

Offshore hedge funds

Not a separate asset class

Defining offshore hedge funds as a separate asset class is flawed and should rather be included as an extension of active investment strategies...

HEDGE FUND SURVEYS conducted in the industry reveal that doubt exists between investors in terms of whether hedge funds should

be classified as a separate asset class or not. An international survey – conducted in 2005 by the National Strategic Investment Dialogue; are hedge funds a separate asset class? – put the question to a leading group of investment professionals.

The survey revealed the following: 45% of the participants responded that they view hedge funds as a separate, distinct asset class; 12% answered that they don't view hedge funds as a separate asset class and integrate hedge funds as a supplement to the traditional asset classes.

A third replied that they treat hedge funds both ways, while 10% subscribed to neither view.

Another hedge fund survey conducted in South Africa during 2003 included the question: Should hedge funds be treated as a separate asset class?

Some 71% of the respondents believed that hedge funds should be treated as a separate asset class, while almost 25% did not believe that hedge funds constitute a separate asset class, with 5% of participants not answering the specific question.

In both surveys conducted, participants provided mixed answers as to whether hedge funds should be treated as a separate asset class or not.

Why have we witnessed these views between investors on how to classify offshore hedge funds?

Hedge funds have a number of characteristics that differentiate them from traditional investment management, such as their legal framework, compensation structures and the fact that the investment manager typically has his/her own capital invested alongside the third party investors.

As a result investors to date have adopted a "functional approach" and have informally grouped hedge funds as a sepa-

Traditional manager	Traditional strategies: consist of traditional asset classes ie equities, bonds, cash and property
Hedge fund manager	Combines traditional strategies with alternative strategies such as leverage, shorting and arbitrage

rate asset class due to their "dissimilarity" with the traditional asset classes.

We would argue that although offshore hedge funds have a number of key characteristics that distinguish them from traditional investment management, it doesn't necessarily mean that one has to classify offshore hedge funds as a separate asset class.

The main reason being that a traditional offshore investment manager typically only invests in conventional asset classes, such as equities, bonds, property and cash, whereas an offshore hedge fund manager generally combines these traditional investment strategies with alternative strategies, such as short selling and arbitrage, to name a few.

Another way to look at this is to turn to the textbook: what is the definition of an asset class? The term asset class is debated today with little consideration as to what it actually means. The following definition was taken from the Investopedia:

"A specific category of assets or investments, such as stocks, bonds, cash, international securities and real estate. Assets within the same class generally exhibit similar characteristics, behave similarly in the marketplace and are subject to the same laws and regulations."

To determine whether a specific category of assets or investments such as offshore hedge funds can be called an asset class some key criteria must be taken into account. Below we assess how offshore hedge funds measure up against the traditional definition.

- **Similar securities:** Hedge funds fail this test. They include a range of securities with different characteristics,

such as equities, commodities, bonds, currencies, derivative instruments and many more.

- **Economic rationale:** Asset classes, such as equities and bonds, have an economic rationale driving their returns. Equities pay dividends, bonds and cash pay interest and property gives returns in the form of rental payments. Hedge funds, on the other hand, don't have any specific economic theory driving their returns.
- **Correlation:** For investments within an asset class to behave similarly there needs to be a relatively high correlation between these investments within the specific asset class. Hedge funds fail this test, as they can include a wide range of investments with a wide range of correlation behaviours.
- **Regulations:** The hedge fund industry to a large extent is less regulated but generally complies with the same laws and therefore only partially passes this test.

Hence it is our view that investors are mistakenly mislabelling offshore hedge funds as a separate asset class. Offshore hedge funds are an extremely mixed group of investments, focusing on a wide range of strategies and holding individual investments of virtually every traditional asset class.

As investors become more acquainted with offshore hedge funds, we expect to see a greater percentage of investors including hedge funds as an extension of the active investment strategies and not as a separate asset class.

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