

SP²VOL 380
28 October 2005
Funds on Friday
Compiled by SP² Advisory Services

Hedge funds

This week we continue our discussion of hedge funds by considering the perspective of Octane, a major player in the global fund of hedge fund environment.

What is a hedge fund?

A hedge fund is:

- an actively managed investment portfolio that
- seeks positive returns.

The rationale behind a hedge fund is to grow investors' assets rather than merely exceeding a market index or peer group benchmark, which may result in a negative investment return despite outperforming that index or benchmark. In the pursuit of positive returns, hedge fund investment managers can use a wide variety of investment strategies and tools. Hedge fund investing offers investors access to opportunities not available in traditional avenues, as the investment managers are less dependent on market direction than long-only traditional investments such as equities, bonds and property.

What is the difference between a hedge fund and a unit trust or mutual fund?

- Hedge funds aim at growing an investment, i.e. producing positive returns. Unit trusts typically aim to outperform a benchmark (market benchmark or peer group benchmark) and are thus "relative" return orientated.
- Hedge funds can invest in a wide range of investment opportunities and strategies, whereas unit trusts have limited investment opportunities.
- Hedge funds typically have a low correlation to the broad equity and bond markets, whereas unit trusts have a high correlation to these markets.
- Unit trusts and mutual funds are regulated investment products whereas hedge funds are typically not regulated by financial services authorities.

Are hedge funds a separate asset class?

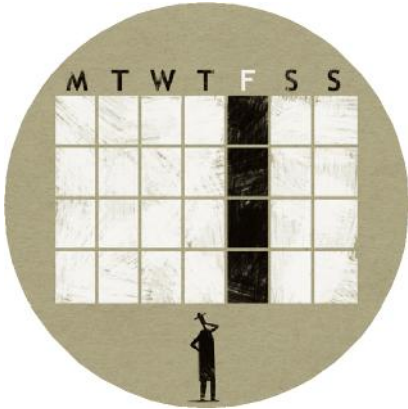
There are three academic ways of defining hedge funds:

- As a stand-alone asset class;
- As the execution of alternative investment strategies within traditional asset classes;
- As financial services companies, i.e. businesses.

Sanlam Personal Portfolios (Pty) Ltd
 Licensed Financial Services Provider Reg no.1999/025360/07
 Directors: AA Raath (Chairman & CEO), E Wessels and IJH Visagie
 Tuscan Park Block A, Cnr Old Oak and Twist Streets, Durbanville, 7550 / Private Bag X5,
 Tyger Valley, 7536. Tel +27 21 917 9002 (Eng), +27 21 917 9000 (Afr), Fax +27 21 917 9001

 **Sanlam**
 Personal Portfolios

The information contained in this document has been recorded and arrived at by Sanlam Personal Portfolios in good faith and from sources believed to be reliable, but no representation or warranty, expressed or implied, is made as to their accuracy, completeness or correctness. Sanlam Personal Portfolios (Pty) Ltd accordingly accepts no liability whatsoever for any direct, indirect or consequential loss arising from the use or reliance, in any manner, on the information provided in this document.



Octane's view is that hedge funds are not a separate asset class. Equities, bonds and other asset classes have an economic rationale for driving their returns. Hedge funds, however, do not have any specific economic theory driving their returns. It is plausible to argue though that the returns of hedge funds are driven by the inefficiencies left by traditional investment managers. Hedge funds should be interpreted as a business or a toolbox of strategies – the investment manager has a wide variety of investment strategies to meet the absolute return investment objective.

But so much for our opinion! We have found that most investors classify hedge funds as a separate asset class. This could be due to the fact that it is easier for investors to view them as a separate asset class for portfolio construction purposes. Investors often construct their optimal long-term asset allocation via an initial mix of traditional asset classes, after which they then assess the impact of an allocation to alternative assets (such as hedge funds) on their total portfolio risk and return. For the purposes of this document, and in line with the investor classification, we will refer to hedge funds as a separate asset class.

What is the size of the hedge industry and is it still experiencing strong cash inflows?

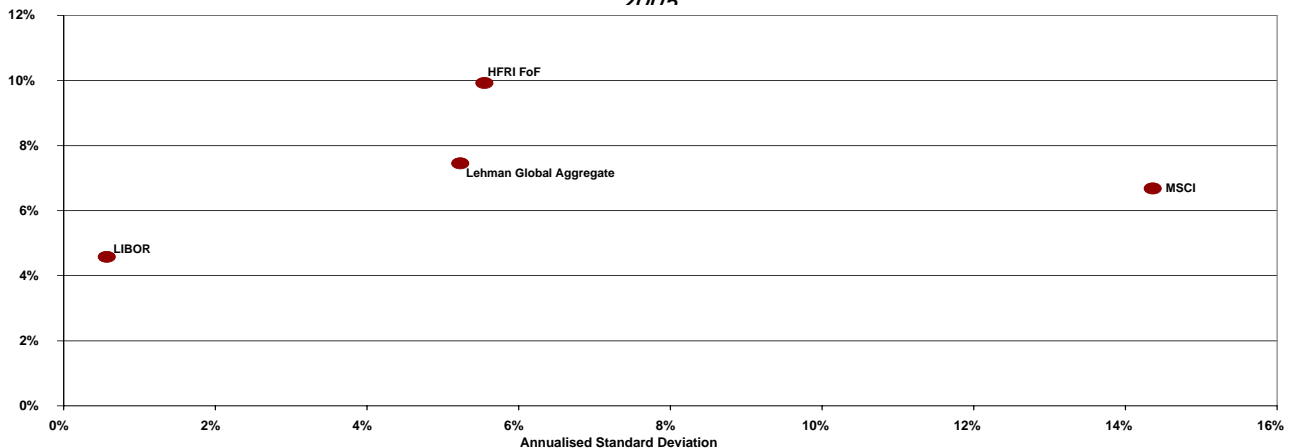
- The current size of the global industry is about \$1 trillion.
- The industry has been growing at between 25% and 30% each year for the past decade and the growth is continuing.
- There are now more than 8000 single strategy hedge fund managers.
- In addition, there are over 2200 fund of hedge fund managers.

How do hedge funds compare with other asset classes (equities and bonds) in terms of performance and risk?

Hedge funds have been the best performing asset class over the past 15 years – in both absolute terms and risk-adjusted terms. Over this period, hedge funds have consistently performed at lower risk (volatility) than bond investments and at less than half the risk of equity investments.

Risk return profile for 15 years ended 30 September

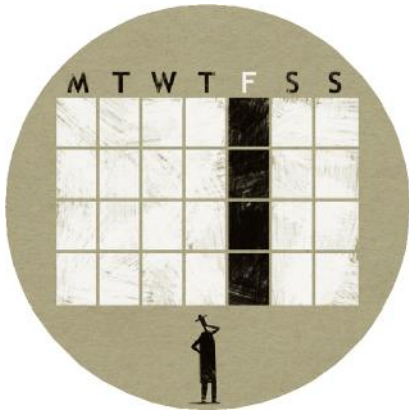
2005



Sanlam Personal Portfolios (Pty) Ltd
Licensed Financial Services Provider) Reg no.1999/025360/07
 Directors: AA Raath (Chairman & CEO), E Wessels and IJH Visagie
 Tuscan Park Block A, Cnr Old Oak and Twist Streets, Durbanville, 7550 / Private Bag X5,
 Tyger Valley, 7536. Tel +27 21 917 9002 (Eng), +27 21 917 9000 (Afr), Fax +27 21 917 9001


Sanlam
 Personal Portfolios

The information contained in this document has been recorded and arrived at by Sanlam Personal Portfolios in good faith and from sources believed to be reliable, but no representation or warranty, expressed or implied, is made as to their accuracy, completeness or correctness. Sanlam Personal Portfolios (Pty) Ltd accordingly accepts no liability whatsoever for any direct, indirect or consequential loss arising from the use or reliance, in any manner, on the information provided in this document.



What are the benefits of investing in hedge funds?

- Hedge funds have the potential to provide positive returns in both rising and falling equity and bond markets.
- The inclusion of hedge funds in a portfolio with equity and bond investments can reduce the total portfolio's risk or volatility while simultaneously increasing portfolio returns.
- Hedge funds can provide consistency of performance and risk, thereby eliminating the need to correctly time the entry and exit from traditional equity and bond markets.

SP² Advisory would like to thank Octane for their contribution to this article.

Next week we will conclude our look at hedge funds by speaking to Edwin Schultz from Coronation, who runs a single managed hedge fund.

Sanlam Personal Portfolios (Pty) Ltd
Licensed Financial Services Provider Reg no.1999/025360/07
Directors: AA Raath (Chairman & CEO), E Wessels and IJH Visagie
Tuscan Park Block A, Cnr Old Oak and Twist Streets, Durbanville, 7550 / Private Bag X5,
Tyger Valley, 7536. Tel +27 21 917 9002 (Eng), +27 21 917 9000 (Afr), Fax +27 21 917 9001



The information contained in this document has been recorded and arrived at by Sanlam Personal Portfolios in good faith and from sources believed to be reliable, but no representation or warranty, expressed or implied, is made as to their accuracy, completeness or correctness. Sanlam Personal Portfolios (Pty) Ltd accordingly accepts no liability whatsoever for any direct, indirect or consequential loss arising from the use or reliance, in any manner, on the information provided in this document.