Adding power to a heady mixture

Fuelling higher growth at lower risk

Robbie Alexander, CEO, Octane Holdings.

INVESTORS have seen their investments exposed to extreme and intolerable swings over the last 15 years. These variances have resulted in investors seeking ways in which to, firstly, preserve their capital, and secondly achieve capital growth in excess of inflation over time.

Investment theory suggests that a well-diversified investment portfolio is constructed by combining assets, which provides returns in excess of a stated objective, lower volatility than that objective and with assets that are not correlated to each other.

A case can be made for investing in hedge funds in terms of each of these three underlying investment objectives. Hedge fund investments, when combined with traditional investments, have over the last 15 years provided investors not only with reduced volatility but have also provided enhanced investment returns and have improved portfolio diversification via their low correlation to traditional asset classes such as equities and bonds.

A hedge fund can be defined as an actively managed investment portfolio that seeks positive returns. The basic idea behind a hedge fund is to make the investors' assets grow – rather than merely exceeding a market index or peer group benchmark, which may result in a negative investment return despite beating that benchmark.

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In their pursuit of positive returns, absolute return investment managers use a wide variety of investment strategies and tools. Absolute return investing offers investors access to opportunities not available in traditional venues, as the investment managers are less dependent on market direction than long-only traditional investments such as equities and bonds.

Investors that have allocated a portion of their investments to hedge funds have typically selected a fund of fund manager to manage their assets. A fund of fund manager selects a range of single strategy hedge fund managers and then combines them into a well-diversified portfolio to achieve the investors' objectives.

Over the last 15 years, the average fund of hedge fund manager has provided investors with an annualized return of 9,6% after all fees, compared with equities (as presented by the MSCI World Index) of 7,1% and bonds (as presented by the Lehman Bond Index) of 7,7%. Cash (LIBOR) yielded 4,4% over this period.

Investors should note that all returns quoted on funds of hedge funds are always net of all fees, including asset management fees, custody and administration fees and transaction fees. In terms of the returns as for the traditional equity, bond markets and cash markets, investors will still need to deduct the fees that they are paying to their managers, custodian, administrator and the manager's stockbroker. One could argue that an investor could deduct at least 1,5% from these returns for equities, 1% for bonds and 0,50% for cash regarding these costs.

If one performs a comparison on a net of fees basis one finds that the average fund of hedge fund has outperformed traditional asset classes such as equities and bonds by 3% to 3,5% per annum over the last 15 years. One should also remember that bonds experienced a strong bull market over the last 15 years and this is not expected to continue going forward. Equities also experienced one of its strongest bull markets ever during

Duncan Theron, Head of Distribution, Pan-Afrika.

the Nineties. Despite these strong performing equity and bond markets, the average fund of hedge fund still outperformed these markets. Also, the average fund of hedge fund has outperformed cash investments by approximately 5,5% after fees over this period.

If one assesses the risk at which these returns were generated one will find that funds of hedge funds performed at similar risk levels (as measured in volatility) as that of bonds (5,6% versus 5,2%) but at about a third of the risk levels that the equity markets (14,2%) have experienced.

The key issue in terms of hedge fund investment is to find the right investment manager. Although the average fund of hedge fund has performed strongly and at low risk, investors should take cognizance that the dispersion between the top quartile manager and bottom quartile manager is material. It is not a simple task to select a good manager. The universe of single strategy managers is in excess of 8 000 managers and the fund of hedge fund universe in excess of 2 000. How does an investor select one or two managers out of this universe?

Octane is an independent, specialist alternative offshore fund of hedge fund investment manager, 100% owned by Sanlam Limited.

Octane was founded in 2001 and has to date constructed various risk-profiled fund of hedge fund solutions with assets under management in excess of US$750m. The portfolios that they have constructed have been top quartile performers since their inception.

Octane's business model is absolutely unique in the international hedge fund industry. Whereas the average hedge fund manager screens the universe of single strategy managers to construct a diversified portfolio, Octane screens the universe of fund of fund managers and combines fund of hedge fund managers with single managers to construct their portfolios.

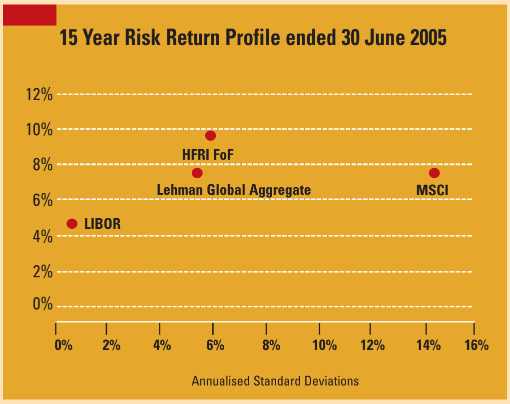
Octane has personnel in Switzerland, New York, London and Johannesburg. The group is headquartered out of Switzerland, with the research and investment team being based in New York, heart of the hedge fund industry. While our consultants operate out of Switzerland, London and Johannesburg, Custodian and Administration services are independently provided out of Luxembourg.

Octane performs sophisticated qualitative and quantitative analysis to source managers and construct client-focused fund of hedge fund solutions. As a result of our client-focused approach our staff in South Africa plays a consulting role rather than marketing role i.e. we work with our clients and their consultants to customise solutions rather than push off-the-shelf product. Solutions are provided depending on the clients' view of liquidity, transparency, and risk and return objectives.

So what does this mean? Simply put, Octane has a number of sophisticated "building blocks" that represent investment mandates with a number of highly experienced investment professionals, who have well established and proven track records.

In essence we look for a team with a good pedigree, a clear focus on risk management and a track record through a variety of market conditions. Intense due diligence of the fund includes, inter alia, a full review of the investment process, risk management, company and team backgrounds, past performance, response to drawdowns, etc.

Considerable time is spent in sourcing these managers, awarding the mandates and monitoring the investments. These building blocks are then combined in different ways



to meet particular investor needs.

These building blocks range from conservative to moderate funds of funds, to more aggressive, alpha-generating return strategies. These are combined and managed to create a range of solutions for our clients depending on their specific needs. ■

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