FUNDS ON FRIDAY
by Glacier Research

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by Sanlam

08 May 2020
Volume 1048

Hedge Fund, an old enemy or new ally

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Within the investments industry, it is a tale as old as time: hedge funds are dangerous. Nervousness around the asset class stems all the way from iconic hedge fund blow-ups in the distant past to misconceptions on the relative riskiness and concerns around regulatory oversight. Even the media loves to hate hedge funds with television shows and movies making somewhat of a habit of depicting hedge fund managers as dodgy rich guys with nothing to lose. Over time though, the industry has substantially, and maybe rather silently, made progress on most of the issues that previously brought doubt to the minds of investors.

Understanding hedge funds is key

The root of the problem remains understanding what hedge funds are and how they work. As a general category of investments, they can be more easily understood when the concept is built upon that which investors already understand. Hedge funds are permitted a complement of additional tools that can be used to improve their performance over more traditional long-only type funds. These tools include leveraging, short-selling and access to a variety of derivatives. All this means is that, for the same level of risk as a long-only fund, a hedge fund is expected to generate better return. Skilful hedge fund managers are those able to consistently produce better risk-adjusted returns than their long-only counterparts. Averaging over the last decade, hedge funds have largely delivered on that promise.

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Versatility that extends to retirement income planning

Taking it a step further, given the extra abilities hedge funds have access to, it's very possible to produce positive returns in both upward and downward markets. This allows for better protection against drawdowns, ultimately making them absolute return-like products. In addition to acting as a hedge against volatile market movements, hedge funds also have the benefit of producing returns that are uncorrelated with traditional asset classes. These two characteristics make them ideal as a 'sweetener' in a retirement fund or even a living annuity product. Allocating a portion of a balanced retirement fund to hedge funds further diversifies a balanced portfolio and reduces the overall risk per the same unit of return in the fund. Within the living annuity space, an allocation to hedge funds aids in protecting against sequencing risk by offering superior protection against drawdowns and in this way aiding against longevity risks as well.

Now to consider a few specific concerns that have plagued investors about hedge funds:

Regulatory oversight

Since 2016, the South African regulator has introduced a framework for oversight of hedge funds. Funds are categorized to suit the needs and investment savvy of the end user by distinguishing between retail investor hedge funds (RIHFs) which, like the name suggests, cater for the retail market that requires a simpler product with stringent liquidity and leverage constraints, and qualified investor hedge funds (QIHFs) intended for the more complex, risk-hungry investor.

Fees

One of the most serious concerns regarding hedge funds is the fees. In fact, investment fees across the market in general are under pressure at the moment and hedge funds fees are no exception in this trend. Retail hedge funds offering daily liquidity are now more commonly available, offering investors a point of access at more competitive fee rates than was previously available in the market.

Riskiness

Fears around hedge funds are very much like the age-old fear people have for flying versus road travel. On average, many more motor accidents happen than airplane crashes. However, the over-publication of the few plane crashes that have happened, has created the cognitive bias in our minds that flying is more dangerous. The same is true for hedge funds. The few iconic hedge fund "blow-ups" skew investors' views on the relative riskiness of them.

A decade ago, many hedge fund managers' investment process was shrouded in mystery but managers have been adopting a more open stance to describing their processes and strategies. Risk management is the anchoring characteristic of hedge fund management and strictly following risk mitigation methods and monitoring risk measures are the carrying purposes in allowing them to produce returns on an absolute basis.

The new “it” fund?

All these points of progress lend themselves to hedge funds being a new ally, especially given the current investment landscape. Having managed funds during the recent tough market, the hedge fund managers that have survived have proven their skills. This, together with the comfort that comes with the progressing regulatory environment, the expectation of absolute returns and the general downtrend in fees, creates the perfect watering hole for retail investors.

Glacier Research would like to thank Suvira Bodha for her contribution to this week's Funds on Friday.

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Suvira Bodha joined Sanlam Investments as part of the graduate programme in 2016, after completing a Bachelor of Business Science degree specialising in Analytics from the University of Cape Town. Her responsibilities focused on junior hedge fund research as part of the Alternatives Academy Graduate Programme. After becoming an analyst her responsibilities broadened to include other private market asset classes within alternatives as well.