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Asset Management

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# An alternative way to classify hedge fund risk

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**“As hedge fund correlation patterns change, so can the nature and degree of the expected portfolio diversification that is provided.”**

## Key takeaways:

- Hedge funds have long been seen as a potential source of portfolio diversification. However, different hedge fund strategies can exhibit very different correlation patterns to traditional assets. To understand those differences, measuring correlation can be a good starting point, but it does not fully explain how diversification can change.
- A useful complement to correlation is to think about convexity, which captures how different hedge fund return profiles may respond as market moves become larger or more stressed. Looking across three broad payoff archetypes – namely directional, relative value, and macro – convexity can help explain why strategies that appear similarly diversifying in calmer conditions may behave very differently when markets are under pressure.
- With RBC BlueBay’s customised hedge fund solutions, clients can tilt towards return profiles with convexity characteristics that may help deliver the type of diversification they are seeking, while remaining aligned with broader portfolio construction and evolving risk and return appetite.

## Understanding the diversification challenge

The attraction of hedge funds as a source of diversification is not new. Indeed, based on analysis done over time within the industry, it is widely acknowledged that such alternative assets can at times offer absolute return potential and relatively low correlation to traditional asset classes. This helps to improve risk-adjusted returns and to moderate portfolio volatility.

What is less widely appreciated, however, is that diversification characteristics are not static. They are dynamic, and can vary depending on both the fund’s strategy mix and broader market conditions. As hedge fund correlation patterns change, so can the nature and degree of the expected portfolio diversification that is provided.

Furthermore, diversification can sometimes appear to be absent when it is not properly understood. While a hedge fund may appear to have lost its diversification benefits in a particular market environment, in reality it may simply be behaving in line with its expected payoff profile, even if, with hindsight, that was not the profile initially sought.

## Introducing convexity and how it can help understand hedge fund behaviour

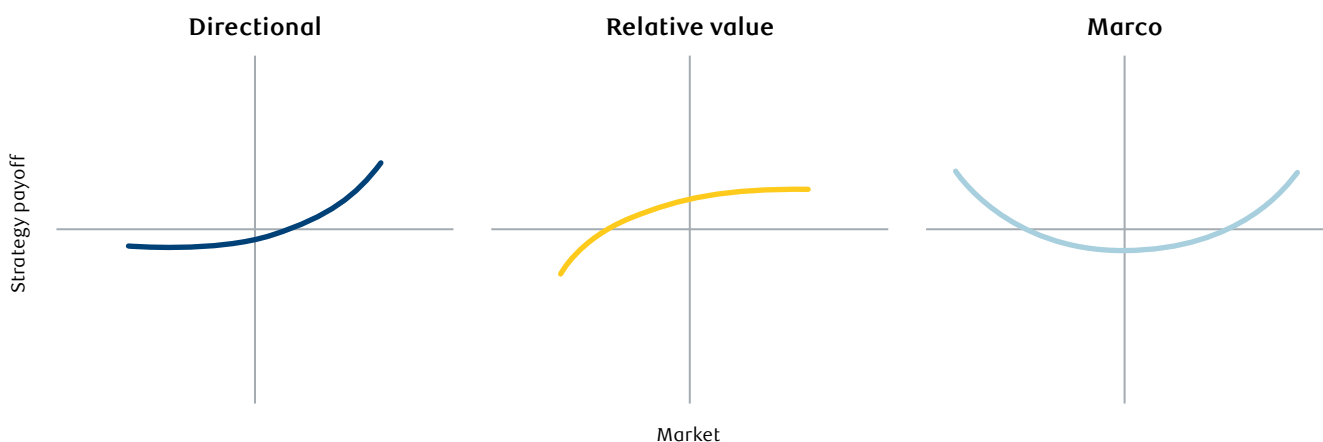
Hedge funds are often discussed in terms of diversification and correlation, but those measures do not always capture how hedge fund strategies behave when markets become more stressed. Based on industry research, a useful complement here is to consider the strategy's payoff shape in terms of convexity.

Convexity describes the non-linear way an investment's price or return profile can respond as underlying market factors change, especially when moves become larger or more stressed. This matters because not all hedge fund strategies behave in the same way.

At a high level, many hedge fund strategies can be grouped into three broad payoff archetypes, each with different stylised convexity characteristics. It is important to note, however, that hedge fund payoffs can ultimately be varied, and there is certainly no single preferred convexity profile. Instead, the right outcome depends on the type of diversification being sought given the portfolio, risk and return appetite, and expected market conditions.

- **Directional hedge funds:** these typically have more market-sensitive return profiles, and some can exhibit asymmetric upside participation depending on how they are constructed. While many such funds will behave broadly, like moderated equity exposure, in certain cases a payoff profile can resemble long call optionality.
- **Relative value hedge funds:** relative value hedge funds often exhibit negative convexity characteristics. In practice, their payoff pattern can at times resemble short put optionality. Returns here may appear relatively steady in more normal market conditions, but can become more vulnerable during periods of market stress, dislocation, or reduced liquidity.
- **Macro hedge funds:** certain macro strategies, particularly those that can be positioned to capture larger market moves, may exhibit positive-convexity characteristics. This means they can at times provide particularly valuable diversification properties when traditional assets are under pressure.

### Three broad stylised payoff archetypes, each with a different convexity shape



Source: RBC GAM, as at February 2025.

### The solution: a fully customisable hedge fund allocation

These broad convexity characteristics can help provide the building blocks for a more tailored hedge fund solution. By drawing from our range of alternative strategies, we can combine different hedge fund types, and in different ratios, to form a customised asset allocation mix. This mix can be designed to tilt towards return profiles with different stylised convexity characteristics, ultimately helping to better reflect a client's broader portfolio objectives.

By utilising RBC BlueBay's Multi-Strategy Fund as a starting point, clients can access a single, customisable entry point into a range of alternative hedge fund opportunities. This allows for the construction of a client solution that can be reviewed and recalibrated over time, helping to keep pace with evolving portfolio needs, market conditions, and risk and return appetite.

## Let RBC BlueBay be your trusted alternatives solution provider

For more than two decades, BlueBay has been at the forefront of alternative credit investing, building on its origins as a long/short credit manager. Today, BlueBay offers a dynamic suite of alternative strategies designed to deliver differentiated outcomes that help our clients meet their evolving needs. As at 31 January 2026, RBC Global Asset Management manages over USD32 billion in alternatives, while the BlueBay Fixed Income investment platform manages approximately USD18 billion in alternative credit strategies.

Against the current investment backdrop of elevated geopolitical tension, interest rate uncertainty, and shifting market regimes, our clients are rightly placing renewed emphasis on alternative solutions. These solutions can complement traditional portfolios in more targeted ways, whether the objective is to seek more resilient returns, improve diversification, enhance yield, or reduce sensitivity to traditional market risks.

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Findlay is a BlueBay Portfolio Manager within the Multi-Asset Credit team. He joined the investment desk in September 2018 as an Assistant Portfolio Manager, originally as a shared resource with the Convertible Bond team but moved to the Multi-Asset Credit team full time at the beginning of 2020. He became a member of the Multi Asset Decision Group in 2024. Findlay has been at the firm since September 2015, initially joining as an intern and working in a number of teams within Operations, most notably in the Treasury Cash Management team where he managed the daily liquidity and currency hedging for the investment floor. Findlay holds a Bachelor of Laws degree and an MSc in Law and Accounting. He is a CFA Charterholder.

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