

Combining hedge and long-only funds is the better approach

Erik Nel, CIO of Terebinth Capital

We believe the notion that investors should choose between hedge funds and long-only funds, is the wrong approach. We believe combining them offers a better outcome.

The Sanlam Alternative Veta Retail Hedge Fund, which we manage, is a cautious to moderate fixed-income-focused hedge fund concentrating on macro strategies and is appropriate for long-term investors. Its objective is to provide returns in excess of 5% over its benchmark on an average annual basis over rolling 36-month periods with a low degree of volatility. The fund is actively managed, with a focus on achieving high risk-adjusted returns within a sound risk framework that identifies high quality, liquid instruments.

Returns in context

Our fund outperformed the ALBI, and STeFI over the period 2013-2017, a particularly difficult time for fixed income. During these years we experienced the EM taper tantrum in 2013, Turkey's interest rate hike in 2014, Nenegate in 2015, Brexit in 2016, and the ANC election of 2017.

If we then look at 2018–2021, we see an easier market for fixed income managers.

To understand returns, investors must understand that markets go through cycles and are driven by the psychology of crowds. This understanding points to how hedge funds differentiate themselves from long-only funds. Hedge funds are much more attuned to the drawdowns. Hedge fund managers acknowledge when their decisions are right or when they are wrong and when they realise they are wrong, they change their position a lot quicker.

The Amplify SCI Strategic Income Fund outperforms the ALBI, but with less than a third of the ALBI's volatility. The reason it's able to do this, is because it's actively managed. The active style is focused on protecting the downside.

If we compare the fixed income performance relative to the ALBI when the ALBI has a positive month, we find that hedge funds will not massively or consistently outperform the ALBI during

these positive months - because the ALBI has a long duration. If the ALBI's duration is seven (i.e. for every 100 basis points the bond yield goes up, you'll lose give or take 7% and if the yields rally 100 basis points you'll gain 7%.) For an asset manager to make 7% when bonds rally 100 basis points, the portfolio has to be in the correct position to even just match the ALBI.

If, however, the ALBI has a bad month, our style will not underperform the ALBI. When the ALBI has a drawdown, you'll see very infrequent drawdowns on our fund.

What should a good hedge fund do?

1. Protect ("hedge") the downside whilst leveraging the upside.
 - Why? Incremental alpha, while protecting downside risks, separates good funds from great funds.
 - How? By protecting the downside and harvesting upside.
2. Use as few units of risk for a unit of return as possible.
 - How? Strict stop loss rules (protect downside).

How does the hedge fund toolset differ from a long-only fund?

We are style agnostic. We seek to generate consistent, repeatable and scalable alpha and our approach is spread evenly over five areas which we believe are the excess return drivers, namely the primary market, government bonds, FRA (forward rate agreements), curve RV and high conviction macro.

Where to for SA?

SA, as with its global counterparts, has an unsustainable debt trajectory. We're at a crossroads and desperately need to implement the correct reform policies, get rid of the radical economic transformation faction and invest in infrastructure and get the private sector involved. In that environment equities will continue to do well and the risk premium in fixed income will drop significantly.

Until we get the needed reforms, policy prudence will be critical. We need to see wage reform, we need to move closer to a balanced budget and also closer to a zero-based budget framework where costs are contained.

Terebinth 2021 Q1 scenarios

Looking forward over the next 12 months, we identify the following three possible scenarios, with the highest probability being "Cyril":

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Cyril 50% Base scenario

- Global growth moves closer to trend; SA's hope pinned on the return of flows into the country.

• Merkel 35% Bull scenario

- Perfect mix of re-globalisation, easier financial conditions and SA-specific market-friendly reform.

• Trump 15% Bear scenario

- SA under severe pressure as lack of policy reform and poor leadership decisions lead to pariah status.

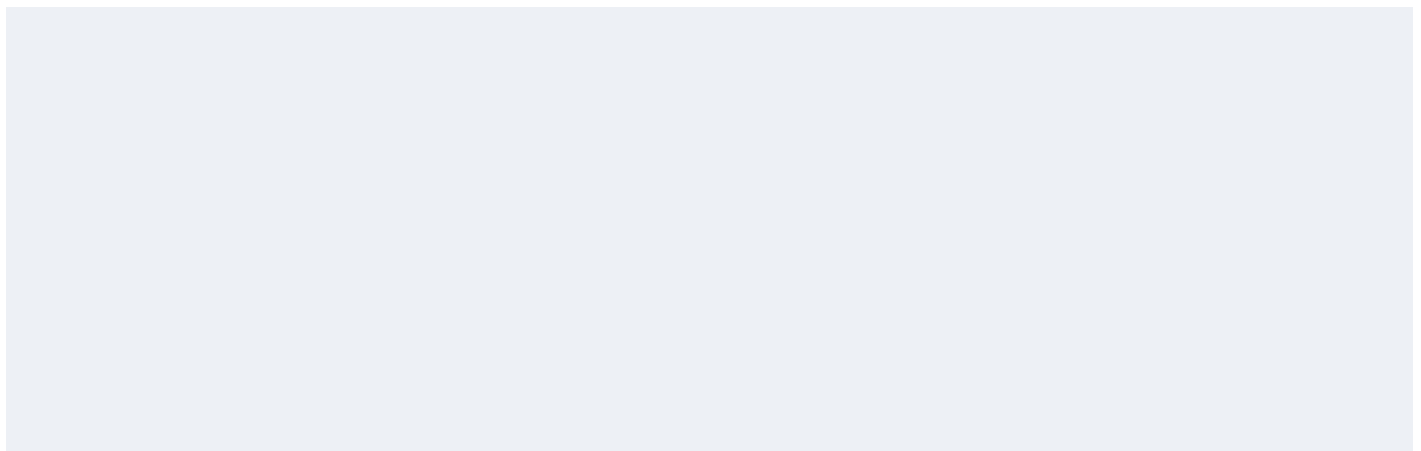
Terebinth Capital: Why invest with us?

The following are core to our business and influence our decision-making:

- Consensus-styled approach – The team's flat structure avoids risk allocation and siloed approaches.
- Culture – We have a culture that's inclusive and client-centric.
- Transformation – Majority female-owned and led, 67% female board, and Level 2 B-BBEE contributor.
- Philosophy – Centered on risk management and downside protection, liquidity and high-quality assets.
- Client centricity – The 'DNA' of our business.
- Investment focused – we are absolute-return focused and outsource all non-core functions.

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

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