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Hedge funds – an alternative strategy in building resilient portfolios

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Against the backdrop of the market uncertainty caused by the COVID-19 pandemic, investors have been reminded to seek ways to add resilience to their portfolios. It is an opportune time to consider the benefits that a long/short equity strategy could add to a diversified portfolio. This strategy makes up the largest component in the South African hedge fund industry and may offer a unique way to enhance the overall risk-return profile of an investment portfolio. Long/short equity hedge funds offer investors a more flexible approach to equity investing than traditional equity unit trusts (also referred to as long-only funds). Not only do they help portfolios retain exposure to equities – which provide the best returns over the long-term – but more importantly, they act as a shield by providing protection when the market declines.

Long/short equity strategy versus traditional unit trust

Long/short equity strategies have the same investment universe as their long-only counterparts, with the main difference being that they have a broader toolkit at their disposal and are therefore able to use techniques that are not available to traditional long-only funds. As the name suggests, long/short equity strategies invest both long and short in publicly traded equities and equity-related instruments.

Similar to traditional long-only equity funds, long/short hedge funds invest in companies that they believe will increase in value. This is referred to as going long. Hedge funds, however, have the added benefit of being able to make money in companies that that they believe will decrease in value (often characterised as businesses with unsustainable returns, low cash flow generation and weak corporate governance). This is referred to as going short (or shorting).

Shorting involves borrowing and then selling a security, with the expectation that the price will decrease, allowing the seller to buy the security back at a lower price and return them to the owner. By selling high and buying low, hedge funds can profit on the differential between the two prices.

Increases diversification

The bi-directional investment strategy (ability to both go long and short) provides hedge fund managers with a lot more flexibility by making use of all of the information they uncover during the idea generation and research process. Investment analysts spend most of their time analysing and understanding businesses that they like and anticipate will increase in value. Hedge fund managers do the exact same, except through their efforts they also identify businesses that they don't like (or like the least) - as there is opportunity to make money on both sides. A traditional long-only equity fund's ability to capitalise on the latter information is limited. The primary form of defence available to them is to be underweight these securities relative to a designated benchmark. This doesn't allow for the opportunity to profit from a decline in the price of these securities, nor does it allow for reduced volatility by adding uncorrelated positions. This is where hedge funds can be particularly useful. Shorting the security, as is done in a long/short equity strategy, allows the manager to fully express their views and conviction. This is particularly useful in the context of South Africa where the equity market has inherently exhibited a high degree of concentration risk with few stocks representing more than 50% of the market. The ability to go long *and short* broadens the portfolios ability to exploit a larger opportunity set. We are of the view that a long/short equity strategy should be considered as an alternative way to hedge against the current economic and political headwinds that face South Africa in addition to offshore investing. ASISA classified South African long/short equity strategies can invest according to the SARB limits of 30% to international investments and a further 10% in Africa excluding South Africa. As a result, these funds can provide further diversification by including international assets.

Offers additional sources of alpha

Moreover, the ability to short securities can provide the long/short equity hedge fund an additional source of alpha, resulting in positive returns being generated in both upward and downward trending markets. A further source of revenue that shorting introduces is upfront cash (through the sale of the borrowed security). This cash can either be deployed to buy more securities or simply used to earn interest, which is then reinvested in the fund (the interest earned on the cash is far larger than the small fee the manager pays to borrow the security).

Improves risk-return profile

Not only can these strategies generate profits from their long and short positions, but the short positions act to reduce market exposure (beta) and can also provide an element of protection (or hedge), when markets decline because the gains on short positions will offset the losses on long positions. The risk-mitigating benefits of long/short strategies are elevated further by the managers' ability and flexibility to dynamically adjust their exposures in response to changing market conditions. Such strategies are typically focused on achieving absolute returns as opposed to relative returns. Managers have several mechanisms at their disposal to reduce risk and protect capital such as reducing overall portfolio gross exposure by concurrently selling longs and covering shorts, resulting in the portfolio having less capital at risk. They can also reduce position sizes to reduce volatility as well as add portfolio protection in the form of derivatives. The result is that long/short equity hedge funds have, on average, returned equity-like returns with significantly lower levels of volatility, while providing smaller drawdowns during severe downturns. The ability to mitigate volatility and limit the size of losses is particularly important to investors who need to draw on their investments regularly, such as investors with living annuities.

We believe that the equity climate, specifically in South Africa, requires a more agile approach to equity investing. Including an allocation to long/short equity strategies in a well-balanced portfolio can provide valuable downside risk-mitigating benefits while also providing the ability to reap rewards when markets recover. According to *HedgeNews Africa*, roughly half of the funds in the South African equity long/short category are classified as CIS retail hedge funds. This type of hedge fund looks and feels like a traditional long-only portfolio with low investment minimums, while providing daily pricing and liquidity. Hedge funds have become a lot more accessible to investors thanks to increased regulation which brings greater protection for investors in South African retail hedge funds.

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

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