Education

To hedge or not to hedge – that is the question

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Rather than being a genuinely philosophical question, as proposed by Hamlet in the William Shakespeare classic, using hedge funds represents a decision that is either opted for or foregone. Understanding what a hedge fund is, however, is what makes answering the 'question' difficult.

An important challenge that investors face is that meeting investment objectives in the future requires greater resourcefulness, given the challenging global growth outlook and the elevated volatility we see from traditional investments. As a result, investors need to explore other strategies in largely untapped areas of the investable universe. Hedge funds have a role to play.

What is a hedge fund?

Hedge funds invest in traditional asset classes that employ different strategies, such as long/short, to enhance returns or reduce risk. This means that, for hedge funds, capturing attractive investment returns is not solely limited to rising markets – they have the ability to be reaped in down markets too. By doing this, hedge funds offer greater flexibility in execution and offer a broader mandate when making investments, compared to traditional modes of money management. Therefore, hedge funds typically have a high-performance return potential, a high-performance return efficiency and are a good diversifier relative to traditional asset classes and styles of money management.

Like any investment, hedge funds are not without risk and need to be managed carefully as they may result in losses greater than their aggregate market value.

Hedge funds are permitted to:

- Invest in unlisted assets
- Use leverage – hedge funds have the ability to borrow. The use of leverage allows a portfolio to amplify its position to exploit opportunities in a scalable way. The objective of leverage is to generate investment returns that exceed the cost of borrowing, which needs careful management. Leverage may result in losses exceeding the net asset value of the portfolio. South African retirement funds that invest in hedge funds and private equity funds that may expose the fund to liability must hold it in a limited-liability structure.
- Invest in long/short strategies – portfolio managers take long positions in assets that are expected to appreciate and short positions in assets that are expected to decline in value. Shorting an asset means that the portfolio manager will borrow the asset they expect to decline and sell it to another investor. Once the asset has declined in value, the portfolio manager will repurchase the stock at a lower

price to return to the lender, which may generate positive returns when prices fall.

In this way, some hedge funds are like an ambidextrous player in the market – they possess a mix of techniques that allows them to play in up and down markets equally well.

Investment managers may employ all, or some, of the strategies highlighted above, according to the investment objective and policy of the specific hedge fund. Hedge fund strategies often yield returns that are more reliant on execution, which emphasises the investment manager's skills rather than the direction of the market.

Hedge fund strategies

Hedge funds adopt three main strategy groups:

- single-strategies
- hedging strategies
- multi-strategies

Single-strategy hedge funds are expected to produce strong returns over an entire cycle, but less consistently than multi-strategy hedge funds.

Single-strategy hedge funds

Relative value/market neutral*	Event driven*	Global macro	Directional*
Equity market neutral	Distressed securities	Macro trading	Equity long/short
Fixed-income arbitrage	Merger arbitrage	Commodities	
Statistical arbitrage	Special situation	Currency trading	
Volatility arbitrage			

**Most prevalent hedge fund strategies in South Africa*

Hedging strategies seek to mitigate against systemic risk (risk of the collapse of an entire industry or economy) but with lower long-term expected returns. This includes techniques that cover tail-risk hedging and managed futures. Multi-strategy hedge funds invest in a variety of strategies, providing diversification within a single portfolio.

Depending on the availability of certain strategies in a given market, a multi-strategy portfolio will typically have between three and eight underlying strategies. A portfolio manager can use their market insight and risk management tools to reallocate between strategies and produce consistent returns due to diversification across strategies. Exposure to multi-strategy portfolios can be obtained through a single manager hedge fund (direct investment into securities) or fund of hedge funds (investment into various underlying hedge funds).

Case study: Hedge fund performance during the Covid-19 pandemic

One of the most significant benefits of hedge funds, or incorporating hedge funds alongside the mainstream component of a an overall investment portfolio, is the diversification benefit potential. With the volatility and extreme market downturns that we have experienced since 2020 due to Covid-19, employing hedge fund strategies within a portfolio over this period could have buffered out some of the noise in the market.

Figure 1 shows how a typical hedge fund strategy performed in South Africa compared to the South African equity market (as measured by the FTSE/JSE Capped SWIX) where equity markets delivered negative returns from January 2020 to the end of August 2021.

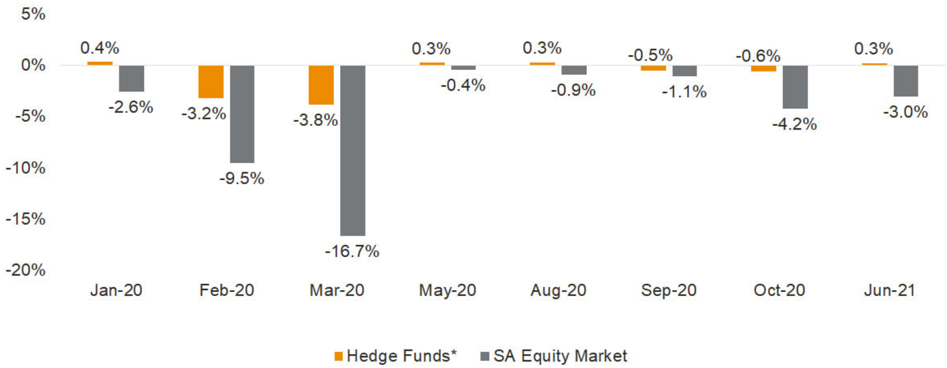
So… which is it?

Seeking further guidance to our philosophical question – an allocation to hedge funds offers a unique ability to diversify traditional equity, credit and interest-rate risks within a typical investment portfolio.

In addition, hedge funds provide exposure to non-traditional return drivers, where performance relies more on the investment manager's skills than on the market direction, resulting in "hedging" properties and a potentially lower-risk portfolio when compared to traditional equity and bond portfolios.

As a result, hedge funds can play an essential role as a good diversifier within an overall portfolio, to provide adequate protection during market weaknesses and improve risk-adjusted outcomes over time.

Figure 1: Hedge fund investment returns compared to the equity market, where equity markets were negative from the beginning of January 2020 to the end of August 2021



Source: Alexander Forbes Investments.

**The performance of the AF Invest Performance QI Hedge Fund of Funds (net of fees) is used as a proxy for the performance of hedge funds*

Over the past few years it has become apparent that harnessing alternative sources of diversification is becoming increasingly important when building portfolio solutions that meet their intended investment objectives.

The core value proposition of hedge funds may be utilised to reduce the impact of market volatility at different times and effectively manage risk. Hedge funds, and the underlying strategies they employ, have a role to play and have proven to be a vital component in an overall portfolio solution.

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