The benefits of fixed income hedge funds in portfolio construction

Marthinus van der Nest – Head of Amplify Investment Partners

Amplify is a range of unit trusts and hedge funds managed by independent, next generation asset managers. We select independently owned asset managers with a proven track record who we believe will add significant outperformance over the long term.

Our range comprises seven long only managers. The long only solutions are managed with a hedge fund mindset and we've specifically identified managers with the skill to manage hedge funds effectively.

Why use hedge funds

We look for managers that can protect on the downside while being able to capture as much of the upside as possible – known as asymmetry of returns. Some asset managers will be better at managing downside and others better at capturing the upside. Also, some mandates are more aggressive than others. This will help clients to diversify their portfolios and protect their capital during market downturns.

How we select the managers

Our aim is to identify the most skilled managers in the market. We look at their people, processes, track record and size. We back managers' skill and select them for their ability to generate alpha. Often, smaller and more focused funds have yielded greater returns with more consistency. The funds should also have sufficient capacity available to meet client's future investment requirements. We look for a minimum of a one-year track record in any fund structure and/or at least three years' experience for the portfolio managers.

The manager's investment philosophy and objectives must be clearly understood, and their process must be consistent and sustainable.

Our four diverse fixed income managers:

Marble Rock Asset Management is the manager of the Sanlam Alternate Rho Retail Hedge Fund.

- The manager takes a global perspective to the fixed income market and opportunities across the yield curve.
- A small allocation to commodities is allowed, given their investment skill in the asset class. This adds extra diversification and an additional lever to maximise outperformance.

Acumen Asset Management is the manager of the Sanlam Alternate Zeta Retail Hedge Fund.

- The manager largely takes opportunities on the middle to long end of the yield curve.
- They select a large number of opportunities with lower alpha but superior risk characteristics.
- They take small, incremental positions with the intention of achieving sustainable growth over the long term.

Terebinth Capital is the manager of the Sanlam Alternate Veta Retail Hedge Fund.

- The manager focuses on taking a broad-based macroeconomic view of the fixed income market, taking opportunities along the full yield curve.
- An added characteristic is their very strong focus on risk management.

Matrix Fund Managers is the manager of the Sanlam Alternate Vega Retail Hedge Fund.

- The manager operates over different hot spots along the yield curve, predominantly over the front end of the curve with high conviction.
- Matrix has a relatively more aggressive strategy, therefore a higher level of both volatility and return over the long run is expected.

How the funds are applied

These managers play on different areas of the yield curve, giving us a different return profile.

The blended portfolio, comprising the four fixed income managers, provides equity-like returns of 13.85% p.a. but at lower level of risk than the ALBI. (Source: Amplify funds since inception 2020 and quoted returns of underlying fund managers since inception 2016).

Drawdowns

When comparing drawdowns of the blended portfolio against those of the ALSI and ALBI, we see that the blended portfolio has far fewer drawdowns, and those drawdowns are also less severe. This is especially important for those about to retire as a large drawdown just before retirement will mean the retiree will be drawing income from a lower capital base.

Reducing sequence risk

Considering the performances of our blended portfolio (including our selected Amplify managers), the return profile clearly indicates the immense value that hedge funds could add when combined within a portfolio. The demonstrably low correlation with traditional asset classes, along with the returns and drawdown characteristics exhibited, provide an ideal solution for managing sequencing risk.

Let's consider a practical example of a typical living annuity client, wanting a portfolio with lower volatility and one which provides greater investment longevity. The client invested R1m in 2011 and draws an income of 7% per annum. After ten years, and when incorporating the return characteristics illustrated above, the client would be materially better off, with substantially more capital, had the portfolio been exposed to hedge funds in some measure. Furthermore, the capital sum at the end of the period increases, the more meaningful the allocation is to hedge funds.

Amplify's latest hedge fund: a long-short equity fund managed by Oystercatcher Investments – the manager of the Sanlam Alternate Theta Retail Hedge Fund.

- Their philosophy is based on a valuation-driven approach with a quality bias.
- The manager invests in quality companies trading at attractive prices, increasing the margin of safety and improving risk/reward.
- Enhanced returns are achieved by implementing arbitrage, quasi-arbitrage, and relative value trades.

Arbitrage refers to the practice of exploiting mispricing opportunities within related investment groupings. This may include buying the stock of a holding company and selling the stocks of related underlying businesses (i.e. if there is a mispricing opportunity with the price of Remgro being undervalued relative to the sum value of its underlying constituents - you could buy Remgro shares, and short sell Distell, FirstRand, Mediclinic etc. Once pricing has moved to reflect fundamental value more accurately you would reverse the trades and realise a profit). Similarly, portfolio managers often make use of arbitrage strategies to exploit mispricing between stocks within the retail sector (i.e. buy Pick 'n Pay and short Shoprite), or the financial sector.

This is an aggressive long-short equity fund. Typically, this fund will have an 80% net-long position in equities. Therefore, the expectation is that if the market sells off, one would experience a decline in the value of the portfolio. Understanding this risk in the hedge fund is important. However, this manager has been able to generate high alpha over a number of years and through difficult times.

It's important to understand that this is a highly aggressive manager and that if there is a drawdown in the markets, investors will participate in that drawdown. This fund would thus be suitable to investors who are comfortable with higher risk levels.

This fund adds further diversification to the existing blend of Amplify's fixed income hedge funds.

Conclusion

We follow a robust research process that has proven itself through the manager selection. We focus on the skill of the selected managers, particularly their experience and track record. Hedge funds can be seen to offer diversification benefits and risk-adjusted returns.

The hedge funds will be made available to Sanlam financial advisers in the near future.

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