Unconstrained thinking

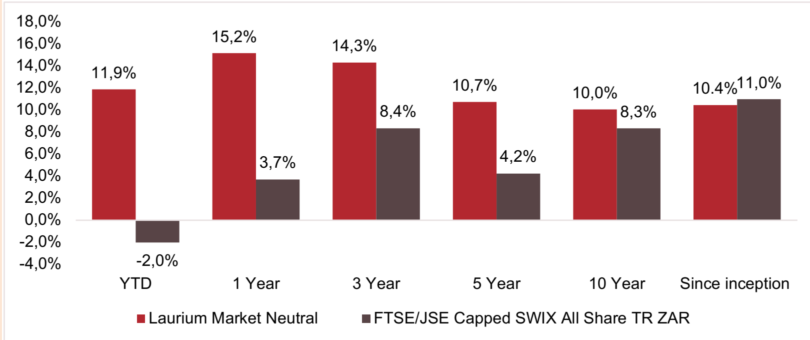
Hedge funds: An effective tool to both grow and protect clients' wealth

KIM ZIETSMAN
Head: Business Development and Marketing, Laurium Capital

There's a good reason why advisors are looking for alternative investment options to grow and protect clients' wealth. During volatile market periods, which we have become so accustomed to, it can be hard for investors to stay the course and not have a knee-jerk reaction when markets are going against them.

Over the past decade and a half during times of market stress (e.g. the Global Financial Crisis, the Covid Pandemic and, more recently, global inflation concerns), hedge funds in South Africa have been able to protect capital well on the downside while still providing equity-like returns on the upside, exactly what is needed for post-retirement savings that are not constrained by Regulation 28, and specifically for those invested in Living Annuities.

Figure 1: Laurium Long Short Prescient RI Hedge Fund vs FTSE/JSE Capped SWIX TR – Annualised Returns net of fees to 31 October 2022



Source: Morningstar Direct

Where do returns come from?

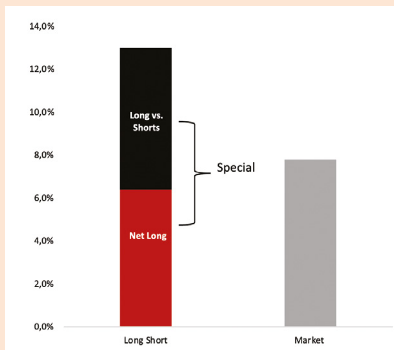
South African hedge fund managers operate in a less efficient market than most other global markets and the market is dominated by big traditional long-only funds. Hedge fund managers can combine substantial research capabilities, employ a flexible mandate and other strategies like leverage and shorting (selling a stock if you think the price is going down) to generate superior risk adjusted returns. Equity long/short is the most used hedge fund strategy in South Africa that looks to generate alpha from stocks rising and falling.

Returns come from:

- Net long exposure to the market, i.e. your long book less your short book.
- Outperformance of long positions relative to short positions.
- Cash interest – hedge funds due to shorting may hold a significant amount of cash. Not only does this cash earn interest, but it also allows you to take opportunities quickly when they arise as you don't have to sell something to buy something as you would do in an equity unit trust, for example.

These returns are augmented by special situations, pair trades, book-builds, and corporate actions.

Figure 2: Source of returns: Annualised three-year returns of Laurium Long Short Prescient Retail Hedge Fund after fees) vs JSE/All Share Capped SWIX, net of fees

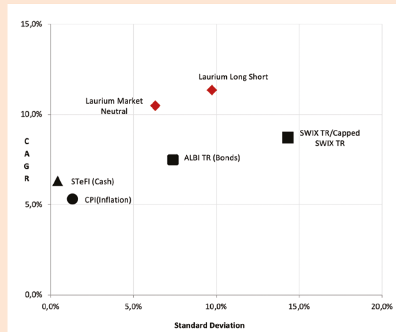


> "Over the past decade and a half during times of market stress, hedge funds in South Africa have been able to protect capital"

How do we manage risk?

The mandate or risk parameters of the fund in terms of leverage and net exposure will largely determine the risk profile of the fund. While managers may use leverage and shorting to amplify returns, we use short opportunities to reduce volatility. Risk can be reduced through having a lower beta and net exposure to the market, and having a higher upside capture than downside capture consistently over time.

Figure 3: Net Return in Perspective vs. Market Indices – 1 January 2009 to 31 October 2022



Source: Morningstar Direct

Who should invest in hedge funds?

1. Suitable for conservative to aggressive investors, depending on the strategy and risk profile of the hedge fund.
2. More aggressive hedge funds can be used in growth or accumulation portfolios, while the moderate or conservative hedge funds are more appropriate for drawdown portfolios, e.g. Living Annuities.
3. Reg 28 funds: Utilising a max allocation of 10% improves overall risk-reward profile; 2.5% may be allocated per manager.
4. Living Annuities and Discretionary portfolio are not constrained: allocations at least 10% to 25% are considered appropriate.