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Investment Perspectives
August 2025

More room for hedge funds

We see hedge fund strategies emerging as key tool in portfolios for harnessing returns in today's volatile macro environment.

BlackRock **Investment** Institute

Rethinking neutral

Summary

- **This is the first part of a portfolio construction series rethinking the "neutral" multi-asset portfolio allocation – that reflects a world without macro anchors and a broadened investment opportunity set.**
- **Today's environment is an evolution of the new regime of transformation we have been in for some years**. Mega forces – structural shifts like geopolitical fragmentation – are reshaping economies. The ensuing transformation could lead to many very different potential outcomes for growth, inflation and government debt and deficits.
- **The loss of long-term macro anchors – like stable growth, contained inflation expectations and fiscal discipline – that have underpinned long-term asset allocation for decades defines this new regime.** That underscores why deliberately managing exposure to fluctuations in factors like growth and inflation – macro risk – matters more now.
- **Static exposures to factors – like growth, inflation or the value equity style factor – are now a drag on portfolio returns. That's a sea change from the decade following the 2008 global financial crisis.** Unintended factor exposures could be more costly today, we find, even though they were arguably ignorable before. We find that top-performing active managers capable of managing or harnessing that macro risk are better rewarded today.
- **Yet we believe this environment of transformation is better than the prior decade for achieving above-benchmark returns, or alpha. That warrants a bigger role for active strategies in multi-asset portfolios.** We find that top-performing U.S. equity fund managers have delivered greater alpha and reduced the drag of macro risk on performance since 2020.
- **We see hedge funds emerging as a key tool in portfolio construction as a result.** Our research finds that top-performing hedge funds, especially macro hedge funds that aim to exploit shifts in the economic environment, have delivered greater excess returns since the pandemic. We also see more opportunity for security selection that can outperform markets – a potentially differentiated source of return in portfolios – rewarding those who deliberately minimize macro risk to favor security-specific risk instead. We find the risk of future returns from certain macro hedge fund strategies is lower than that for developed market public equities in a multi-asset portfolio.
- **We think that justifies boosting allocations to hedge fund strategies in portfolios.** Investors will have unique risk and return targets, with different governance constraints – including the cost of overseeing managers. Yet holding all risk preferences and governance constraints equal, we believe some investors can hold up to 5 percentage points more in hedge funds today than they did before 2020.
- **We argue for sizing hedge fund allocations by considering client-specific liquidity, governance and risk constraints over broad asset class labels.** We think investors should size allocations to hedge funds based on their unique features – not simply as another asset grouped with private markets in an "alternatives" bucket. One way to fund the increase to hedge funds would be by trimming developed market government bonds and equities, depending on the level of risk being added to the portfolio, with no change to the private market allocation.

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Manager skill matters

In February 2024 we laid out our case for why active strategies could play a bigger role in portfolios today, arguing that portfolio manager skill – the ability to consistently outperform peers – is central to capturing the greater potential for alpha in today's more volatile macro and market regime. We think that volatility reflects the economic transformation underway that is being driven by mega forces – big structural shifts such as artificial intelligence (AI). That means there's greater uncertainty about the future path of economies now, with many very different potential long-term outcomes from this transformation.

A core feature of today's regime is the loss of long-term macro anchors – expectations for stable growth, contained inflation expectations and fiscal discipline – that investors could rely on to drive long-term asset returns. It underpins the greater long-term economic uncertainty that is driving greater dispersion in equity returns. See the left chart. The average dispersion of individual stock returns in the S&P 500 surged in 2020 during the pandemic-induced volatility – and has stayed elevated since then relative to the dispersion seen in the decade after the global financial crisis (GFC).

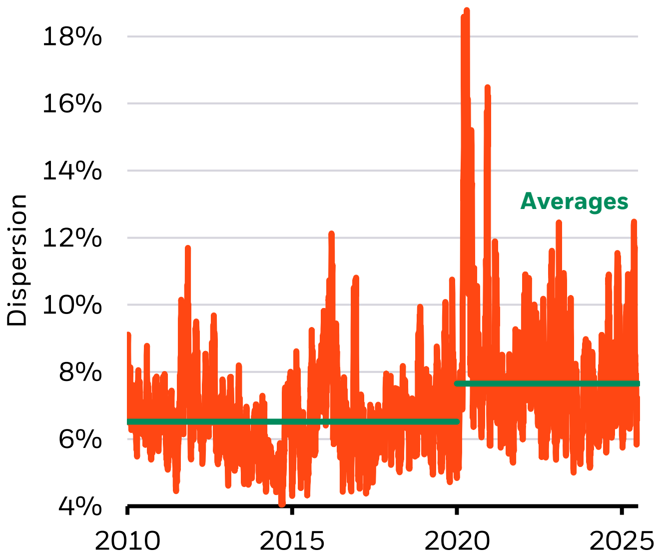
We think this more volatile environment that's driving elevated dispersion can bode well for skilled fund managers to deliver greater active returns, or alpha. We define skill as manager performance that lands in the top 25%, or top quartile, among all alpha-seeking portfolio managers. Our analysis shows that the alpha generated for a manager with skill is greater than it used to be. See the right chart. Top-performing U.S. equity portfolio managers have delivered more alpha since 2020 (the left red bars) but the average manager has not become more skilful – the excess returns for the average manager haven't changed. That means the reward for being skilful is greater now.

Some reasons why? Lost long-term macro anchors means investors need to make big calls about the future path of the economy when learning new information. Getting those calls right requires insight that skilled managers may have. Insight on how the economic transformation will evolve – and on the sectors, industries and companies that stand to benefit – may provide an edge for some managers.

But the loss of long-term macro anchors means investors must be more deliberate about the macro risk they take. When the macro environment was more stable, persistent factor exposures – such as to growth, inflation or the value style factor – typically didn't hurt portfolios. That's no longer the case today. See the green bars in the right chart. Static factor exposures have become a bigger drag on active returns, particularly for the average fund manager. That underlines why macro risk must be managed or harnessed more deliberately, in our view. Skilled portfolio managers have minimized the drag from macro risk compared with the average manager. So portfolio manager skill matters even more today.

Wider-ranging stock returns

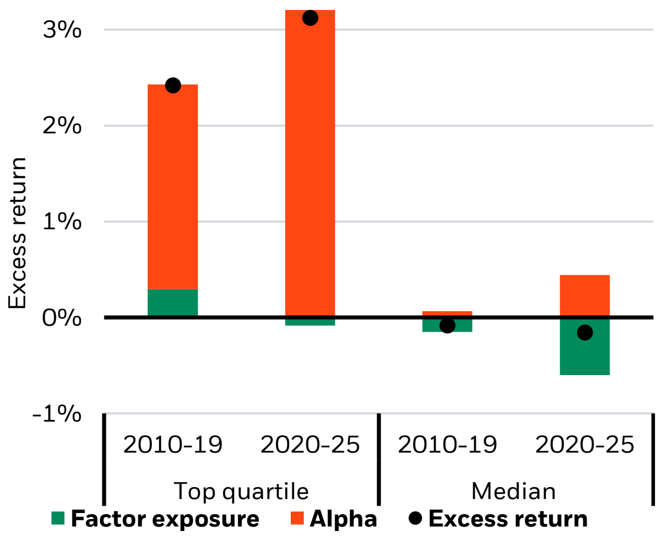
S&P 500 stock dispersion, 2010-2025



The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Capital at risk. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. Source: BlackRock Investment Institute, with data from Bloomberg, August 2025. Note: The lines show the dispersion of individual S&P 500 stock returns. The chart shows two averages for 2010-2019 and 2020-2025.

Greater potential alpha

Three-year excess returns of U.S. equity fund managers



Past performance is not a reliable indicator of future performance. Capital at risk. This information should not be relied upon by the reader as research or investment advice regarding any funds, strategy or security. Source: BlackRock Investment Institute, with data from eVestment and LSEG Datastream, July 2025. Notes: The chart compares the rolling three-year average excess return (into alpha and factor contribution) between 2010-2019 and 2020-2025 – excluding January-June 2020 to avoid skewing the data with pandemic-era volatility – for both top-quartile and median quartile U.S. large cap equity managers in the eVestment universe. We use regression analysis to estimate the relationship between alpha-seeking manager performance and market conditions. Regression analysis is backward-looking and is only an estimate of the relationship. The future relationship may differ.

Harnessing hedge funds

So how have top-performing managers navigated this environment? We find two approaches have helped offset the drag from macro risk on portfolio returns:

1. Frequently assessing and managing macro risk in portfolios.
2. Neutralizing macro risk and relying on strategies that deliver returns regardless of broader market performance.

We've seen how top-performing U.S. equity fund managers have managed to reduce the drag from macro risk and boost excess returns on the previous page. Other managers that aim to deliver alpha but do so with the freedom to manage macro risk much more dynamically: hedge fund managers. Our analysis of Preqin data finds that above-benchmark returns delivered by most top-quartile hedge fund managers have been higher since the pandemic than they were post-GFC. That's especially true for the best-performing macro hedge fund strategies. Styles vary across macro hedge fund managers, with managers taking one of the two approaches to offset the drag from macro risk we've highlighted above. Some may prefer to minimize exposure to macro risk and lean into generating alpha. Others may prefer to lean into heightened economic volatility and frequently assess macro risk in portfolios. We find that hedge fund managers are shifting their factor exposures more often today than they were in the past. See the left chart.

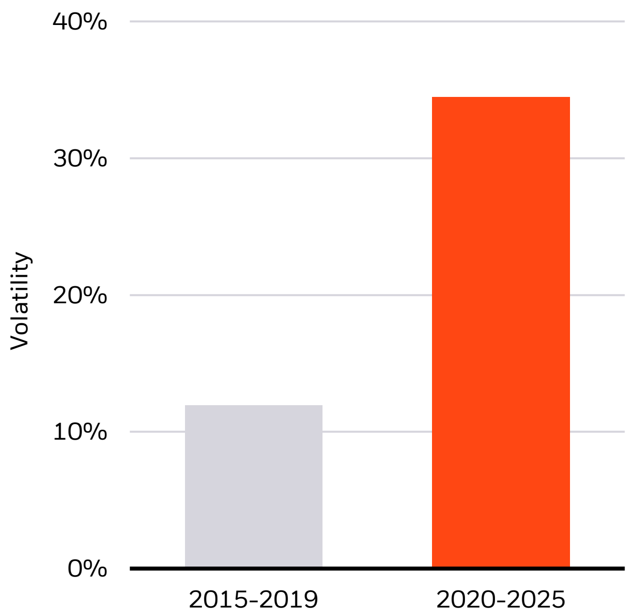
Assuming more alpha is available today, we believe that warrants considering bigger portfolio allocations to hedge funds. We find that holdings in hedge funds would rise by up to 5 percentage points when targeting a similar level of risk found in more traditional portfolio solutions. See the right chart. For low-volatility hedge fund strategies, one way to fund the larger allocation would be by reducing holdings in developed market government bonds. For high-volatility hedge fund strategies, the increase could be funded from public equities – rather than at the expense of private markets. It's worth noting that our work finds that some hedge fund strategies are lower risk than public equities.

Some investors typically class hedge funds as an "alternative" asset class including private markets – so the share of the portfolio allocated to hedge funds is a slice of the total allocation to alternatives. We see that constraining how much can be invested in hedge funds given typical portfolio limits to investing in alternatives. We prefer breaking up that bucket to make hedge funds a distinct allocation separate from private markets. Allocations to private markets could then stay the same.

Differing investment objectives and constraints will shape how investors allocate to hedge funds. For example, those with less tolerance for risk would invest less of their portfolio in hedge funds compared with an investor that has more tolerance for risk. Data from Preqin's *Institutional Allocation Study 2025* suggests the average allocation to hedge funds ranges across investors, from between 4% for European pension funds to 17% for U.S. wealth managers. Rather than sizing allocations based on asset class buckets like alternatives, we think investors should consider liquidity, governance and risk constraints when allocating to private markets and hedge funds.

Shifting factor exposures more

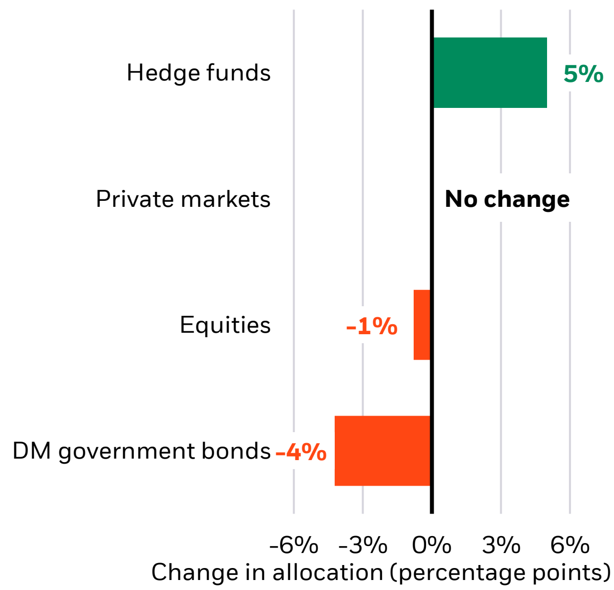
Volatility of hedge fund exposure to U.S. stocks



Past performance is not a reliable indicator of current or future results. Capital at risk. Source: BlackRock Investment Institute, with data from Preqin, August 2025. Note: The bars show the avearge dispersion of exposure to broad market risk, often called beta, within the hedge funds that have at least 10 years of data across 2010-2019 and 2020-2025.

Funding the allocation

Hypothetical changes in portfolio allocation



This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance. Source: BlackRock Investment Institute, August 2025. Note: The bars show how allocations to hedge funds, equities and developed market (DM) government bonds would change to capture an assumed increase the potential for alpha in hedge funds, while maintaining a similar level of risk to a 60/40 portfolio (60% in stocks, 40% in bonds).

.**Index Disclosures:** Index returns are for illustrative purposes only and do not represent any actual fund performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

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