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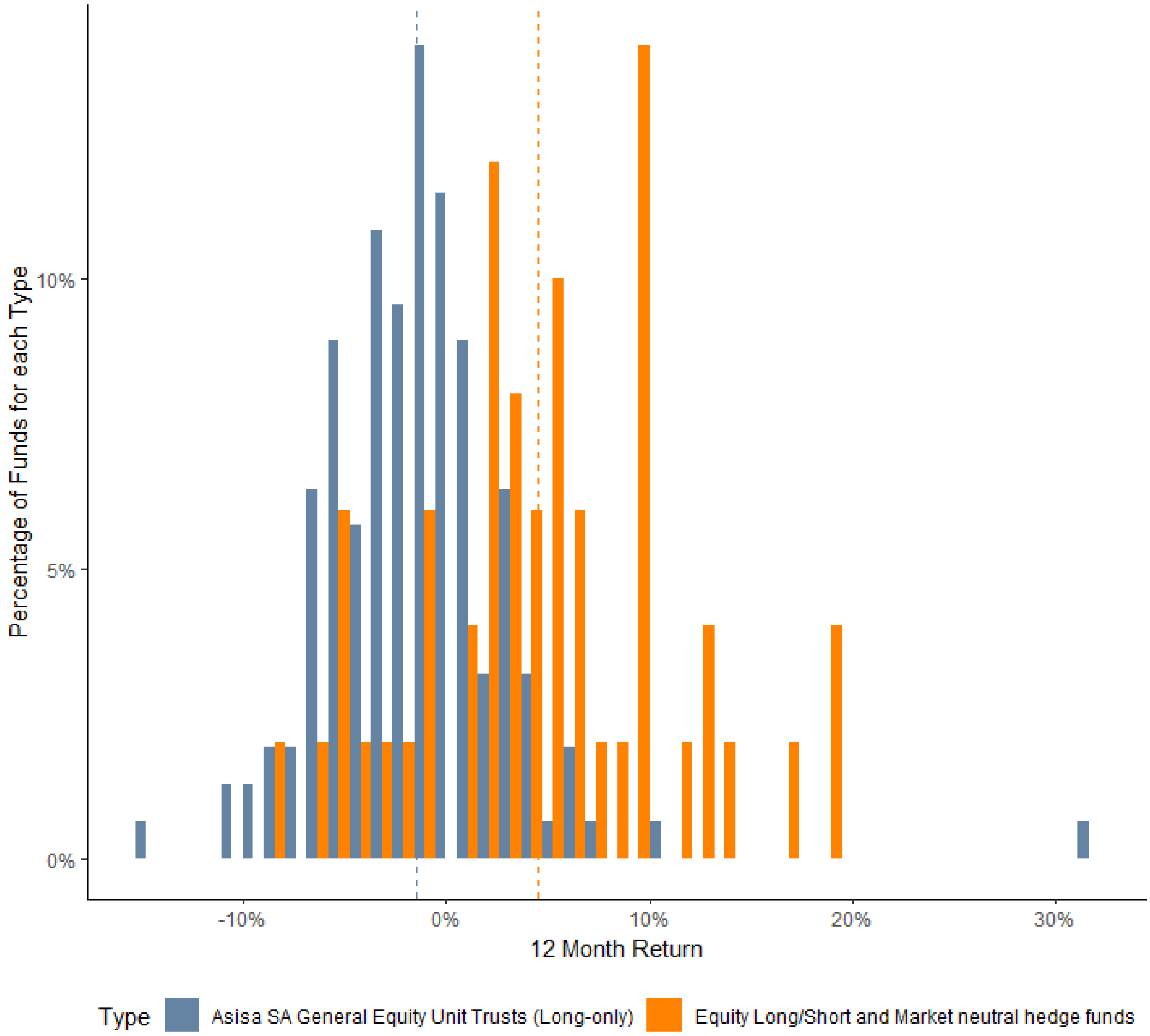
Is now the time to reconsider hedge funds?

Written by: Cornelius Zeeman, Portfolio Manager at Fairtree Asset Management

During the past year, many investor discussions and articles have focused on whether clients should look to move more of their wealth offshore to hedge their exposure to South Africa, in light of the country's unprecedented economic and political challenges. Whereas there are many good performance and emotive reasons to invest offshore, perhaps many of these discussions have overlooked the key role that local hedge funds can play in providing investors with a much-needed hedge against South African's challenging investment environment.

We recently compared the returns of all 157 funds in the ASISA SA General Equity unit trust sector compared to all 50 Long/Short and Market Neutral hedge funds for the 12 months ending 30 September 2019. See below for a distribution of returns of all the funds.

Glacier Financial Solutions (Pty) Ltd, I A member of the Sanlam Group | Private Bag X5 I Tyger Valley 7536 I Email: client.services@glacier.co.za | Tel +27 21 917 9002 I Fax +27 21 947 9210 I Web www.glacier.co.za | Reg No 1999/025360/07 I Licensed Financial Services Provider

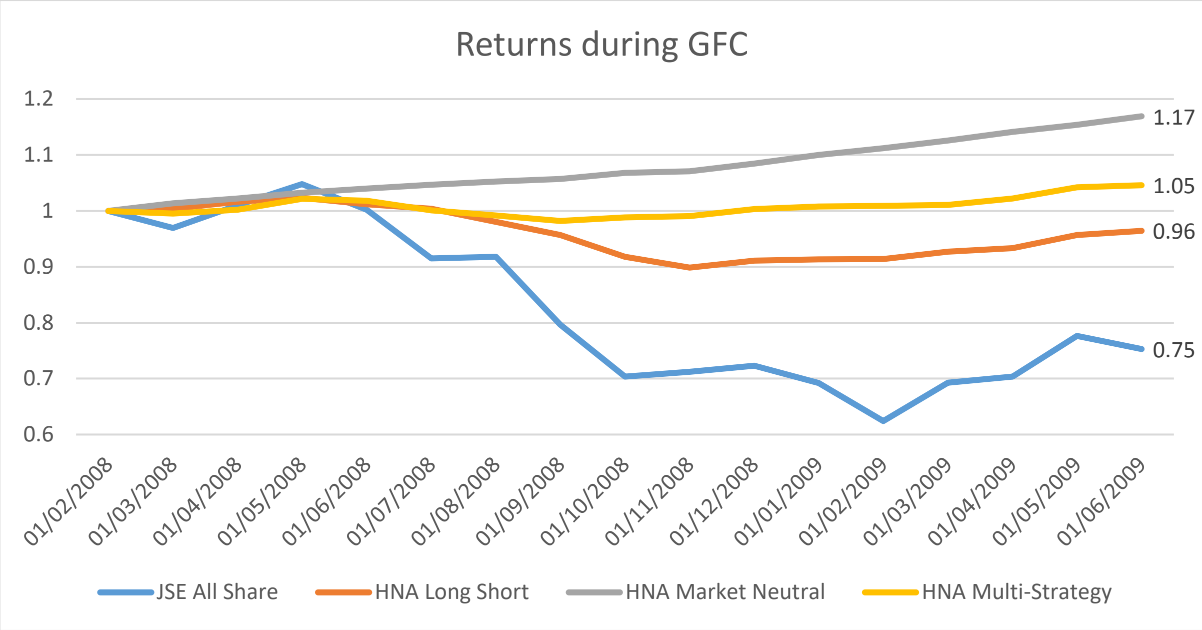


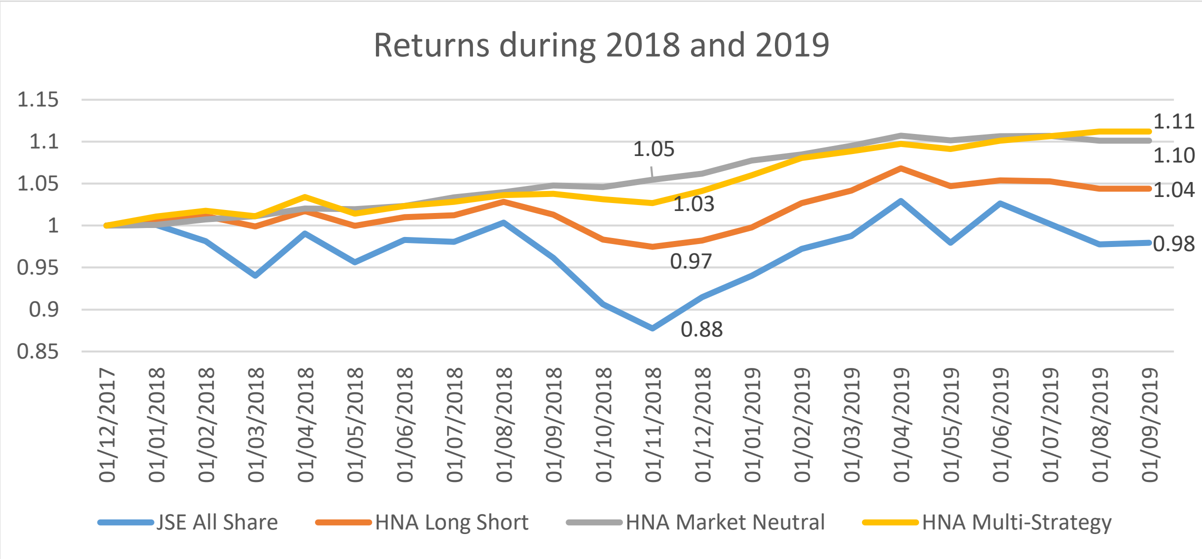
Source: Morningstar Direct

Equity unit trusts had an average 12-month return of -1.46%, with only 33% of funds managing to deliver a positive return over the past twelve months. Furthermore, only 6% of equity unit trusts managed to outperform the hedge funds' average return of 4.54%.

Is investing in hedge funds too risky?

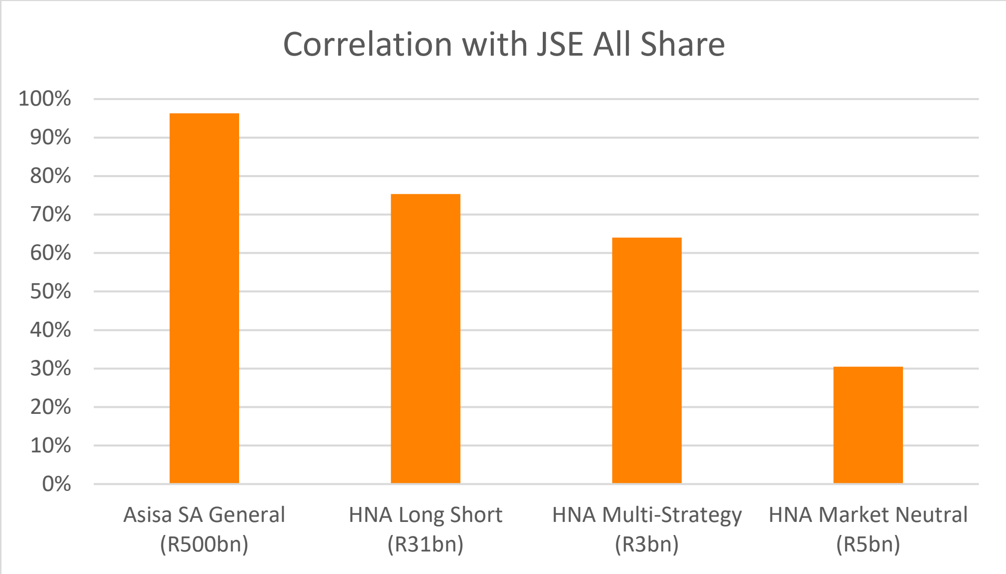
People are often reluctant to invest in hedge funds due to the perceived risks involved. This is ironic, because hedge funds actually use instruments and strategies to hedge the investment – hence the name. During the last twelve years, we've had two periods where the JSE All Share suffered big corrections. The first one was during the Financial Crisis of 2008 and the other one was during the latter part of 2018. Using Hedge News Africa index data, it is evident that all three major equity hedge fund classes managed to outperform the market comfortably during these times of turmoil.





Source: Hedge News Africa

Hedge funds have a much lower correlation to the JSE All Share than traditional long-only funds. They offer you the ability to outperform the equity market, while preserving your wealth during market corrections. This makes them a valuable building block in any portfolio.



Source: Hedge News Africa

Are hedge funds only for the elite or do they offer protection for ordinary investors?

The hedge fund industry has also transformed itself steadily over recent years. In the South African long/short equities (ZAR) hedge fund sector, almost 50% of funds are now classified as retail hedge funds. This means they look and feel like a unit trust that everyone is familiar with. Most of these funds have daily pricing, daily liquidity and low minimum investment thresholds e.g. R 50 000. Borrowing (or gearing) in the funds is also limited to 2x, which is low if you consider that most people buy their homes with 10x gearing. Furthermore, retail hedge funds may not invest in volatile asset classes like soft commodities.

Tellingly, of these retail hedge funds, 82% outperformed the JSE All Share over the past two years. This compares very favourably with the 45% of long-only funds that managed to achieve the same feat.

Hedge fund managers have been regulated under FAIS since 2007. Previously, hedge funds were not recognised under Regulation 28. However, in 2011 National Treasury and the FSB introduced changes that recognised hedge funds and alternative investments as an integral part of any diversified portfolio and allowed allocations of up to 10% of a portfolio’s assets.

In 2015, hedge funds were included under the regulation of the local Collective Investment Schemes Control Act, also known as CISCA.

Are hedge funds poor value for money?

Hedge fund fees are similar to that of unit trusts. The majority charge a 1% base fee and 20% performance fee. Since hedge funds often limit the size of their funds to protect their alpha-generating capabilities, it is appropriate to charge this type of fee.

One must be careful to focus solely on the cost of investments. In the investment world, if you are happy to get what the market does, then it is appropriate to find the cheapest index tracking fund, though it will always underperform the market because of costs.

However, as with any life decision, you normally weigh up the costs versus the benefits. For example, if you are buying a Mercedes, you are willing to pay more, because you know the ride will be more comfortable and faster than a Mahindra. The same logic should apply to the investment world. If you are happy with a slow car, you should go for cash. If you are happy with an uncomfortable ride, you should go for a passive index tracker. If you prefer a combination of the speed and comfort, you should strongly consider hedge funds.

Surely hedge funds act immorally by shorting shares?

Some people do not like the fact that hedge funds can make money when a company's share price falls. The easiest way to think about this is that a company's share price will oscillate around its fair value. Short sellers play an important role in steering markets to higher efficiency by actively selling down a share where the market price is not reflecting poor quality fundamentals, and this aids in price discovery (ensuring a share is not overvalued).

It is however, a problem if short sellers are spreading propaganda or "false news" to benefit their positions. This rarely happens, because if it is not backed up by facts, they lose their credibility very quickly. So, they can effectively only profit once from a strategy based on deception.

Why is the current environment very favourable for hedge funds?

Low-return environment

In an environment where about 25% of global bonds are now offering negative yields, returns are likely to be more subdued in the future, especially if more countries enter recessions.

The best way to think about a hedge fund is as an investment strategy with a broader toolkit than a unit trust fund. They should therefore be able to deliver better returns in this environment. The extra tools hedge fund managers deploy in markets include the ability to short, and to use leverage.

For example, you have R1 million to invest:

#1: You buy a property for R1 million, and pay the full price in cash, without a bond. If the property's price increases by 20%, you have a property worth R1.2 million.

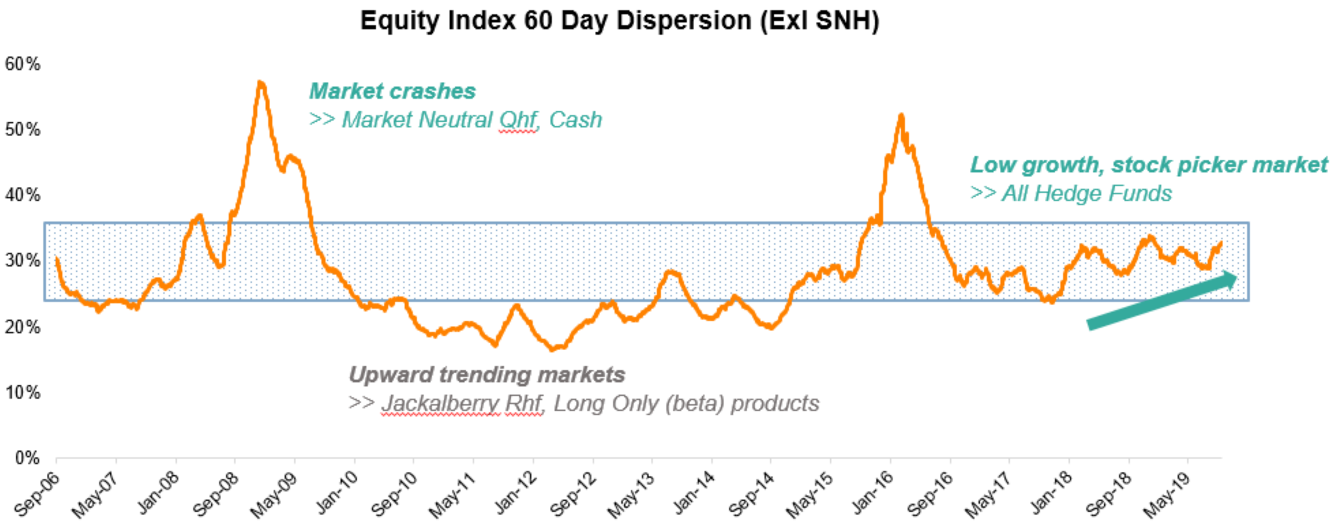
#2: You buy a property for R10 million. You put down a deposit of R1 million and take out a bond to finance the additional R9 million. When the price goes up by 20%, you sell the property for R12 million. If we assume that you paid the bank an interest amount of R1 million on the loan of R 9 million, your profit is R1 million after you repaid the loan, which is a return of 100%.

So, instead of a return of R200 000 under option #1, by applying leverage, your return is R1 million on the same investment amount.

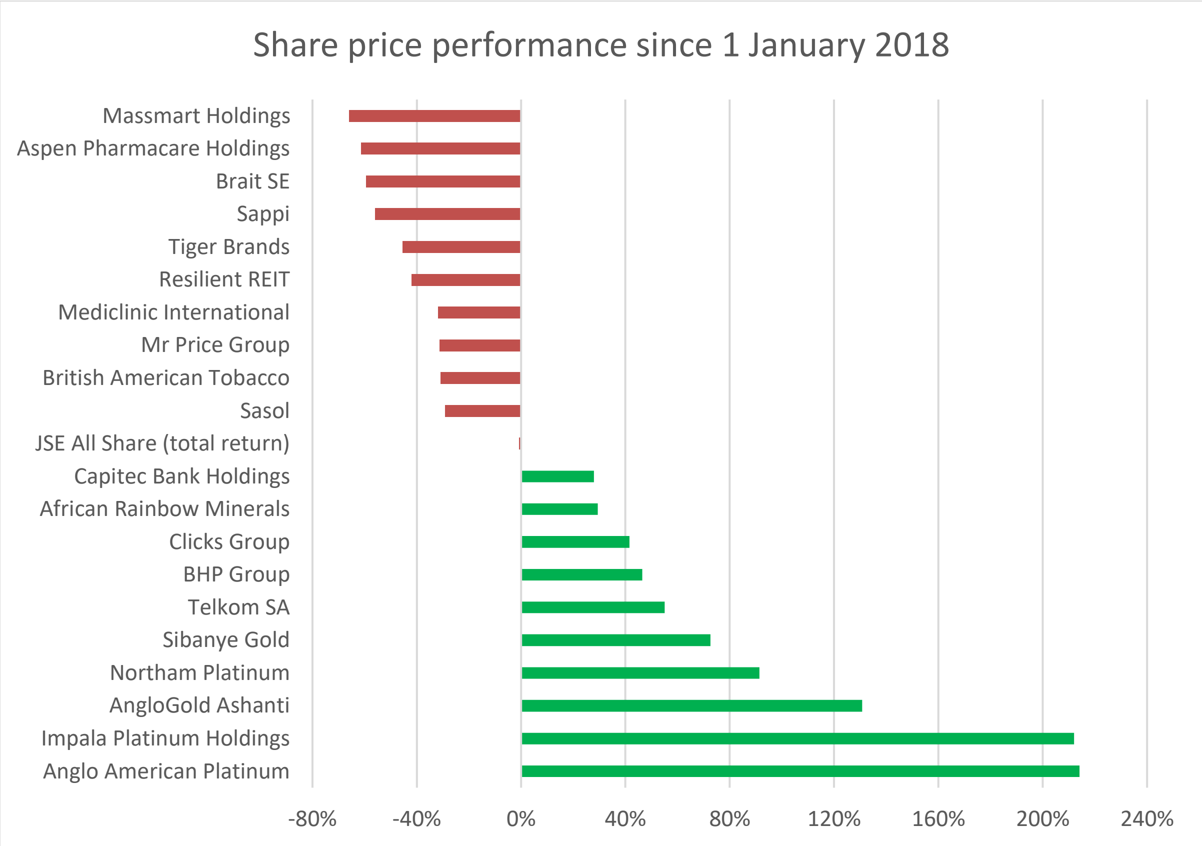
Hedge funds have exactly the same ability to apply leverage by investing in share futures and therefore an investment manager can make investors' investments work harder in a low return environment and produce better returns.

Volatile environment

Hedge funds perform best when the market is experiencing heightened, but not extreme dispersion. (Dispersion measures the range of returns of different companies within an index.). Dispersion offers trading opportunities, and this is exactly the environment in which we find ourselves. This dispersion is driven by macro risks, like Brexit and the US-China trade war, as well as company specific drivers.



The last two years have seen a big divergence in the top and bottom performing stocks. Although the JSE is largely flat, we've seen some companies deliver stellar returns. Precious metal companies account for the majority of the sample below, but the market has also rewarded some companies gaining market share in their respective industries. We all know about Steinhoff, but there are many stalwarts, that have also seen a fall from grace. This environment is ripe with opportunities.



In a traditional unit trust portfolio, investment managers will simply hold the shares that they prefer and not invest in the shares they believe will underperform. A key benefit of hedge funds is that they can do both: buy the preferred shares and generate additional returns by shorting the shares that are expected to underperform. In this volatile investment world where there are wide-scale political, economic and technological disrupters at play, we believe that hedge funds' ability to generate returns from rising and falling share prices, is a key additional reason to consider their inclusion in clients' investment portfolios.

Conclusion

So perhaps, as we are watching the South African economic and political news with bated breath, we should heed the words of the famed economist and Nobel Prize winner Harry Markowitz, that called “diversification the only free lunch in finance.” It is time to reconsider hedge funds’ rightful position in providing diversification in a client’s investment portfolio, as they offer exposure to the best long-term asset class, namely equities, but in a more conservative manner. Hopefully, they will help investors benefit from Markowitz’s free lunch as well.

Glacier Research would like to thank Cornelius Zeeman for his contribution to this week's Funds on Friday.

Cornelius Zeeman
CA(SA), CFA

Cornelius Zeeman is a Chartered Accountant and Chartered Financial Analyst. He joined Fairtree five years ago, after starting his career at Deloitte. He has been a co-Portfolio Manager of the Fairtree Relative Value Hedge funds, which include the Fairtree Jackalberry Equity Long Short SNN Retail Hedge Fund and Fairtree Morula Equity Long Short SNN Retail Hedge Fund over the last two years. He is an equity analyst forming part of the Fairtree long-only equity team, which has won the Raging Bull: 5-year award for the last two years.