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The flexibility of hedge funds

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Hedge funds have long been viewed as an arcane area of investing suitable only for the wealthy or more adventurous. The reality is that since 2015, hedge funds in South Africa have been regulated under the Collective Investment Schemes Control Act (CISCA) and more recently have become available for investing through LISP platforms such as Glacier by Sanlam. If managed according to their strict definition, hedge funds are designed to protect capital rather than be a source of risky returns.

Unlike traditional fund mandates, hedge funds can employ a variety of strategies across asset classes and geographies and are able to profit from both long and short positions. A well-managed hedge fund should provide investors with superior risk-adjusted returns through a range of economic cycles.

These are best explained by reviewing practical examples.

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1. Use of leverage to protect capital during periods of market stress

Hedge fund mandates set net and gross exposure parameters for a fund. For example, a fund can be net short or have an exposure of greater than 100%. By comparison, a fully invested long-only equity fund is required to be at least 95% invested in equities at any given time and cannot exceed 100% net exposure.

A hedge fund mandate provides the manager the flexibility to decrease exposure to 'risky' assets in periods of market stress. For example, Charts 1 and 2 illustrate the change to gross exposure of the Bateleur Market Neutral Fund and Bateleur Long Short Fund during the first quarter of 2020 – a period characterised by extreme capital market volatility.

In this period, where the JSE All Share Index (total return basis) declined 21.4%, the reduced gross exposure enabled the Bateleur funds to limit drawdowns.

In response to the pandemic, policymakers announced unprecedented economic and fiscal support that spurred asset prices higher. In this environment, hedge funds could opportunistically increase gross and net exposure to capture upside when conditions are more favourable. Our experience is that capital preservation in periods of market stress, leads to outperformance over the long term.

Chart 1: Bateleur Market Neutral Fund Gross Exposure

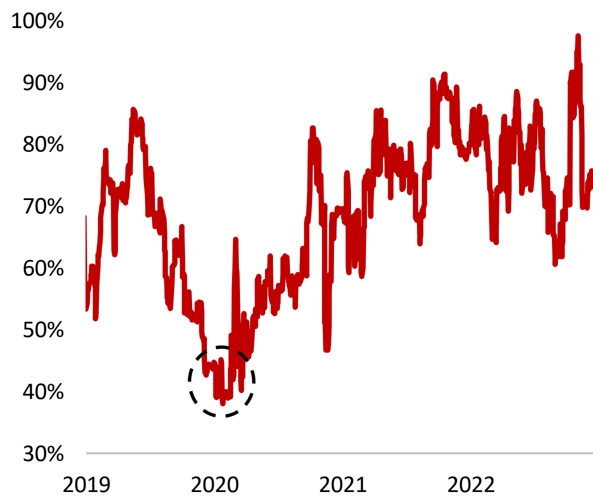
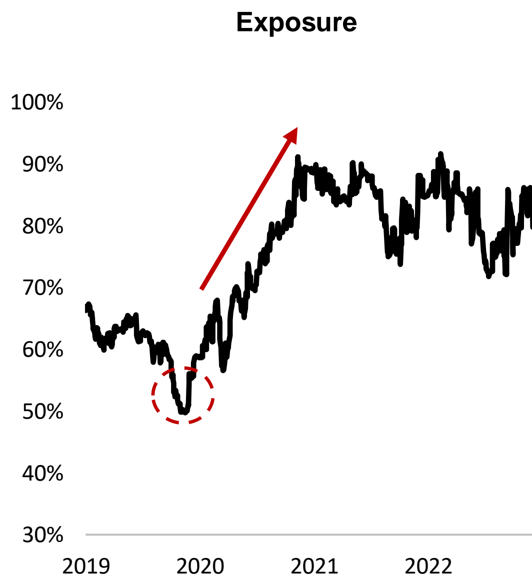


Chart 2: Bateleur Long Short Fund Gross Exposure



Source: Bateleur, Riscura

2. Relationship of commodity companies relative to commodities – the Sasol example

Commodity prices are highly unpredictable and volatile – add foreign exchange volatility to the equation and the ability to accurately forecast earnings becomes even more daunting. Hedge funds have the ability to capitalise on the price relationship of commodity companies relative to their underlying commodity drivers – for example Sasol versus the rand price of oil.

The relationship of Sasol's share price relative to the rand price of oil is an indication Sasol's profitability at a point in time. However, recently, the ratio has deteriorated due to operational missteps impacting profitability at the company and for the same reasons the share price of Sasol weakened. From September 2022 to March 2023, long-only equity managers would have incurred a 25% loss had they held onto their shares in Sasol (Chart 3).

Chart 4 illustrates numerous entry and exit points a hedge fund manager could have used to profit from the relationship of Sasol versus the rand price of oil irrespective of the recent decline in Sasol's share price.

In this scenario, a hedge fund manager can acquire shares in Sasol and short the rand price of oil, taking a view on the valuation of the company relative to the oil price at a particular point in time irrespective of the future direction of either Sasol's share price or the rand price of oil. When the ratio increases, the hedge fund manager profits from the transaction and can lock in gains. This is a typical example of market neutral transactions where profits are derived from the normalisation of a ratio and not by utilising directional exposure.

Chart 3: Sasol share price (R cps)

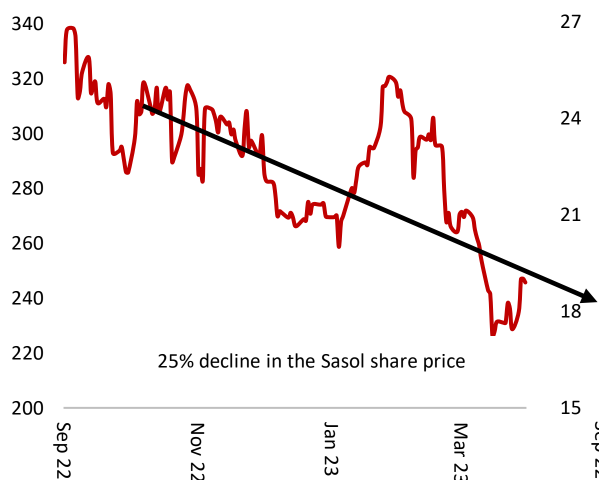
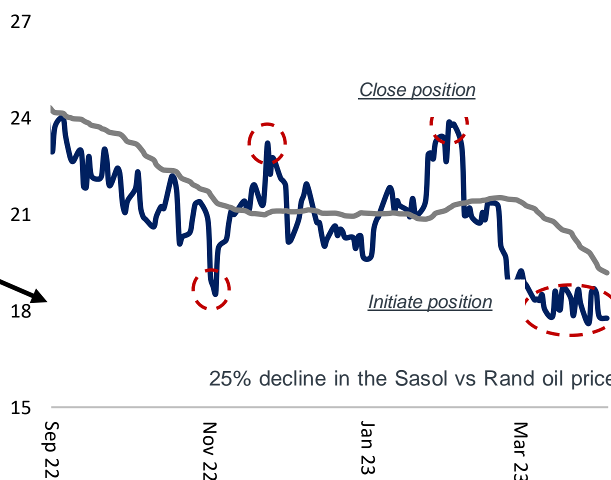


Chart 4: Sasol share price vs. rand price of oil



Source: Bateleur, Bloomberg

3. Using long and short positions to gain access to a targeted asset – the RMI Holdings example

RMI Holdings ('RMI' renamed OUTsurance) was a listed financial services investment holding company, the value of which largely comprised its shareholding in listed (Discovery and Momentum Metropolitan) and unlisted (OUTsurance and Hastings) financial services businesses. It is common for holding companies to trade at a discount to its implied net asset value (NAV), however for RMI, the discount reached a very wide 28% (Chart 5).

At the time, management provided various reasons to continue operating as a holding company and resisted calls from the investment community to unbundle its listed stakes in Discovery and Momentum Metropolitan.

Chart 5: RMI premium/(discount) to NAV

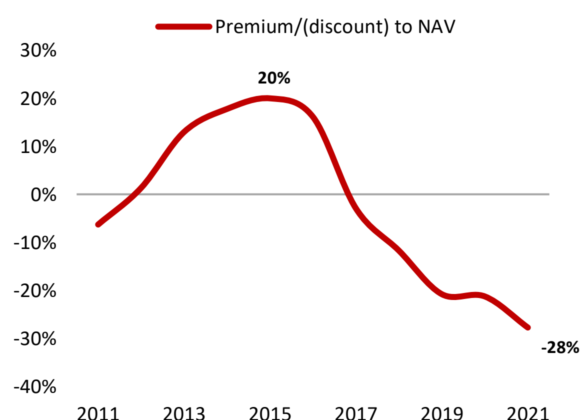
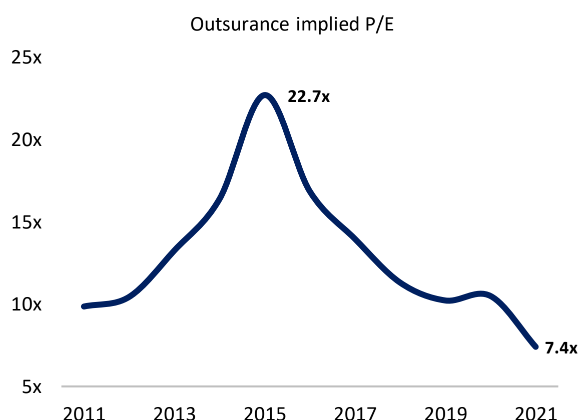


Chart 6: OUTsurance implied P/E rating



Source: Bateleur, company reports

A seasoned investor's rationale for investing in RMI would be to obtain investment exposure to OUTsurance – the unlisted short-term insurer in which RMI held an effective 89% interest. It would not be to indirectly invest in Discovery and Momentum when these shares could be accessed directly in the listed market in a more efficient manner.

The primary concern at the time was that the underlying value of OUTsurance was not being adequately reflected in the RMI share price. This was evidenced in the substantial discount that RMI traded at relative to its underlying NAV and the low implied price-to-earnings ratio of OUTsurance (Chart 6).

A long-only equity manager, wanting access to OUTsurance, had no option but to acquire RMI shares and be content with RMI's sub-optimal corporate structure and questionable strategic decisions.

Hedge funds were able to initiate an investment in RMI from a different perspective. To gain exposure to RMI's attractive unlisted investment (OUTsurance), hedge funds could implement short positions in Discovery and Momentum relative to a long position in RMI. In doing so, they altered the economic interest of the fund's RMI exposure and stood to benefit from a narrowing of the holding company discount or a rerating of the OUTsurance valuation.

In September 2021, the RMI board announced a review of the holding company structure, the outcome of which was the distribution of all listed assets and subsequent news notifying the market of the sale of its unlisted stake in Hastings Group. RMI would effectively transition to OUTsurance.

In this scenario, both the long-only and hedge fund manager benefitted from the substantial value unlock and subsequent rerating of OUTsurance as the market recognised the qualitative nature of the business. In the hedge fund manager's instance, this was achieved by utilising 42% less capital and significantly reducing the market risk of the position.

4. Accessing unique unlisted opportunities – the Distell example

In March 2023, Heineken's long-awaited acquisition of Distell was approved by the Competition Tribunal. Accordingly, all scheme conditions were fulfilled, and shareholders had the option to receive cash or equity in two newly created unlisted entities.

Newco, largely owned by Heineken, includes most of Distell's brands and Heineken's South African assets for which Distell shareholders had the option to either receive R165 per share or to remain invested in the unlisted entity. Furthermore, Distell's Scotch whisky business and Gordon's London Dry Gin ('Gordon's') brand, housed in Capevin, was separated from the transaction with Heineken and will be majority-controlled by Remgro. Shareholders had the option to receive R15 per Capevin share or elect to remain invested in the unlisted company.

Most fund managers did not have appetite or flexibility to invest in an unlisted asset and the natural choice was to select the cash option. CISCA hedge fund mandates permit hedge funds to hold up to 10% in unlisted assets which provides the opportunity to consider the investment merits of Newco and Capevin as unlisted businesses.

An investment in Capevin is potentially an attractive opportunity based on a combination of factors such as valuable brands, a low valuation multiple and the possibility of corporate action.

The biggest obstacle was how to acquire sufficient Distell shares to be able to follow the Capevin equity option in a meaningful way. CISCA limits allow sufficient flexibility to invest up to 30% in a single stock, which in the case of Distell, would equate to 2.5% holding in Capevin. Importantly, this transaction could not be replicated in a traditional fund mandate as unlisted securities are only allowed under very specific circumstances.

In this scenario, the hedge fund mandate provides the capability to acquire a substantial single stock position to obtain meaningful exposure to an attractive unlisted asset.

Selecting a hedge fund

There are clear benefits to including hedge funds in a diversified portfolio. For astute investors, proper research and due diligence are needed to understand a fund's past performance and risk metrics as the return profile and associated risk of each fund is unique. Preference should be given to funds with a lengthy track record and a stable investment team.

When choosing a hedge fund, it is key that the fund display the ability to protect capital and exhibit the use of alternative asset management strategies. Analysis of leverage used in the fund – not just at a specific point in time but over the life of the fund – is important to differentiate funds that generate returns from gearing versus manager skill.

At Bateleur Capital, we are firm supporters and proponents of hedge funds. More than eighteen years of history operating in this space support our positive stance.

Glacier Research would like to thank Charl Gous for his contribution to this week's *Funds on Friday*

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