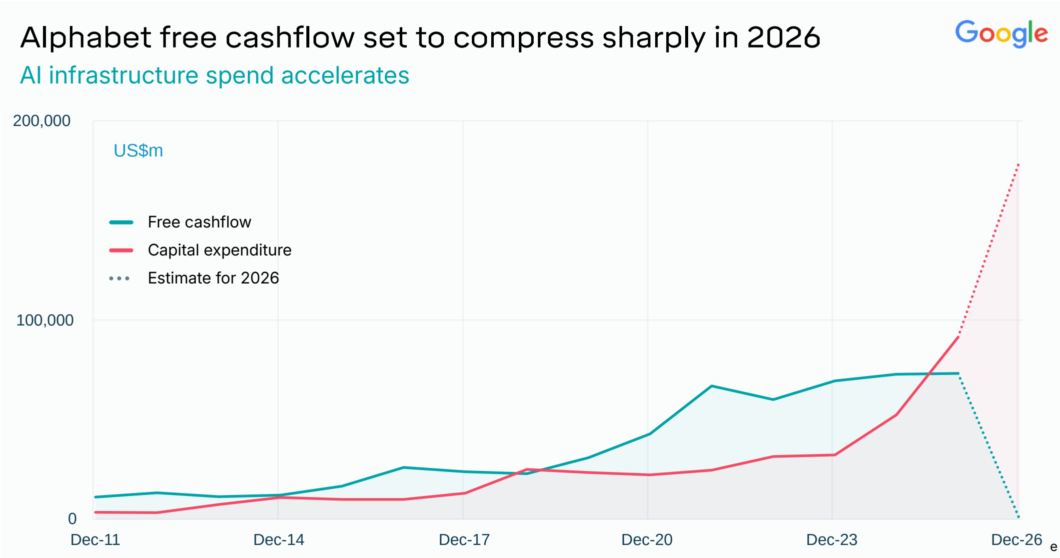
Strong earnings have driven most market gains, with valuation expansion providing an additional tailwind.



Source: Bloomberg. Earnings growth and P/E multiple contributions have been proportionally adjusted to match the S&P 500 total return. Minor differences in the original Bloomberg decomposition arise from interaction effects between earnings growth and valuation changes.

Considerable earnings growth has come from the build-out of AI technology, including required manufacturing capabilities and infrastructure. Many of the advantages that AI brings to businesses are obvious and companies have been willing to invest heavily, often sacrificing all free cash flow in order to maintain competitive positions.

Over time, incremental improvements are likely to fade, pricing pressures may emerge and company management teams may shift back towards cash generation. At that point, earnings expectations may prove too optimistic.

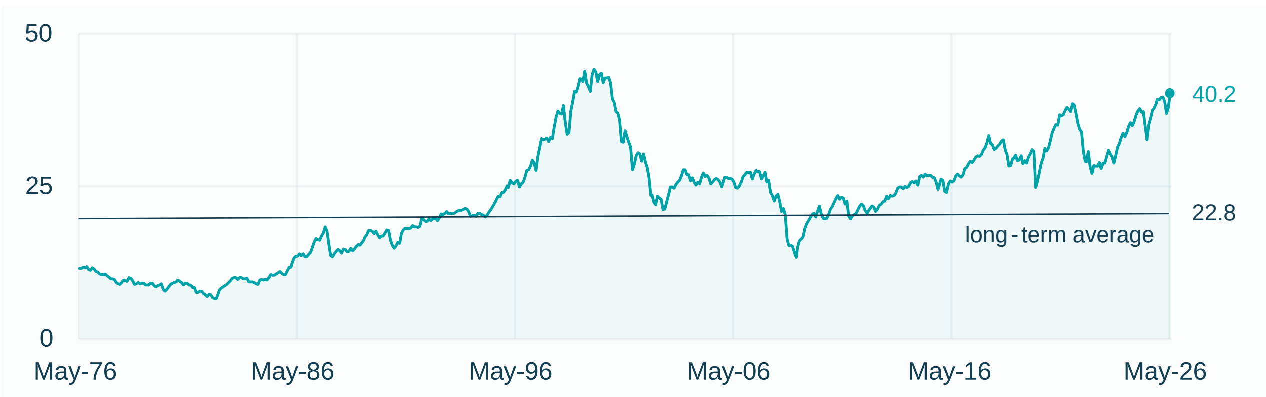


Source: SEC 10-Q and 10-K filings for Alphabet Inc., CEO statement on capex guidance from abc.xyz.

Global equity markets now trade on a trailing P/E of around 23, above long-term averages. Many major markets sit at elevated CAPE percentiles relative to history.

The US market in particular has traded at valuation levels well above its long run mean. High valuation multiples do not cause drawdowns. They do, however, reduce the margin for error and compress forward return expectations.

Shiller CAPE measures equity valuation by comparing prices to average, inflation-adjusted earnings over the past 10 years.



Source: Shiller Data shillerdata.com

Investors face an uncomfortable asymmetry:

- strong recent returns
- more modest prospective returns
- a wider range of possible outcomes

This combination is precisely where diversification earns its keep.

What do hedge funds actually offer?

The term hedge fund is used loosely. It can refer to highly leveraged equity strategies or market neutral approaches with varied sources of return.

In practice, it is a Wildchild of an asset class, diverse, unconstrained and at times deliberately different. In an environment where there is uncertainty around valuations and earnings, strategies with low market beta and less dependence on broad market direction should attract attention.

Hedge funds aim to deliver diversified, risk-adjusted returns through flexibility, specialist strategies and less dependence on market direction.

On the plus side, hedge funds can offer:

- **Access to a wide range of flexible opportunities**, including long and short positioning and dynamic exposure management
- **Access to inefficiencies**. Strategies such as event driven, relative value or macro target opportunities that long only portfolios cannot capture.
- **Improved risk adjusted returns**. Historically, hedge funds have delivered competitive returns with lower volatility and better downside protection than equities.

The trade offs

Fees matter. Management and performance fees can materially reduce net returns and require careful negotiation.

Complexity and dispersion. Strategies are heterogeneous and outcomes vary widely between managers. The gap between top and bottom quartile managers is significant.

Liquidity constraints. Lock ups and gating can limit flexibility.

The benefits can be compelling, but fees, liquidity and manager selection often determine the outcome.

If you know how to look and analyse them, identifying some of the best hedge funds can be straightforward. Accessing those managers can be more difficult, given capacity constraints imposed by many of the most successful firms.

Taken together, this is not an asset class you buy passively. Outcomes depend heavily on selection and portfolio construction.

Why the opportunity is back

Put the pieces together and the argument becomes clearer. First, the macro tailwinds have shifted. Higher rates and inflation increase the opportunity set for active, unconstrained strategies.

Second, traditional diversification is less reliable. The correlation between equities and bonds has been less stable, weakening the classic 60/40 framework.

Higher rates, elevated valuations and less reliable diversification have strengthened the case for hedge funds.

Third, starting valuations matter more. When equities are expensive, the cost of relying on them exclusively rises.

Finally, the industry has matured. With over $5tn of assets, hedge funds are now a core institutional allocation, with broader strategy sets and better infrastructure than in earlier cycles.

What this means in practice

Over the long term, equities are likely to form a large part of most diversified portfolios. Right now, however, this is a reminder to diversify when it feels least necessary.

A pragmatic approach to including hedge funds typically involves:

- combining complementary strategies such as macro, relative value and equity long-short
- focusing on managers with clear, repeatable sources of return
- paying close attention to fees and alignment
- constructing portfolios deliberately, not accumulating funds opportunistically

The question is not "what return will this allocation deliver?" but "what role does it play in the portfolio?"

In conclusion

Hedge funds did not disappear. They were crowded out by an unusually benign environment for traditional assets. That environment has changed. With equity valuations elevated and macro conditions more volatile, the case for non-market driven returns is stronger.

Hedge funds offer one route to achieve this, but only when used well. Access, selection and pricing are the difference between average outcomes and good ones.

It is a good time to be diversifying. Done properly, hedge funds can help. Done with care, they can help more. So yes, where appropriate, we would advocate adding some 'ill behaviour'.

Dr James R Cooke, CFA
Director of Research
james.cooke@assetrisk.com

Market commentary

Ceasefires and negotiated settlements for both Iran and Ukraine continue to be discussed but have yet to materialise.

Disruption to oil supply persists and commodity prices remain elevated. The transmission extends beyond energy. Higher fuel costs and disrupted shipping are feeding into fertiliser and transport costs, which in turn are pushing up agricultural prices, albeit unevenly.

Sir Keir Starmer, the UK prime minister, announced his resignation as leader of the Labour Party. This has triggered a leadership contest, with recent by-election winner Andy Burnham emerging as the clear frontrunner, although the process is still ongoing.

With inflation rising again, central bank guidance has shifted in a more hawkish direction. US inflation has moved back above **4%**, while the Federal Reserve now projects policy rates of around **3.8%** into year end, reinforcing the shift towards higher for longer. Markets have repriced towards the risk of further rate increases. Government bond yields have moved higher as a result, leading to broadly weaker bond prices. Equities have continued to appreciate, supported by strong earnings and positive guidance, particularly from companies exposed to artificial intelligence.

In the US, earnings expectations for 2026 remain robust, with growth forecast at over **20%**.While growth remains resilient for now, the macro mix is becoming less comfortable.

The SpaceX IPO completed during the period, raising roughly **$80bn** and briefly valuing the company above **$2tn**, marking the largest issuance on record and underscoring continued risk appetite.

Stagflation risks are not yet the base case in market pricing. However, the combination of firmer inflation and moderating growth means they are no longer remote. A further rise in concern would not be too surprising.

Geopolitical tensions, rising inflation and higher interest rate expectations are keeping markets alert, with resilient growth and strong equity performance offset by increasing concerns that stagflation risks are beginning to build.

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