June 2023

Heads I win, Tails you lose

For most investors, hedge funds have historically been opaque products where 'magic' happens. The domain of the wealthy, with limited access, high hurdles for entry and outsized returns.

In South Africa, the industry has struggled to gain traction, although for a niche of investors, around R100bn worth[1], they have found a compelling proposition in which to invest. Hedge funds offer the ultimate outcome: upside growth with limited downside, and this appeals to investors widely, particularly those who have made their wealth and where loss aversion is a key factor in their decision-making process.

In this month's comment, we explore the hedge fund proposition in more detail and how investors can consider them as options within their financial plan.

Origins

The concept of hedging is not new, with the origins tracing back to 1700s Paris, with the trading of debt instruments known as '*rentes'*. One particular observer, Louis Bachelier, noted how the best traders were making diverse bets in order to generate profit. He later captured the mathematical logic behind these bet payoffs, which later found its way into modern finance theory via the Black-Scholes option pricing model[2]. This paved the way for the creation of financial derivatives in the 1970s which could enable profit-making through assets going up as well as down. As Bachelier explained: "*I have in fact known for several years that it would be possible . . . to imagine transactions where one of the parties makes a profit at all prices."*[3]

The simple concept of making a profit when assets go up as well as down provides the basic premise for hedge funds today. While they have evolved greatly into a wide variety of strategies, they are typically explained by:

- Holding assets they think will go up. E.g. Microsoft goes from $100 to $200, the profit is $100.
- Selling assets short, which they think will fall in value. Importantly here, they don't hold the asset in the first place, so their exposure is in fact negative. E.g. Microsoft starts at $200 and ends at $100, they have also made a $100 profit on the position.

By playing both sides of a position they expand their opportunity set beyond that of a traditional long only investment manager who is focussed solely on buying assets they believe will go up. This drives what should be a superior return outcome, given the broader ways to make money. Apart from this difference, hedge funds differ from long-only funds in the following key ways:

- Hedge funds can take their total market exposure ('gross exposure') above 100% of the capital invested. For example, if you were to invest R1m, this could be invested as R1.5m in investments the hedge fund manager believes will go up, and negative R0.5m in investments the manager believes will fall. They have essentially doubled their exposure to the market - termed their 'gross exposure'. They are giving themselves more chances to make money, given the same initial capital investment.
- Hedge funds have also originated as profit-centric funds, contrasted with the traditional investment fund which has a long-term savings orientation. This difference can drive large differences in risk-taking and investment approach, given that there isn't necessarily an anonymous list of pension fund investors relying on the outcome. Rather, they are typically wealthier, more sophisticated investors who understand the risks involved. For this reason, you can find more aggressive position-taking and more concentrated holdings in many hedge funds, driving higher returns.
- Avoiding market falls is another key benefit of a hedge fund and one which appeals greatly in times of stress. Hedge funds achieve this through broader market hedging, so for example rather than believing a single asset like Microsoft will fall, they bet on the fact that the whole market may fall, and when it does the profit realised helps offset any losses they carry on their favoured positions, helping produce a smoother return profile for investors.

So, on the face of it, hedge funds should be able to outcompete a traditional fund only looking to benefit from shares which go up. Below we explore the context of making a decision when it comes to hedge fund allocations.

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Fair comparisons

We'll start by making sure we are comparing like for like. As hedge funds vary greatly in their strategies it can be troublesome to create fair comparisons. In SA, the majority of hedge funds are what are known as "Long/Short" funds[4]. These are funds which are typically equity centric, and where their net equity exposure is in the region of 50% to 70% on average (although this can swing quite widely). The common goal is often to deliver equity-type returns, but at half the risk, or some variation of this.

The Long/Short funds we focus on in this article are characterised in this way: equity centric, with gross exposure of less than 200% of the capital invested. Given the fact these funds take more than 100% equity exposure, and concentrate their positions both positive and negative, we generally set the fair equivalent investment as a fully invested equity fund. Hedge funds tend to present their funds alongside money market or balanced funds as well, as a measure of what the alternatives are. We believe an equity-based portfolio – like an index fund tracking the market – is a better gauge by which to measure these funds as they are able to build a portfolio with full equity exposure, and then use their extra tools to add value over and above this starting point.

Extra Tools

The strategies which hedge funds like this will tend to employ cover the following areas:

- *Stock market hedging*: protecting against broad market falls.
- *Short selling*: taking a negative position in a share the manager thinks will fall in price.
- *Holding companies they believe will rise*. Often this will be a relatively stable part of the portfolio.
- *Pair trades*: this is where the manager will buy and sell two similar companies, where they are betting that one will outperform the other. For instance, buy Standard Bank, Short sell ABSA. If in this case Standard Bank rises 20% and ABSA falls 10%, they make 30% profit. And if Standard Bank rises 20% and ABSA rises 10%, they still make a 10% return.
- *Corporate actions*: special situations such as a company unbundling from its parent can create significant opportunities to make money. Recent examples in SA include OUTsurance (from RMI) and Thungela (from Anglo American).
- *Currency trades*: betting on particular currency trade-offs.
- *Offshore allocations*: for some funds, this has become a more recent pursuit as the risk in SA has become elevated and the range of investment opportunities has reduced. Most often these positions are favoured positions which are held, rather than short sale positions.
- *Other asset classes:* from time to time a hedge fund will allocate to other assets, including government and corporate bonds, listed property, preference shares and other tradeable instruments, over and above listed equity.

Efficacy

In our relatively narrow stock market, the range of instruments has been on the decline for several years as companies have delisted and new issues have been rare. There are also limitations on the quantum of exposure which can be sold short on particular instruments given the availability of liquidity at the time. This creates somewhat of an asset size constraint on fund managers.

To mitigate this, with the problem being too many assets to manage, many hedge funds will close to new business at certain times to preserve future return potential. Funds are increasingly looking offshore to mitigate this problem, however, they are faced with a highly competitive market and it is not obvious their domestically oriented skillset can translate offshore in the same way.

Fees & Costs

This is often a philosophical debate across the industry, given the typical expensive fee structure which is found in most hedge funds. "*If a fund delivers the goods after fees, who should care what the fee is?*" is the logic applied here. In theory, this is right. The way we assess this is to consider what the overall cost of the fund would be relative to other alternatives, and at the same time, to what extent the fee structure impacts the feasibility of the fund manager adding value once fees have been deducted. Linked to this, are they implicitly taking on more risk than desired, to help offset the fee structure in the first place? Fee structures differ across the industry, but generally have some basic similarities:

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- A relatively high fixed fee structure of between 1% and 2% per year. This compares with a market-based index fund of 0.25% where no value add is targeted.
- In addition, a performance hurdle to beat which is usually zero or a bank cash rate.
- Thereafter, a sharing of profit – usually 20% of any excess return above the hurdle.

This performance fee component is also mostly paid only where the fund's value reaches a new high, to avoid paying for returns which have already been paid for in the past. This is known as the 'high water mark'.

Operating costs are also significant in hedge funds. As they are more active in their trading, the costs of executing their strategies can be 10 or 20 times that of a conservatively traded fund. As the investor receives the net proceeds after all costs and fees, as well as that paid in tax, we need to look at all components together.

The example below illustrates the costs via two funds we have reviewed recently, the 36One SNN Retail Hedge Fund, and the Peregrine Capital High Growth H4 Retail Hedge Fund. For comparison, we have included a market/passive equivalent portfolio[5].

Cost Estimate: Past 3yrs % per year			As at May 2023
	36One	**Peregrine**	**Market**
Fund Manager Base Fees	1.0	1.5	0.3
Fund Manager Performance Fees	2.9	3.9	N/a
Administration Charges	0.3	0.3	0.0
VAT	0.6	0.8	0.0
Total Expense Ratio (TER)	**4.7**	**6.5**	**0.3**
Transaction Costs (Ave)	0.8	1.7	0.2
Total Investment Charge	**5.5%**	**8.1%**	**0.5%**

Source: Fundhouse/Refinitiv/Fund Managers

This table highlights a few points to consider:

- The cost of management is high before any value is added. Investors need to have a very high comfort level that these costs will be recovered when allocating.
- Transaction costs are very high relative to a traditional fund. These are paid to the stockbroker and to tax, and are necessary to implement what is inherently a highly actively managed strategy.
- Performance fees can add materially to the cost. This in itself shouldn't be an issue provided the hurdle is fair and such that the profit share is fairly allocated between the manager and the investor.

These costs also only reflect a point in time and can vary widely depending on the performance of the fund relative to its hurdle. In the case of 36One they will take 20% profit share of returns above the Standard Bank Call Rate with the performance fee component capped at 3.50% per year, and Peregrine will take 20% profit share for any positive return made with no fee cap, provided the fund has reached a new high value (the high water mark).

When considering costs, we prefer to compare with the reasonable alternative, in this case a passively managed portfolio. A hedge fund which is over 100% invested in equity should be able to add value over and above what is available simply and cheaply.

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Comparing returns, we get the following estimates of returns before and after fees, considering the past three years to May 2023:

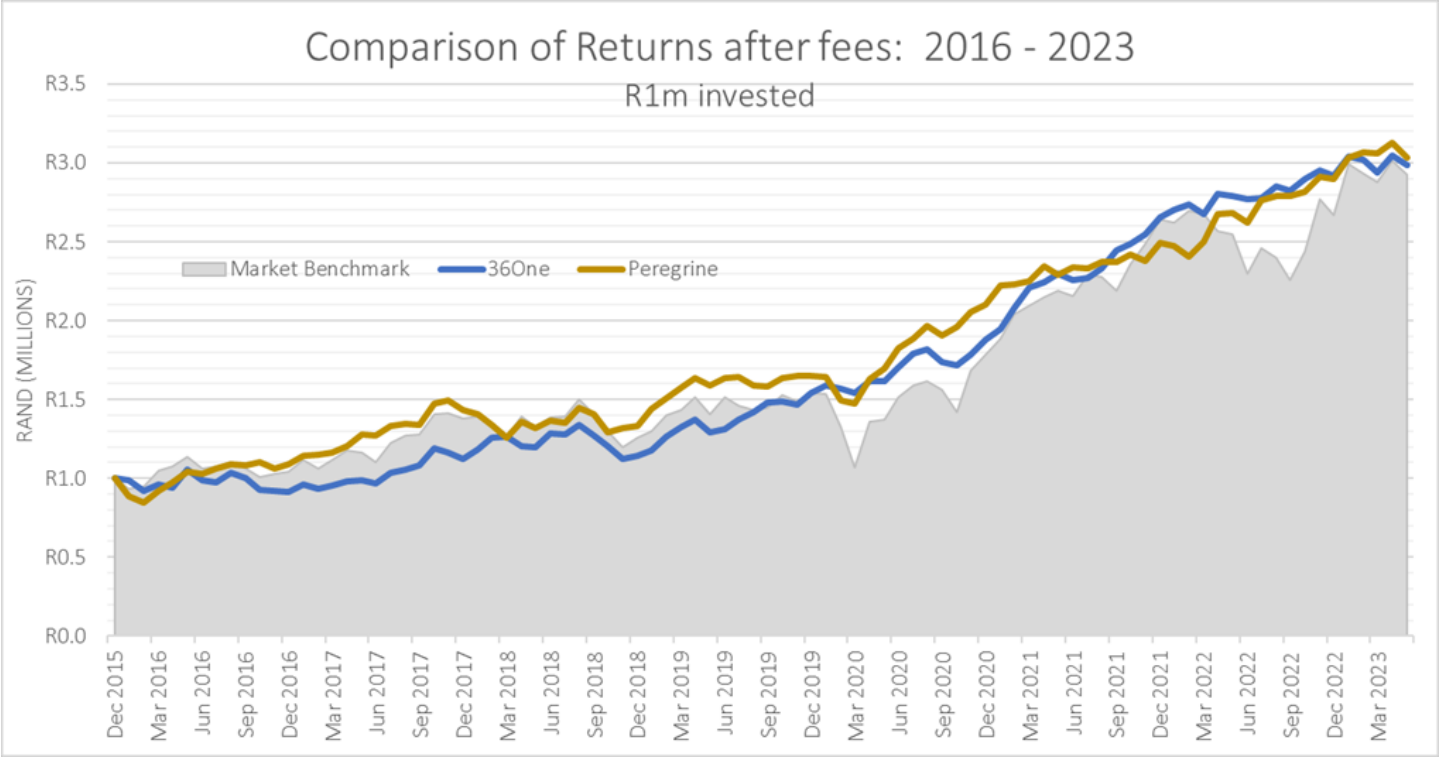
	36One	Peregrine	Market
Return before costs p.a	20.6	21.2	18.7
Deduct costs	5.5	8.1	0.5
3yr Return Net of Costs p.a	**15.1**	**13.1**	**18.2**

Source: Fundhouse/Refinitiv/Fund Managers

This highlights an important consequence of using fee hurdles which do not reflect the investment approach of the fund. While both 36One and Peregrine have managed to achieve higher returns than the market before costs in this example, they have fallen far behind when accounting for costs. The investor would have been better served in a passive market fund. The benefit of the additional tools at the hedge fund's disposal has been outweighed by the cost in this case.

The second point to note is that this creates a very high starting point for these funds to add value when costs are considered. Availability of investment ideas, the hit rate on successful ideas, the availability of opportunities such as corporate actions, and the managers offshore capabilities need to be high probability areas of value add to be able to justify the trade-off before considering an investment.

Looking back over the past seven years or so, when hedge funds were first regulated and made available in familiar collective investment funds for retail investors, we see the following picture:



Source: Fundhouse, Refinitiv.
Returns shown are for the Retail Investor fund class, and where unavailable the Qualified Investor class is used

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The shaded area reflects the return earned by holding a simple low-cost market portfolio. R1m would have ended up at R2.9m over this time horizon. Bear in mind we have had Nenegate, State Capture, trade wars, COVID-19 and the 2022 inflation shock to navigate over this period. Both 36One and Peregrine would have delivered R3m over this time horizon. The net benefit to an investor is marginally positive, but has it rewarded them for the larger degree of risk taken?

The point on risk is worth explaining a bit more. Risk is considered differently depending on who you ask. For us, it would be where your fund invests in an asset and loses capital on that investment which is unlikely to be recovered.

With the passive market portfolio, you can deal with the occasional blow-up, such as Steinhoff, which while painful at the time does not define the fund given the broad diversification across assets. With hedge funds, this risk equation becomes more acute as they take both positive and negative positions, expose the fund to higher degrees of equity exposure given the capital invested, and can often have concentrated, event-specific bets in place. While these particular funds have avoided business defining investment errors, the nature of a hedge fund means it can be more exposed to single points of failure when compared with a broad market fund. This type of risk is quite different to volatility, which is the day-to-day and month-to-month movement in assets. Here the hedge funds excel as they dampen this volatility through their hedging activities. Investors in theory get a better journey: growth with less of the downside. Major blow-ups, such as Long-Term Capital Management (LTCM) in 1998 and, locally, Evercrest in 2007, are examples of funds gone wrong which ultimately lead to closure and loss of capital.

The decision trade-off

Hedge funds score well by offering investors a wider opportunity set, with more tools at their disposal. They also offer a managed journey which should be smoother than that provided by the broader stock market. But it is not a slam dunk decision: efficacy concerns for us cause us to pause on defaulting to hedge funds, and the cost structures mean that the hurdle rate for value add can be unjustifiably high. Where you are able to find an established manager who covers the core competencies outlined above, and where the cost structure is reasonable, a hedge fund allocation can make sense. Importantly it should be seen as growth asset exposure, not low or medium risk. Secondary aspects like liquidity and fund capacity also need to be assessed when making these decisions as they can have consequences down the line. Lastly, there can be differences between the 'Retail' fund and the 'Qualified' investor fund which are worth exploring upfront, each adhering to different regulatory guidelines.

If all of this gets a bit complicated, starting with a low-cost passive fund is a compelling alternative. Patience is the cost you pay in this scenario, which is a sensible guideline for most investment decisions.

Overall, heads I win, tails you lose…sometimes.

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[1] Around 3% of the savings industry using collective funds for investment
[2] An option is a financial derivative where the payoff is linked to a future uncertain event

[3] Source: The New Yorker, A Brief History of the Hedge Fund, 19 March 2021

[4] Around 60% of assets: source: ASISA

[5] 80% SA Equity + 20% Global Equity

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REDFIN WEALTH

INVESTMENT - RETIREMENT - FINANCIAL PLANNERS

June 2023

MARKET REPORT

30/06/2023

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	0.7%	5.9%	19.6%	16.1%	9.6%	10.3%	16.9%	14.0%
FTSE/JSE SA Listed Property	ZAR	0.7%	-4.4%	10.0%	11.3%	-3.5%	1.5%	26.9%	21.4%
SA All Bond Index (ALBI)	ZAR	-1.5%	1.8%	8.2%	7.6%	7.4%	7.4%	8.4%	8.1%
SA Cash Index (SteFI)	ZAR	1.9%	3.7%	6.8%	5.0%	5.8%	6.3%	0.4%	0.4%
Balanced Benchmark	ZAR	2.4%	7.8%	18.3%	12.5%	9.3%	10.1%	11.6%	9.5%
SA Inflation (1 month lag)	ZAR	1.6%	2.6%	6.3%	5.8%	4.9%	5.2%	1.4%	1.4%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity (Datastream World)	USD	7.0%	15.4%	19.1%	12.7%	9.6%	10.1%	18.3%	14.7%
Emerging Markets Equity (Datastream EM)	USD	1.0%	5.1%	2.2%	2.7%	1.3%	3.3%	18.9%	16.9%
Global Property	USD	0.5%	2.2%	-4.9%	4.9%	4.2%	6.1%	19.4%	16.1%
Global Bonds (Barclays Global Bond Index)	USD	-1.5%	1.4%	-1.3%	-5.0%	-1.1%	0.2%	8.6%	7.3%
Global Cash	USD	1.3%	2.6%	4.5%	1.7%	1.9%	1.3%	0.5%	0.4%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	0.7%	5.9%	19.6%	16.1%	9.6%	10.3%	16.9%	14.0%
Global Equity (Datastream World)	ZAR	13.9%	28.2%	37.4%	15.9%	16.9%	17.4%	16.8%	15.1%
Emerging Markets Equity (Datastream EM)	ZAR	7.6%	16.7%	17.9%	5.6%	8.0%	10.2%	14.2%	13.2%
Global Property	ZAR	7.0%	13.4%	9.6%	7.9%	11.1%	13.1%	19.1%	17.2%
SA All Bond Index (ALBI)	ZAR	-1.5%	1.8%	8.2%	7.6%	7.4%	7.4%	8.4%	8.1%
Global Bonds (Barclays Global Bond Index)	ZAR	4.8%	12.6%	13.8%	-2.3%	5.5%	6.9%	15.2%	13.7%
COMMODITIES									
Gold (US Dollars)	USD	-3.1%	5.5%	6.0%	2.4%	8.9%	4.7%	14.0%	14.1%
Gold (Rands)	ZAR	3.2%	17.2%	22.3%	5.3%	16.1%	11.6%		
CURRENCIES									
Rand / Dollar	ZAR	-6.5%	-11.0%	-15.3%	-2.8%	-6.6%	-6.6%	16.0%	14.9%
Rand / GBP Pound	ZAR	-9.5%	-17.3%	-20.7%	-3.8%	-5.8%	-4.8%	13.9%	14.6%
Rand / Euro	ZAR	-6.9%	-13.5%	-20.3%	-1.8%	-5.2%	-4.8%	13.6%	13.1%

Spot Rates		30-Jun-23	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	18.9	18.9	16.4	13.7	9.9	7.5
Rand/GBP	Rand	24.0	24.0	19.9	18.1	15.1	12.4
Rand/EUR	Rand	20.6	20.6	17.1	16.0	12.9	8.6
RATES							
Libor 6m $	US$	5.8	5.8	2.9	2.5	0.4	1.1
Repo Rate	Rand	8.25	8.25	4.75	6.50	5.00	12.00
Prime	Rand	11.75	11.75	8.25	10.00	8.50	17.00
All Bond Index Yield	Rand	10.5	10.5	11.6	9.4	7.9	9.7
COMMODITIES							
Gold ($/oz)	US$	1 916.0	1 916.0	1 806.9	1 251.1	1 215.4	347.7
Platinum	US$	897.0	897.0	907.0	851.0	1 317.0	667.0
Oil (Brent Crude) $	US$	74.5	74.5	114.9	79.4	102.6	28.6
INFLATION							
SA Inflation	%	6.3	6.3	7.4	4.5	5.4	9.4

data provided by FE Analytics

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