

Global equities tumble, but offshore hedge funds yet again show their worth!

GLOBAL EQUITIES KING – *but not for too long?* Who wanted to invest in offshore hedge funds when global equities (i.e. MSCI World Index) gave 18% pa for the three years prior to the sub-prime crisis that started in June 2007? Not too many investors.

The sub-prime crisis and global credit squeeze impacted markets negatively during the second half of 2007 and well into the new year with record losses at some of the largest global investment banks. It started when US bank, Bear Stearns, ‘spooked’ the markets with news of major losses and accounting difficulties with its investments linked to US housing loans i.e. “the US sub-prime housing crisis”.

For the month of January 2008, the MSCI World Equity Index was down 7,6%, effectively “wiping out” the gains of 2007, and was down approximately 10,1% from June 2007 to 15 February 2008.

The hedge fund industry was not spared as the sub-prime housing crisis also took its toll on certain hedge fund strategies. Two of Bear Stearn’s hedge funds that invested in securities tied to the mortgages collapsed in July, followed by Boston-based hedge fund, Sowood, after the fund incurred large losses in the credit markets. The widespread turmoil in global capital markets also impacted negatively on quantitative strategies whose highly leveraged computer-driven trading models were caught “flat-footed” by a market volatility spike following the sub-prime lending market meltdown.

But, there were more winners than losers! The biggest gains last year were by funds that were “short” the US sub-prime market together with emerging market funds. Emerging market funds have been the best performers, returning more than 20% for the calendar year 2007. And previously “out of favour” strategies such as global macro returned to form.

Offshore hedge funds as a whole have

weathered much of the storm. The HFRI FoF Index was up 10% for calendar year 2007 according to Hedge Fund Research Inc and down only 2,5% for January 2008. It is therefore no surprise that institutional investors are increasing their allocation to hedge funds – the big attraction being the diversification benefits with the ability to “preserve” capital when equity markets are posting large losses, such as the latter part of 2007 leading into 2008.

The table below shows how hedge funds have managed to “protect” capital during these periods.

HOW HEDGE FUNDS HAVE MANAGED TO “PROTECT” CAPITAL DURING THESE PERIODS			
CRISIS	DATE	MSCI WORLD	HFRI FoF
First Gulf War	Jul '90 - Sep '90	-18,26%	7,72%
Fed hike	Feb '94 - May '94	-2,47%	-5,19%
Tequila crisis	Oct '94 - Jan '95	-2,25%	-3,66%
Asian crisis	Jul '97 - Oct '97	-2,57%	5,66%
Russian crisis	Jul '98 - Sep '98	-11,99%	-10,02%
Technology bubble	Sep '00 - Mar '01	-22,59%	-1,62%
World Trade Center	Aug '01 - Sep '01	-13,21%	-1,40%
Recession	May '02 - Sep '02	-23,22%	-1,89%
Second Gulf War	Dec '02 - Mar '03	-9,67%	1,84%
GM credit crunch	Apr '05 - May '05	-0,45%	-1,18%
Interest rate fear	May '06 - Jun '06	-3,44%	-2,50%
Sub-prime market crash*	Jun '07 - 15 Feb '08	-10,13%	1,10%

* HFRI FoF return for 15 February 2008 is 0,81%. Estimated using the HFRX Global Hedge Fund Index.

The HFRI FoF Index outperformed the MSCI in nine of the last twelve “equity market crises”, posting positive or small negative returns. Despite the drawdown experienced by hedge funds during the Russian crisis, hedge funds managed to live up to expectations during most of these crisis periods and provided what

institutional investors expected from them – better risk-adjusted returns with lower downside risk.

The current sub-prime crisis is a good “live” example of why hedge funds play such an important role in overall strategic asset allocation. From June 2007 to date, the MSCI is down 10,13%, with the HFRI

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FoF Index posting a small positive return. However, many South African retirement funds currently have no exposure to offshore hedge funds. This is largely because some of the reputable consulting houses do not advise or do not believe hedge funds to be appropriate for institutional portfolios.

This is contrary to what is experienced abroad. JP Morgan Asset Management’s 2007 survey on alternative assets conducted amongst 280 institutions that represent approximately 1,9 trillion euro under management, shows that institutional investors across Europe plan to allocate more than 100 billion euro into alternative assets over the next couple of years – driven by the desire for diversification rather than an expectation of lucrative returns. To quote Paul Trickett (European Head: Watson Wyatt) from the *Financial Times* “...the best value potential lies in hedge funds and any strategy that delivers absolute returns”.

Yes, investors are looking for stable absolute returns. “Ticking along” may not sound exciting but is in line with the more cautious approach of institutional investors. And this is what makes hedge funds such an attractive proposition. Perhaps hedge funds are king over the longer term – outperforming global equities over the longer term at significantly lower volatility levels? Hopefully, the recent announcement by the Minister of Finance to further relax exchange controls for institutional investors, collective investment schemes and long term insurers will result in hedge funds gaining a “bigger slice of the pie”.

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