Retail hedge funds are coming to South Africa (SA). Paving the way for this is regulation that has been in place since April 2015, bringing hedge funds into the ambit of collective investment schemes. The regulation, driven by National Treasury, is overseen by the Financial Services Board (FSB).

Globally, the hedge fund industry is very well established, with over two trillion US dollars of assets under management and a number of sophisticated strategies for hedge fund managers to choose from. By contrast, South Africa is very small with about R60 billion assets under management, compared to that of the long-only industry in South Africa, where there is close to two trillion rand invested in Collective Investment Schemes.

This year, things are set to change with the advent of hedge funds being regulated under the Collective Investment Schemes Control Act (CISCA) and approved for sale to the public by the FSB. The main aim of this regulation is to protect investors in hedge funds and assist with monitoring systemic risk, while promoting the integrity of the industry and encouraging financial market development. The man on the street in SA will be able to invest in Retail Investment Hedge Funds (RIHFs), whereas previously one needed to be a qualified investor, and have a minimum of R1 million in order to invest in a hedge fund. The minimum investment for a RIHF will be R50 000.

**Distinguishing between RIHFs and QIHFs**

1. Retail Investor Hedge Funds (RIHFs)
   - No restrictions on who can invest
   - Highly regulated
   - Valued on a daily basis
• Repurchase policy of no longer than one month
• To be available via platforms and to Model Portfolios

2. **Qualified Investor Hedge Funds (QIHF’s)**

• Minimum of R1 million
• Institutions and Qualified Investors who have knowledge of the market
• Limited regulation
• Repurchase policy of no longer than three months

**Volatility (risk)**

Top of mind for many investors when it comes to hedge funds is risk. It’s an area where perception can be very different to reality. Hedge funds cover the full risk spectrum – low to high. Generally, investors don’t want to take on more risk than is necessary with their money, but some risk is required for a good return. Investors and advisers have a measure to consider when assessing risk. What you are looking for is a return that is achieved without taking unnecessary risk. Volatility is a key consideration for investors; most of whom accept that there will be ups and downs but want to avoid extreme moves.

Hedge fund strategies vary - many hedge against downturns in the markets, especially important today with volatility and anticipation of corrections in overheated stock markets. The primary aim of most hedge funds is to reduce volatility and risk while attempting to preserve capital and deliver positive returns under all market conditions.

**Downside protection**

When addressing downside protection, we look at the maximum drawdown – the most an investor could have lost. Ideally a fund should have lower drawdowns than the market. A low drawdown will demonstrate that a fund can protect capital. Hedge fund managers think about risk in terms of loss of capital, and actively manage risk to try to limit their losses. South African hedge funds have been successful in protecting capital and minimising drawdowns, resulting in enhanced returns and lower risk.

**Diversification**

By reducing exposure to general market movements and only targeting specific risks, a hedge fund can produce a return stream that has a low level of correlation and a lower level of downside volatility, compared to general risky assets such as equities. This has valuable benefits in portfolio construction, and can lead to a more consistent return profile in a diversified portfolio.

Investors can no longer rely on simple strategies that are weighted heavily towards fixed income assets in order to produce reliable returns that meet financial obligations. In today’s world, investors need comprehensive, nimble, diverse investment portfolios that provide opportunities to maximise return while minimising risk. Portfolio
diversification provides an additional layer of risk management preventing investors from being overly concentrated in a specific type of asset.

Where an investor feels that equity markets are overvalued or where an investor does not want to take on the risks associated with equities - an allocation of some monies to hedge funds can be justified on the basis that diversification reduces the risk of significant losses in your portfolio.

**Understanding Hedge Fund Strategies**

**Long Short Equity**

Hedge fund managers can either purchase stocks that they feel will increase in value, *(long position)* or short sell stocks they think will decrease in value *(short position)*. In addition to this, *leverage may be used to enhance returns*. In most cases, the fund will have positive exposure to the equity markets – for example, having 70% of the funds invested long in stocks and 30% invested in shorting of stocks. In this example, the net exposure to the equity markets is 40% (70%−30%) and the fund would not be using any leverage (The gross exposure would be 100%). If the manager, however, increases the long positions in the fund to, say, 80% while still maintaining a 30% short position, the fund would have gross exposure of 110% (80%+30% = 110%), which indicates *leverage* of 10%. It is key to understand the net exposure and leverage of the funds that you are investing in. Some are very aggressive and may have up to 400% gross exposure (like some QIHFs), while others may be more conservative and have an average net exposure of 150%. RIHFs may only have a maximum gross exposure of 200%, whereas QIHFs are only limited by their mandate that they have specified.

**Market Neutral**

In this strategy, a hedge fund manager applies the same basic concepts mentioned in the previous paragraph, but seeks to minimise the exposure to the broader market. This can be done in two ways. If there are equal amounts of investment in both *long and short positions*, the net exposure of the fund would be zero. For example, if 50% of funds were invested long and 50% were invested short, the net exposure would be 0% and the gross exposure would be 100%.

**Summary**

Investing in some hedge fund strategies can provide significant enhancements to diversified portfolios, especially during times of equity market distress. Since strategies vary considerably in the hedge fund universe, investors must clearly define their objectives and constraints when considering an allocation to hedge funds.
Glacier Research would like to thank Gavin Kyte for his contribution to this week’s Funds on Friday

Gavin Kyte, B Com (Hons) CFP

Gavin joined Laurium Capital in October 2015 and is responsible for business development. He has 8 years’ experience in the financial services industry. He was part of the STANLIB graduate programme in 2008, and furthered his career at STANLIB until 2013 before joining Investec Asset Management.