

OFFSHORE HEDGE FUNDS: HAVE SA RETIREMENT FUNDS MISSED OUT?



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Background – exchange control liberalisation

SA retirement funds were first permitted to invest offshore in July 1995 through asset-swap arrangements (totaling not more than 5% of total assets) with non-residents. In June 1996, this 5% limit was increased to 10% and further increased in May 2003 to 15%. Many retirement funds utilised the partial relaxation of exchange controls to diversify their investment portfolios by increasing offshore allocations to the maximum 15% allowance. How are these funds invested offshore?

Little or no exposure towards hedge funds

Most SA retirement funds are invested offshore in *balanced* portfolios with approximately 60%-70% in global equities¹. Some consultants even allocated 100% to offshore equities, based on their asset-liability modeling results. It's noteworthy that few portfolios have any exposure towards hedge funds at all; generally, those that do have a small exposure of less than 3%.

Hedge funds provided respectable returns – benefit of diversification under-estimated

Since SA retirement funds started investing offshore, the MSCI World Index returned 7.5% in US\$ and the Lehman Bond Index 6%. The HFRI FoF Composite² outperformed both equities and bonds with an annualised return of 8.3%. Thus, not only has the average fund of hedge funds outperformed but it has done so at similar volatility (risk) to bonds and less than half that of equities. In addition, many actively managed equity portfolios struggled to outperform the MSCI World Index after fees. So, not surprisingly, we have witnessed an increasing move towards passive management.

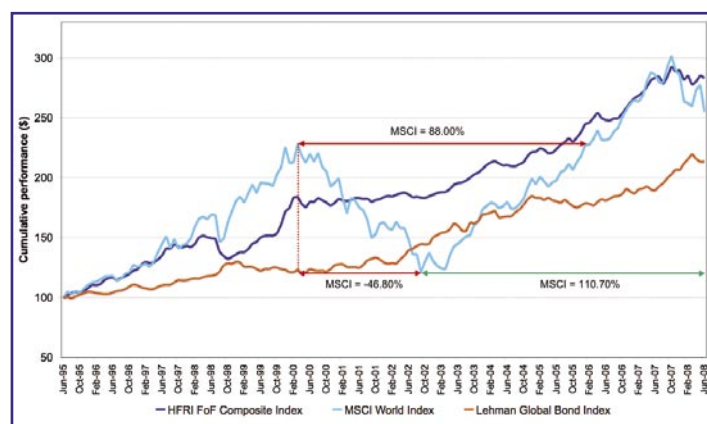
Jul 95 - Jun 08	Annualised return (\$)	Standard deviation
MSCI World Index	7.49%	13.75%
Lehman Bond Index	6.01%	5.15%
HFRI FoF Index	8.34%	5.86%

The figure below shows how major indices performed over the period. The large equities drawdown of 46% experienced during the last bear market is significant. Sadly, it took retirement fund members nearly five years to regain their capital in US dollars. One wonders what the impact of the current equities drawdown will be on those members retiring within the next few years? This

highlights the important role that hedge funds play in members' offshore portfolios. It is therefore no surprise that retirement funds abroad are setting targets to increase their allocations towards hedge funds.

"Pension plans allocate on average 6% of total assets to hedge funds – with ceilings around 15%. The prediction is for the average allocation over the next two years to be around 8% to 9%" – Prequin Special Report

Figure 1: HFRI vs. MSCI & Lehman Bond Indices (July 1995 to June 2008)



Are retirement funds likely to increase their allocation to 20%?

In this year's Budget, the Minister of Finance announced further liberalisation of exchange controls; retirement funds are now permitted a maximum of 20% of total assets offshore. The FSB has announced that Regulation 28 of the Pension Funds Act will be amended in due course, but in the interim retirement funds are able to apply for exemptions permitting funds to hold 20% offshore. Research conducted by many domestic investment managers shows that the optimal offshore allocation for SA retirement funds varies between 30% and 40% of total assets³.

One can therefore expect that most boards of trustees will utilise the additional 5% and increase their offshore exposure to 20% of total assets. A 20% allocation will place a much sharper focus on how the foreign portfolios are managed. It will also leave no more place to hide for underperforming traditional portfolios, and it will have a meaningful impact on the overall success of the fund.

Hence, with global equities down 15% this year already, and with the ability of hedge funds to "protect" on the downside with a "smoother" return profile, hedge funds surely will be on the "radar screen" for potential inclusion?

"The best value potential lies in hedge funds and any strategy that delivers absolute returns" – Paul Trickett (European Head: Watson Wyatt) –ft.com: 7 Jan 2008

¹ Fifth Quadrant Asset Manager Review (Business Report, 7 August 2008). ² HFRI FoF Composite: an equal-weighted index that consists of 800 funds of hedge funds. Returns are all reported in dollars, net of all fees. ³ Collective Insight: "Getting the most out of international investing" (Winter 2006).