HSBC Asset Management

2024: Why alternatives are still relevant

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Investors like clarity. Whether it's clarity of something that's either positive or negative is largely irrelevant. Decisions can be made with any outlook in mind. In our view, 2024 could be a year where investors get the clarity they need. We are likely to see greater clarity around the macro-outlook and this could provide conditions for recent fund vintages to potentially be good performers. Should it evolve this way, investors might be able to take advantage of lower asset prices, balance sheet restructuring, distressed asset sales and discounts in secondary markets. After a further challenging year in 2023, we believe activity could begin to increase in 2024.

Alternative asset classes have been impacted by the shifting macro environment over the last 18 months or so. They have been at the mercy of a mix of higher interest rates, lower growth and greater volatility that has particularly affected strategies that rely on leverage to deliver their performance.

This change in the macro situation has had several impacts. There has been a slowdown in activity on many fronts: weaker exit markets, difficult fundraising, slow deployment of committed capital and tighter credit conditions. This has added to pressure on pricing, particularly in real estate markets. It has also led to a cautious mindset among investors. With higher yields available on low-risk investments, such as US Treasuries, other asset classes must work harder to justify their place in portfolios.

As we enter and progress through 2024, there is a broader acceptance that we have hit peak rates – in the short-term at least. The future path of potential rate cuts is still uncertain, however. In addition, there is likely to be some divergence between central banks and their likely path forward. We expect interest rates to begin falling in many countries, but the timing and magnitude will likely be varied.

In macro conditions such as we are experiencing now – and in the environment many are expecting – we believe there are likely to be more investment opportunities. Dislocation in outlooks, in our view can help to make some assets more attractive and additional clarity will help investors to make decisions. It is likely that those who have committed capital to funds, which have not yet deployed the capital will be well-placed in the short-term. This may spur other investors to commit capital too, as many will want to get on the front-foot and be ready to take advantage of any repricing when it happens – rather than after the event.

Any forecast, projection or target when provided is indicative only and is not guaranteed in any way.

Source: HSBC Asset Management as of January 2024.

In our view, there are several reasons that investors continue to allocate towards alternative investments. These include: the potential for returns superior to many other asset classes, often non-correlated returns and portfolio diversification. These traits have resulted in interest outside the traditional institutional investors, with retail / non-institutional investors increasingly targeted by fund managers.

However, the long-term track record of solid performance could be challenged by interest rates, which have moved significantly higher over the last 18 months. Despite the short-term challenges, over the medium-long-term, there is likely to be structural tailwinds for alternative assets. We believe clarity on the macro-outlook and the potential for falling interest rates are likely to be key drivers of activity in 2024. As a result, in our view, there is a solid case for investing in alternatives in 2024.

Asset Class Outlook

Private Equity

Private equity markets have weakened from the highs experienced in 2021. The exit environment, particularly, has suffered from a significant slowdown, lowering distributions to investors. Given the recent move higher in interest rates, managers are likely to have to work harder to generate returns.

We believe investors can position themselves positively, through a focus on managers investing in sectors / companies with downside protection and proven ability to generate returns through operational improvement, rather than financial engineering. In this situation, entry valuations are important, with a larger re-set more likely in a recessionary environment. Should rates begin to decline significantly, in our view growth strategies are likely to stabilise and accelerate faster relative to other strategies, notwithstanding the fact that an economic slowdown may precede significant rate cuts.

Venture Capital

The venture capital market has largely followed that of private equity, with reduced activity and lower distributions to investors. This part of the market has been hit particularly hard by falling valuations, with many companies experiencing down rounds as they raise capital.

We believe that despite this, it is possible to attempt to be proactive as an investor, targeting those parts of the market that are likely to be better protected and experience rising demand. Climate tech is one such area, likely to experience further growth as climate goals are pursued. In addition, a focus on early-stage investments will also reduce dependence on IPOs as a future exit route, leading to some protection from the volatile IPO market, in our view.

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Source: HSBC Asset Management as of January 2024.

1. As of 30 September 2023. AUM includes committed capital ('dry powder').

Private Credit

There are some major shifts underway in global lending markets. As banks reduce activity in areas they were once dominant, other options have emerged. Private credit markets are a beneficiary of this structural shift. We believe borrowers are also seeing the benefits of this chance, as they seek customised funding solutions, clear paths towards execution, and the benefits a long-term and close relationships can bring.

Rising rates have helped drive returns higher, with many investors looking to private credit as a direct replacement of previous fixed-income allocations. While direct lending is the largest strategy within the asset class, infrastructure debt has experienced rising AUM. Default rates are generally low and recovery rates high, while there are investments options for those seeking exposure to short-duration or long-duration investments. We believe that private credit should continue to be a major focus for investors.

Real Assets

Expectations that interest rates may be at their peaks in many countries should mean that investors position themselves in anticipation of a future reduction in rates. While the magnitude of any cuts in interest rates is uncertain and dependent upon the macro outlook, in our view this should lead to real estate cap rate stabilisation – albeit probably at a higher rate than in recent years. Lower interest rate expectations have seen listed real estate discounts to NAV narrow significantly.

In a more benign macro environment, those real estate sub-sectors with a more secure income profile and lower leverage should outperform, in our view (despite higher equilibrium rates). Following recent price corrections driven by higher interest rates, there may be opportunities for value-add or opportunistic strategies to acquire at a low base, but obtaining financing may be an issue, favouring investors with access to equity. In APAC, the market cycle is lagging slightly behind, with capital values expected to bottom out in 2024, providing an opportunity to invest at favorable prices. This is particularly true in Australia, where underlying fundamentals remain robust.

Infrastructure investment, aiding the energy transition, is, we believe, likely to be an area of growth, given the path needed to hit climate targets. These targets will not be hit with existing infrastructure, so new greenfield development will be needed, presenting a range of opportunities over the long-term.

Hedge Funds

At present there is still uncertainty when it comes to the global macro outlook. Predictions of a US recession have not borne out (so far), while there is also a disconnect between market expectations of US interest rates and communication from the Fed. Add in the fact that 2024 is a year in which many countries go to the polls and uncertainty abounds. We believe this should play into the hands of macro hedge funds, which should be well-placed to benefit from possible movements and dislocations during 2024.

Similarly, with significant upward movements in global interest rates, credit funds could be well-placed to capitalise on any resulting market inefficiencies – particularly given that yields are currently elevated on an absolute and relative basis. In addition, default rates are still relatively low, despite increasing back towards pre-pandemic levels in many instances.

HSBC Asset Management – Alternatives

We believe the anticipated outlook for 2024 is likely to play to the strengths of HSBC Asset Management. Our experienced alternatives teams currently manage more than USD67bn on behalf of our clients.[1] With experience across many alternative asset classes, from private equity, private credit, hedge funds, real estate and venture capital, we are well-placed to help our clients meet their portfolio objectives.

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Key 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.
- **Technological risk** exists when the technology, on the scale proposed for the project, will not perform according to specifications or will become prematurely obsolete. The risk of technical obsolescence following completion becomes particularly important when a project involves a state-of-the-art technology in an industry whose technology is rapidly evolving.
- **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.
- **Political and economic risks:** General economic conditions may affect the activities. Changes in economic conditions, including, for example, inflation, unemployment, competition, technological developments, political events and other factors, none of which will be within the control of the General Partner or the service providers, can substantially and adversely affect the business and prospect investors. Due to the geographic scope of its activities, the strategy may be vulnerable to country or regional-specific political, macroeconomic and financial environments or circumstances.
- **Investor's capital at risk:** Investors may lose the entirety of invested capital.

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