BlackRock

Hedge Fund Solutions (“HFS”)

Diversification Rewritten

Preparing for a wider range of outcomes

BlackRock Hedge Fund Solutions

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HFS: Diversification Rewritten

Authors

Diana Myint
Managing Director,
Co-CIO of HFS

Albert Matriotti
Managing Director,
Co-CIO of HFS

Key Takeaways

- The range of market outcomes is widening, making it more difficult to rely on static portfolios as correlations shift and diversification benefits become less predictable.
- Investors are increasingly allocating to hedge funds as a flexible, unconstrained approach that can generate returns from multiple sources and provide a more adaptive form of diversification.
- Realizing these benefits requires more than broad exposure, with outcomes driven by the ability to identify, access, and combine high-quality managers within a disciplined portfolio framework.

A wider range of outcomes

Investors stepped into 2026 with an uncomfortable mix of conditions: asset prices hovering near all-time highs, a steady drumbeat of tail risks, and a growing sense that the old playbook for diversification is less reliable than it used to be. Recent volatility has already begun to challenge that balance. In this environment, markets can feel almost weightless. Prices respond more to narratives rather than underlying fundamentals, and even small shifts can cause sharp reversals.

The underlying dynamics are also more complex than they appear on the surface. We have an AI investment cycle that has become a pervasive force shaping capital allocation, market structure, and investor behavior across asset classes.

We have geopolitical fragmentation that can reprice commodities, supply chains, and investor sentiment overnight. And we have a policy regime where central banks are no longer moving in lockstep, which tends to show up as wider relative value opportunities, but also faster rotations when expectations shift.

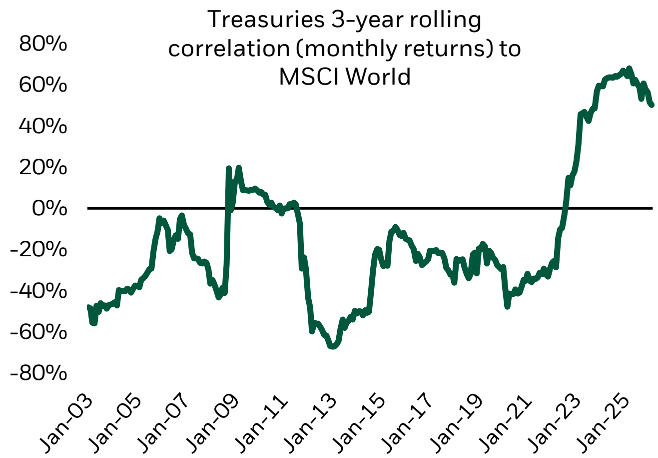
None of this is a call for imminent crisis. It is simply an observation that the range of plausible outcomes feels wider, and that markets are charging a higher price for complacency. In this setting, static portfolio construction becomes less effective, increasing the importance of flexible, actively managed sources of return that can adapt as conditions evolve.

Diversification is becoming less reliable

Correlations across asset classes are evolving in ways that challenge long-held assumptions behind traditional portfolio construction. The classic equity and bond mix, often viewed as a balance between growth and defense, has proven less effective in periods of stress. Take 2022 for example, when both stocks and bonds declined in tandem, leaving many portfolios exposed despite appearing diversified on paper.

More broadly, many portfolios are less diversified in practice than they appear. That's because the true drivers of risk have become more shared across asset classes. Equity leadership has been concentrated within thematic cohorts, credit has been buoyed by the same risk appetite that supports equities, and even assets that investors often treat as "ballasts" have behaved differently at key moments.

Rising correlation between equities and treasuries



Source: BlackRock. 1 February 2026.

Long-duration bonds, once a broadly accepted hedge to equity drawdowns, have at times moved together with risk assets. Gold, too, has behaved less like a defensive hedge and more like a tactical asset with distinct drivers, rallying alongside equities at various points over the past year. Even within equities, sector diversification can be misleading if the underlying exposure is ultimately to the same growth and liquidity factors.

The more relevant distinction is not the asset class label, but the risk it carries. When the market's dominant narratives stumble, the spillover can be broader than the portfolio construction framework suggests. AI is a good example. It is no longer just a "tech theme." It influences capex, power demand, credit issuance, and expectations for growth, productivity, and inflation. If that engine slows, the knock-on effects can show up across market segments that investors assumed were independent.

Taken together, these dynamics suggest that traditional diversifiers are less reliable than they once were. Assets that have historically provided protection can work for a period, then fail just as quickly, making it harder to draw on past relationships when constructing durable portfolios.

Portfolio construction is a key driver of outcomes

In this environment, portfolio construction plays an increasingly central role in determining investment outcomes. It requires moving beyond conventional notions of diversification, since simply owning many assets is not enough. The focus shifts to whether exposures behave differently, at different times, and for different reasons.

This requires more deliberate ownership of risk. It means stress-testing assumptions, looking through exposures to identify hidden concentrations, and understanding how quickly those exposures can be adjusted when market structure changes. It also means acknowledging that some assets can look stable in benign markets while carrying asymmetric downside in periods of stress, where low volatility can mask meaningful underlying risk.

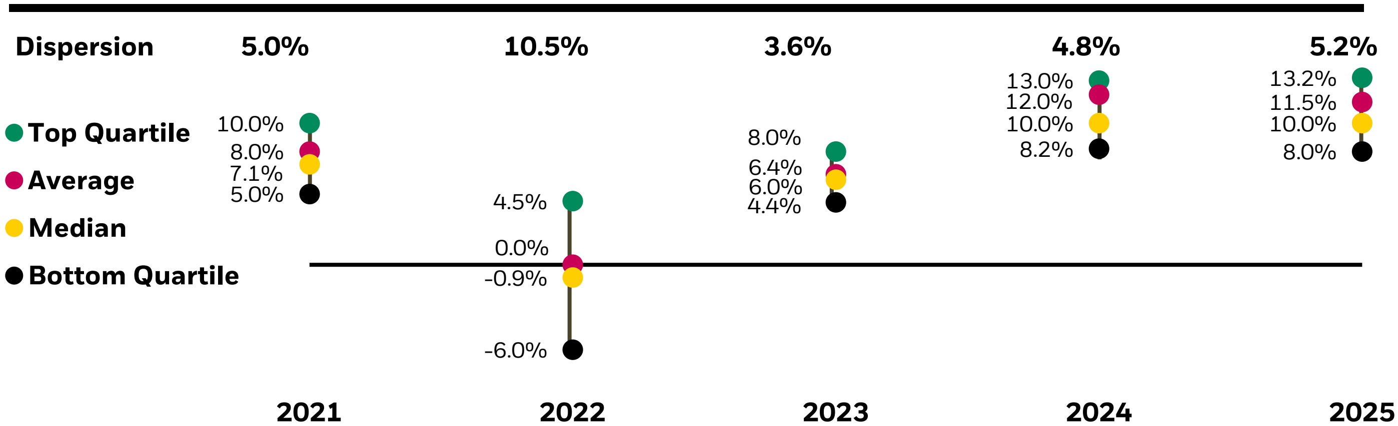
This is where hedge funds can play a distinct role, not necessarily as a replacement for traditional or private market assets, but as a flexible complement that can adapt across market regimes. Unlike more constrained investment strategies, they are not bound to directionally long exposures, can allocate across asset classes, and can reposition as conditions evolve.

For many investors, this provides a practical way to incorporate a more tactical lens into portfolios without needing to build that capability internally.

As dispersion, policy divergence, and structural disruption reshape the macro landscape, skilled hedge fund managers are well positioned to capitalize on these dynamics. They can harvest inefficiencies across markets, provide liquidity when it is scarce, and translate idiosyncratic opportunities into repeatable sources of alpha that are less dependent on market direction, while also preserving capital in periods of stress. However, broad exposure alone is unlikely to deliver desired results.

The same forces that create opportunities also increase dispersion in outcomes. Not all managers are equally positioned to capture these opportunities, and the gap between top- and bottom-performing hedge funds tends to widen in exactly the environments that feel most opportunity rich. Against that backdrop, the ability to identify, access, and size the right managers becomes a key determinant of strong and stable returns.

Distribution of realized returns across allocators' hedge fund portfolios



Past performance is not indicative of future results.

Source: Goldman Sachs Capital Introduction and Allocators Surveys, 2021-2025. All data as of 16 January 2026.

Investors are turning to hedge funds and specialized partners

Many investors are adjusting their portfolios in response to these forces. Hedge fund sentiment has improved meaningfully over recent years, and many investors are increasing exposure, often with a preference for diversified portfolios across both managers and strategies that can keep market beta in check. For investors who are not already incorporating these tools, it raises a natural question of how well their portfolios are positioned to navigate a wider range of outcomes.

What's notable is that the allocation decision is increasingly tied to portfolio architecture, not just return targets. Investors are looking for hedge fund allocations that can sit alongside traditional building blocks and behave differently when correlations rise, helping to deliver more resilient outcomes at the total portfolio level.

Delivering on this objective is not straightforward. Alpha is scarce, and identifying managers that will generate it consistently requires significant resources, access, and expertise. As a result, investors are increasingly turning to dedicated hedge fund allocators that specialize in constructing diversified portfolios, providing ongoing risk oversight and liquidity management, and acting as an extension of their own investment capabilities to support broader portfolio objectives.

Manager selection and access are critical to delivering on these objectives, given the vast universe of hedge funds and the fact that many of the most sought-after are typically closed to new investors. Gaining exposure requires a well-resourced and experienced team with long-standing relationships, a track record of early identification and investment, and the scale to be a meaningful partner. Those able to invest early and at scale are better positioned to secure capacity with top-tier managers over time, as well as more favorable terms, including discounted fees, enhanced transparency, and tailored structures (e.g., SMAs).

But not all approaches to constructing a multi-strategy and multi-manager hedge fund portfolio are the same, and the differences can be meaningful. When access is constrained and dispersion is high, outcomes are increasingly shaped by the ability to source, evaluate, and combine the right managers within a disciplined and process-oriented framework.

Our perspective

The next few years are likely to reward selectivity, discipline, and adaptability more than broad exposure. AI should continue to shape capital allocation and market behavior, but outcomes may become more fragmented as the cycle matures and the market focuses less on narrative and more on execution. Valuations can remain elevated for longer than many expect, but they also leave less room for disappointment. And with correlations evolving, diversification needs to be measured by behavior under stress, not by asset class labels alone.

HFS: Diversification Rewritten

Our role is to help investors navigate that complexity through a disciplined investment process that combines our expertise in sourcing, evaluating, and monitoring hedge funds with a thoughtful and rigorous approach to risk management and portfolio construction. That means long-standing manager relationships with established access and preferential terms, the ability to assess both strategy edge and operational quality with appropriate depth, and an approach to portfolio construction that is intentional in how strategies are integrated, risks are calibrated, and exposures are managed across market conditions. Bringing these elements together ultimately drives more consistent outcomes across varied market environments.

If the last few years have taught investors anything, it is that a faster-changing world demands a more flexible approach to portfolio construction. Hedge funds are not the only answer, but in a market where traditional diversifiers are less dependable and dispersion is doing more of the work, they represent a practical and increasingly important building block for constructing more resilient, adaptable portfolios.

Delivering on this requires capabilities that many investors do not have in-house, making the choice of the right partner all the more important.

BlackRock Hedge Fund Solutions (HFS)

At BlackRock, our dedicated Hedge Fund Solutions team has been partnering with clients since 1995 and is one of the world's largest allocators to hedge funds. Our global team of more than 100 investment professionals builds portfolios designed to be resilient across a broad spectrum of market scenarios.

We focus on incorporating diversity across hedge fund strategies, regions, and asset classes while employing tactical top-down adjustments during periods of market dislocation. Over time, we have expanded our network of hedge fund managers and refined our investment process to address the risks and inefficiencies inherent in capital markets. Our scale allows us to engage deeply with managers and, in many cases, secure differentiated access and terms on behalf of clients.

We have invested through multiple market cycles and structural shifts within the industry, experiences that inform how we evaluate risk and construct portfolios today. Above all, we maintain a commitment to process and discipline, recognizing that consistent outcomes are driven less by short-term positioning and more by rigorous manager selection and thoughtful portfolio design.

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