

MONEY & INVESTING

HEDGE FUNDS

Taking the plunge

Many pension funds and private investors want to increase their exposure to hedge funds, but it remains an opaque and confusing field.

The average pension allocation to hedge funds in SA is barely 1%, compared with more than 6% in the US and 18% for US university endowments.

Hedge fund fees are also a subject of controversy as they are much higher than those for other assets, being typically a 2% base fee and 20% of the profit.

But even California's CalPers, one of the world's largest pension funds (which is used to paying as little as 0,08% on most of its assets), says it is happy to have paid an annualised 9,3% over three years as it is consistently beating the benchmark.

The appeal of hedge funds is that, increasingly, they are protecting capital when equity markets slump. In the past year, with the backdrop of the US sub-prime crisis, world equities have fallen more than 4%, whereas the average global fund of hedge funds that make up the HFRI index has gone up 0,8%.

The only time that global hedge funds had a sizeable loss was during the Russian debt crisis of September 1998, when the HFRI fell 10%. Duncan Theron, MD of hedge fund consultancy Octane, says it was at the tail end of a long bull market in which hedge fund managers had built up large, unhedged equity holdings.

Their clients were questioning whether to continue paying high fees when hedge funds had underperformed equities for



Albert Louw Fees under pressure

Robbie Ishababata

several years.

Locally, in the six months to March 2008, when the JSE's all share index had fallen 0,1%, the average hedge fund gave a positive 3,1%.

It does not help that regulations are so ambiguous. Hedge funds are not regulated but are not illegal either. Regulation 28 of the Pension Funds Act, which replaced prescribed assets legislation in 1989, allows funds to invest 2,5% of their assets in "other" assets such as private equity, unlisted shares and hedge funds. Through a debenture structure, they are allowed to invest up to 5%

into each fund.

Theron says the law is silent on the 15% that funds are allowed to invest internationally, and some institutions have their entire international allocation in hedge funds — not a bad strategy if they want diversification from their off-shore investments, as hedge funds have a much lower correlation to the JSE than international equities.

According to a recent survey by SEI, a US-based investment manager, the main objective in allocating to hedge funds is diversification in 43% of cases; in 33%, it is to find absolute returns and in 18%, to

decrease volatility. None of the respondents answered that hedge funds were chosen primarily as a way to enhance returns.

The problem for pension funds, however keen they may be to diversify, is knowing where to start. This is not yet a problem locally, in which there are 16 funds of hedge funds, all of which are still open to new business. None of these has a big brand name, but all at least had positive performance after fees over the past difficult 12 months — varying from 1,38% for the Symmetry Multi-Strategy Fund to 10,5% for the Sygnia All-Star Fund of Hedge Funds.

The fund management industry is so small in SA that many of the new hedge fund managers are already well-known to consultants and the big financial advisers. Recent fund launches have been the Obsidian Fund, run by former RMB portfolio managers Royce Long and Richard Simpson, and Constellation run by Omri Thomas of Polaris Capital (and previously of Sanlam). In August, Murray Winckler, the former head of Deutsche Securities, launches Laurium Capital.

Octane's head of institutional business, Albert Louw, says fund fees will come under pressure from a number of low-cost alternatives. There are replication strategies, in which quantitative techniques are used to give similar returns to hedge funds. Another is through investable indices, which invest in hedge funds on a passive basis.

The other emerging competitor is the 130/30 fund (*Money & Investing* May 2) which can sell up to 30% of its net portfolio short and which charges a much lower fee than hedge funds.

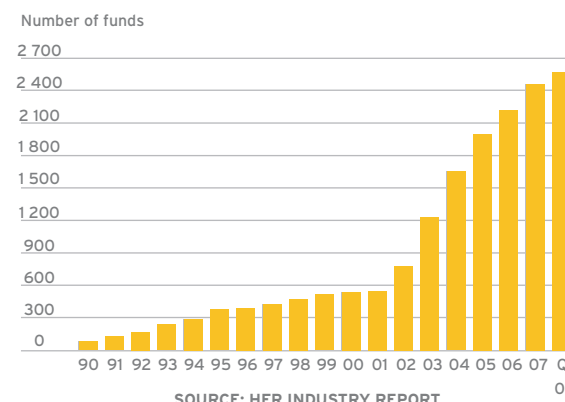
But for now, hedge funds maintain their cartel-style charging structure. Internationally, it was comparatively easy simply to pick one of the 80 hedge funds available in 1990.

But Louw says that this has grown to almost 2 600 funds of funds. The performance database for these funds is not readily available on the Internet — it is available only at a hefty subscription.

In practice, a handful of funds of funds that actively market in SA account for almost all the business. These are Octane (part of the Sanlam group); Aurum (controlled by SA's Gundle family); Peregrine

MASSIVE CHOICE

Growth in international funds of hedge funds



subsidiary Stenham; TriAlpha, once part of Absa; Thames River, run by SA expat Ken Kinsey-Quick; and Coronation International. Nedbank also has a couple of well-established funds of hedge funds.

The Stenham Universal Fund of Funds is a good example of a fund which,

perhaps in a rather unexciting way, keeps grinding out strong returns. Over 10 years it has given a 10% annualised return, which may look no more than solid but was over a time when global equities gave just 3,4% and bonds 6,3%.

The equity markets collapsed by 44% over the two years after the technology bubble burst in March 2000. Stenham Universal went up 38% over that time.

Blue Ink fund of funds portfolio manager Kevin Ewer warns investors not to choose funds on their past performance. Conservative investors might have been tempted to invest in a hedge fund

that had not had a negative return from its opening in March 2003 to February 2007 — but that fund was the (inappropriately named) Bear Stearns High Grade Structured Fund, which had lost its entire asset base by June.

Stephen Cranston

No safety in brands

Not all fund failures in hedge funds are from high risk takers.

The theoretically blue-chip Russell Alternative Strategies and Alternative Strategies II funds are in the process of closing down and handing money back to clients. These include SA clients such as Liberty, Investment Solutions and the Telkom Pension Fund, as well as to individual clients of Alexander Forbes. Russell has US\$1,1bn of SA-sourced assets in its \$200bn investment portfolio.

Russell Investment Group, based in Tacoma in the US, has been known for a conservative investment approach, called multimanagerment, which spreads small bets across dozens of managers.

When it was gathering assets for its No 2 fund last year, it was happy to set up video conferences with Tacoma for the FM and to give details on fund performance. But by April this year the shutters were down and there was no comment of any kind on the subject.

The last recorded performance for

the Alternative Strategies Fund was a 3,8% loss in December 2007. For the year the fund lost 4,8%, compared with 10% for the average fund of hedge funds.

The wheels started coming off when David Tsujimoto, who had run the hedge funds for six years, left in September 2007. Ironically, Alternative Strategies is a so-called nondirectional fund, which should produce positive returns in good and bad markets.

When the funds' close-down was first mooted in April, combined assets had fallen from \$6bn to \$2bn. But because a lot of this money was invested in illiquid hedge funds, the withdrawals are being staggered over several months.

According to Dow Jones, 44% of the flagship fund's assets are in illiquid capital arbitrage and event-driven hedge funds.

The final loss to investors in the fund may never be disclosed, but at least the CEO of the business, Craig Ueland, has fallen on his sword. **Stephen Cranston**

AHEAD OF THE PACK

Cumulative performance

