



Why hedge? Or rather, give me a good reason as to why not?

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Global investors have made a BIG deal of hedge funds over the last decade. As testament to this, one only needs to look at the hedge fund asset class growth over the period. According to data from Chicago-based group Hedge Fund Research, industry assets grew from \$2.9 trillion at the end of 2011 to \$4.1 trillion at the start of 2022 – a whopping 41% growth in AUM.

On the domestic front, the latest available figures from Novare had the South African hedge fund industry sized at R61.5 billion in 2020, or US\$4.2 billion equivalent. Rand hedge funds make up circa 0.1% of the global hedge fund industry today and have also seen strong growth of almost 90% between 2012 and 2020.

So why do investors allocate to hedge funds? There are two reasons primarily – the first being the absolute return performance signature of ‘true’ hedge funds, and the second is to access a source of returns with a low correlation to market beta.

The ability to have generated absolute returns over the last 20 years has been challenging. The bursting of the dot.com bubble, the housing market induced Global Financial Crisis, the Covid-19 lockdown sell-off of March 2020, and most recently Russia’s invasion of

the Ukraine have all created significant shocks to global markets.

As Albert Einstein said: “The most powerful force in the Universe is compound interest.” To illustrate this point, the table below shows the Visio SNN Market Neutral Retail Hedge Fund’s ability to protect capital during volatile markets, as well as largely generate absolute returns during bear markets to allow for positive compounding of returns:

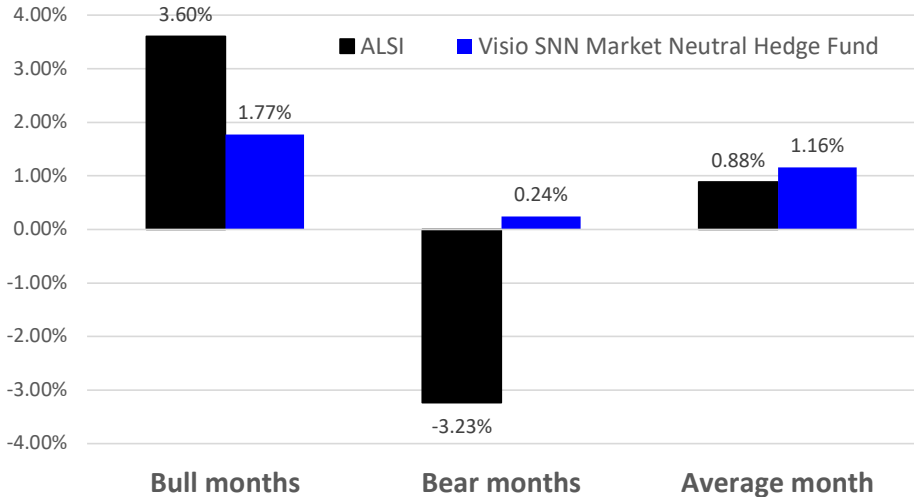
Figure 1

Calendar Year	Fund	ALSI	INDI 25
2008	+0.6%	-23.2%	-15.7%
2018	+16.9%	-8.5%	-17.9%
2022	-1.1%	-10.1%	-11.8%
'08, '18 and '22 compounded	+16.3%	-36.8%	-43.0%
Return required to catch up to fund		+84.0%	+103.9%

The fund offers a convincing example of a South African market-neutral hedge fund with an extensive track record.

The bandied about acceptable equity market down capture in the industry is for an equity hedge fund to only participate in around 25% of the equity market downside, and to capture

Figure 2



up to 75% of equity market upside. If one compounds the 2008, 2018 and 2022 year-to-date returns shown in figure 1, one gets a return of 16.3% for the Visio SNN Market Neutral Retail Hedge Fund. Over the same period the ALSI and INDI25 indices were down -36.8% and -43.0% respectively. These are significant drawdowns when looking at the 2008, 2018 and 2022 periods on a combined basis. In order for the ALSI and INDI 25 to fully recover from their drawdowns and 'catch up' to the Visio SNN Market Neutral Retail Investor Hedge Fund, these two indices would need to generate returns of 84% and 104% respectively. For the ALSI, this would take five years if one applied its annual return of 13.2% over the last 20 years. Similarly, the INDI25 would take six years, having annualised 13.9% for the last two decades. Clearly limiting downside capture is key!

Once again, we have seen volatile markets, as we have experienced thus far in 2022, lead to an increase in appetite for hedge funds locally, with investors looking for the market protection that market-neutral hedge fund strategies can provide.

From looking at the example above, it is not disputed that trying to time the market is a mug's game, nor is it disputed that skilled hedge fund managers can limit downside

capture. This is a good reason to always make a hedge fund allocation a permanent feature of your strategic asset allocation (SAA).

To drive the point home even further, let's dig deeper into the analytics and look at the upside and downside market capture for the Visio SNN Market Neutral Retail Hedge Fund on a monthly basis. Looking at figure 2, over the period of the fund's life from November 2006 to September 2022, it has managed to capture half (+1.77%) of the market upside during market bull or up months, which have averaged 3.6%/month. Where Einstein's positive compounding force comes into effect is the fund's ability to have generated average returns of 0.24% versus the average ALSI bear month return of -3.23%. These average absolute returns over both the up and down months for markets result in an average return of 1.16% for the fund, well ahead of the market's 0.88% average monthly return. For those Warren Buffet fans out there it heeds to his two rules for investing: Rule #1: Don't lose money, and Rule #2: Don't forget Rule #1!

Another reason to consider hedge funds is a reduction in portfolio risk. When one thinks of risk, you consider drawdowns and the permanent loss of capital, as well as the volatility of return streams. Suffice to say the drawdown argument has been addressed, but

what about volatility? The norm is to study the standard deviation of a product's returns. If we look at these metrics over the life of the Visio SNN Market Neutral Retail Hedge Fund, its volatility has been 8.5%, which is just over half of that of the ALSI's vol of 15.1% over the same period. The INDI 25 index volatility wasn't far off that of the ALSI over the period at 14.8%. Hedge funds ably check this volatility box too!

The next metric to consider is the Sharpe Ratio, a measure of return generated for each unit of risk. It goes without saying that higher average returns in the numerator together with lower volatility in the denominator will lead to superior risk-adjusted returns or Sharpe Ratios. Since November 2016, the Visio SNN Market Neutral Retail Hedge Fund has achieved a Sharpe Ratio of 0.5 versus the ALSI's 0.0 and INDI25's 0.2. Check another box!

Another key benefit of hedge funds is the ability to diversify portfolios and 'not putting all your eggs in one basket'. And diversification can be broad within hedge funds across exposures, both long and short, across markets domestically and offshore, across sectors on a global scale, across asset classes (equities, bonds, derivatives, cash) as well as across currencies.

One last item to address is portfolio exposures and correlations. A variable net hedge fund's net exposures can range from a minus quantum to 100%, whilst the gross exposure as measured by the commitment method can max out at 400% for retail products. This variation in exposures, and the ability to profit from utilising both short positioning and leverage, can result in a source of returns with low correlation to equity markets, ie: low market beta and equity risk. The correlation of the Visio SNN Market Neutral Retail Hedge Fund to both the ALSI and the INDI 25 indices has been 0.4 since November 2009, and even lower to the RESI index at 0.3 for the same period.

I hope the above has gone some way to convince you of the benefits of hedge funds. The asset class is more broadly accepted and utilised offshore, especially in the US where



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the first hedge fund launched back in 1958, almost 65 years ago. On the local front, hedge funds have only been managed in South Africa since 1995, making the domestic hedge fund industry relatively young at around 27 years old. Given the low minimum investment amount of R25,000 required for retail investor hedge funds, these products are now more accessible than before. Go on, why don't you give hedge a try? Or convince me why not!

Craig French joined Visio Fund Management in April 2012 where he is responsible for product development and client relationship management. Initially founded by Patrice Moyal in 2003, Visio's dynamic team manages assets across listed strategies for a diversified client base that includes some of the world's largest and most sophisticated investors. Before Visio, Craig worked at Alvine Capital in London for five years as a portfolio manager and analyst investing in hedge funds, both globally and across investment strategies. He holds a BSc (Hons) and MBA (Finance).