FUNDS ON FRIDAY

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The value of hedge funds in a diversified portfolio

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The famous quote by American psychologist Abraham Maslow, 'If all you have is a hammer, everything looks like a nail,' is a powerful reminder of the limitations of relying solely on traditional asset classes for investment success. In the ever-changing and unpredictable world of investments, having a diverse set of tools is essential. Hedge funds are one such tool – they can significantly enhance the potential return of a diversified investment portfolio.

The foundation of successful portfolio management is diversification. In the words of Nobel economics laureate Merton Miller, 'Diversification is the only free lunch in finance. It allows you to reduce risk without sacrificing potential returns.' Traditional asset classes like stocks and bonds are undoubtedly valuable, but their performance can be influenced by similar market forces. Hedge funds, on the other hand, operate independently of these forces, as they have the flexibility to employ unconventional investment strategies.

By adding hedge funds to a diversified portfolio, investors can access alternative sources of return with low correlation to traditional assets, effectively reducing overall portfolio risk. Unlike traditional investments that often follow the ebb and flow of the overall market, hedge fund managers have the freedom to seek opportunities that others might not be able to exploit. These skilled managers can take both long and short positions, employ leverage and use derivatives to capitalise on market inefficiencies.

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Niche markets

Hedge fund managers often specialise in niche markets that might not be accessible through traditional investments. In our view, the nuances of the South African financial market offer attractive opportunities in this regard.

The traditional 'buy and hold' strategy can leave investors exposed to market downturns. Hedge funds, however, offer dynamic risk management techniques to help protect capital and optimise risk-adjusted returns. Experienced hedge fund managers can employ hedging strategies, which involve buying securities that act as insurance against potential losses in other parts of the portfolio. By actively managing risk, hedge funds can assist in maintaining portfolio stability.

Despite having been around for more than two decades and posting attractive returns, South African investors' overall exposure to hedge funds remains low. Why have traditional investors been reluctant to invest in these funds? Apart from the perceived complexity of their strategies, hedge funds were historically unregulated, required large initial investments and provided limited liquidity. As a result, they were a luxury enjoyed by only a few.

Greater access

Over the past decade, however, this has started to change. With hedge funds now regulated under the Collective Investment Schemes Control Act (CISCA), a wider set of investors can enjoy access to these alternatives in a well-regulated, liquid environment. Pension fund regulation (Regulation 28) now also allows investors to hold up to 10% of their retirement portfolios in registered hedge funds, subject to a limit of 2.5% per hedge fund or 5% per fund of hedge funds.

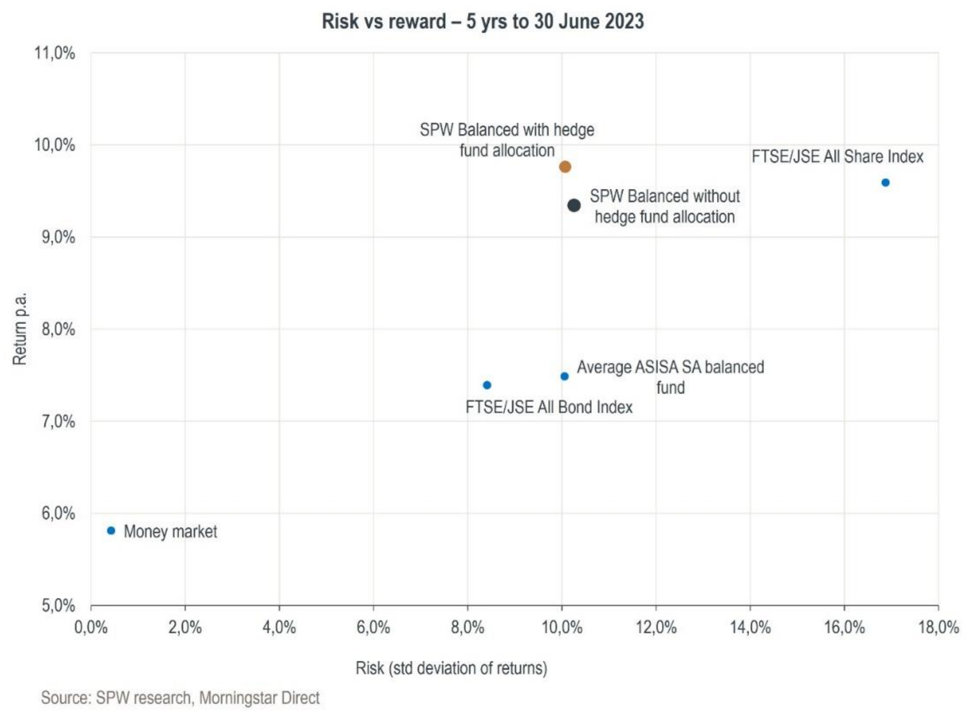
Unfortunately, current legislation does not yet allow collective investment schemes such as unit trusts to invest in a hedge fund. This is expected to change in future, but in the meantime, it provides private client managers such as Sanlam Private Wealth with an advantage when it comes to accessing hedge funds for retirement portfolios.

While it's true that hedge fund managers typically charge higher fees than traditional asset managers, these are usually linked to outperformance over their benchmarks. Given the level of skill and active management involved, there are no low-cost substitutes available. Ultimately, what matters to investors is the net-of-fees return and how this compares to the returns of other investments.

Hand-picked blend

At Sanlam Private Wealth we've leveraged the extensive skills and expertise across the Sanlam Group to identify the best hand-picked blend of independent hedge fund managers, optimised for our clients' multi-asset portfolios. We're excited about the benefits we believe this will deliver to our portfolios from both an expected return and a risk point of view.

The chart below shows how the blend of hedge funds that we'll be adding (within the 10% Regulation 28 limit) would have impacted the risk-reward outcome of our houseview Balanced Portfolio over the past five years.



Portfolio efficiency is improved by moving towards the top (higher return) and left (lower risk) on the chart. The hedge fund allocation adds both return enhancement and risk reduction to the overall portfolio, resulting in a more efficient portfolio. The hedge fund managers have been chosen based on their proven skill and track record within their areas of expertise and combined in such a way as to achieve an optimal outcome for the portfolio, subject to strict risk parameters, ensuring a diversity of strategies and complying with regulatory limits.

Optimal solution

Incorporating hedge funds into an investment portfolio offers several advantages, including enhanced diversification, the potential for higher returns and better risk management. Through our own research and leveraging the expertise of the Sanlam Group, we have diligently explored and identified the optimal hedge fund solution for our client portfolios. This expanded set of investment tools should put us in a good position to deliver an enhanced outcome for clients in the future.

Glacier Research thanks Renier de Bruyn for his contribution to this week's *Funds on Friday*

Renier de Bruyn
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Renier de Bruyn joined Sanlam Private Wealth at the start of 2010 as an equity analyst. After co-managing the multi-asset portfolios with the director of Investments since 2021, he was promoted to head of Asset Allocation in 2022. Renier graduated with a Bachelor of Commerce (Honours) in Financial Analysis from the University of Stellenbosch and is a CFA® charter holder.