

Advertorial

Role of offshore hedge funds for investors

The offshore hedge fund industry experienced phenomenal growth over the last ten years with approx \$1.5 trillion currently under management i.e. about 20% growth per annum. Over this period, the majority of the assets have been derived from wealthy private individuals. However, institutional investors are now also piling into hedge funds, with the latest research indicating that approximately 50% of all new inflows are coming from these investors.

The strong growth witnessed is mainly the result of the US bear market - following the tech bubble in 2000 with investors "suffering" sharp equity losses and increasing desire to search for other investment strategies such as offshore hedge funds to diversify their portfolio risks. This forced investors to re-assess their investment policies with investors putting pressure on financial advisors to look beyond traditional asset classes i.e. equities, bonds property and cash. Investors required that financial advisors place a greater emphasis on absolute return and downside protection strategies. Investments in lower correlated strategies, thereby providing more diversification, have also become a recent focus for these investors. For this reason, many financial advisors began in the early part of this decade to apply a methodical study of offshore hedge fund investing - a daunting task if one considers there are more than 9000 single hedge fund managers and more than 2300 fund of hedge fund managers.

Today, academic studies present ample evidence of the diversification benefits in terms of adding offshore hedge funds to the investor's total offshore portfolio mix. Yes, offshore hedge funds fulfill a very important role in retail



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investors' portfolios. They provide competitive absolute returns, display lower volatility than equities, have relatively low correlation to traditional asset classes and typically provide downside protection during equity market crises.

COMPETITIVE RETURNS AND LOWER VOLATILITY

Over the 10-year period ended 31 March 2007, offshore hedge funds have delivered competitive returns with lower volatility than traditional long-only investments in offshore equities and comparable to that of offshore bonds.

The risk/return scatterplot below shows that the HFRI FoF Index (a proxy of 750 offshore fund of hedge funds) produced an annual return of 7.7% p.a over the ten-year period with volatility less than half of that of equities. The HFRI FoF Index also performed better than bonds with very similar volatility numbers. Also take note that all hedge fund numbers are quoted net of all fees whereas investors still need to deduct management fees from their equity and bond investments.

LOW CORRELATION

In addition, offshore hedge funds have relatively low correlation to traditional asset

Correlation: 10 years to 31 March 2007

Correlation	MSCI	Lehman bond index	HFRI FoF
MSCI	1.00	0.02	0.60
Lehman bond index		1.00	-0.04
HFRI FoF			1.00

classes with a negative correlation towards bonds. The correlation between offshore hedge funds and the MSCI has only been 0.6, whereas hedge funds showed a negative correlation towards global bonds i.e. -0.04 over the 10-year period. Ideally, investors would want to include assets that have low or negative correlation with the other asset classes in their overall portfolio.

ABILITY TO PRESERVE CAPITAL WHEN EQUITY MARKETS ARE POSTING LARGE LOSSES

Offshore hedge funds also managed to weather most of the financial market crises during the 1990's and early 2000's. The graph below shows how hedge funds have managed to "protect capital" during these periods.

The HFRI FoF Index outperformed the MSCI equity index in all of the last six equity market crises posting positive or small negative returns. The only time when hedge funds also experienced similar losses to the equity markets was during the Russian debt crisis.

Despite the drawdown hedge funds experienced during the Russian crisis, hedge funds managed to live up to expectations during most of these periods and provided exactly what investors expected from them i.e. better risk-adjusted returns with lower downside risk.

BUT, REMEMBER - NOT ALL HEDGE FUNDS ARE THE SAME!

When investors diversify their portfolio by including offshore hedge funds, they need to recognize that the term "hedge" or hedge fund is only a generic description for a wide variety of hedge fund strategies that are implemented by hedge fund managers. The "multiple personalities" of offshore hedge funds extend beyond the traditional boundaries of typical asset classes i.e. equities, bonds, property and cash. Hedge funds typically combine the traditional asset classes with strategies such as short selling, arbitrage and leverage, to name a few. In simple terms, an offshore hedge fund aims to exploit inefficiencies in the offshore markets.

Investors need to recognize that the range of offshore hedge fund strategies that offshore hedge fund managers apply varies materially and not all of these strategies necessarily aim to guarantee or protect investors 100% against short-term market downturns. At

present there are in excess of 15 distinct investment strategies used by hedge funds globally, and the list continues to grow. Only one or two of these strategies are not correlated to the returns of the broader equity markets.

It is therefore imperative for investors to make certain they include the appropriate hedge fund strategies as well as hedge fund or fund of hedge fund manager(s). Today, the majority of investors prefer to utilise offshore fund of hedge fund managers to ensure they follow due process when it comes to the selection and management of their offshore hedge fund investments. However, as noted, even this task is a daunting one with more than 2300 offshore fund of hedge funds to choose from.

MEANINGFUL ALLOCATION REQUIRED

For offshore hedge funds to play a role in an investor's offshore portfolio mix, it is important for investors to make a meaningful allocation towards hedge funds. Octane's experience shows that South African investors have typically invested less than 5% of their total assets to hedge funds. This is a relatively low percentage if compared to offshore research conducted. Research papers have suggested investors should commit at least 10-20% to hedge funds

CONCLUSION

This is the theoretical case for -"the role of offshore hedge funds for investors", but there are a number of practical issues that investors need to consider before deciding to increase their allocations. For example, offshore hedge funds are typically less liquid, less transparent and investors may be uneasy about choosing the right offshore hedge fund



Duncan Theron: Managing Director of Octane, Pan-Africa

managers or fund of hedge fund manager(s). This could be an overriding constraint for some retail investors in terms of the final weighting allocated to offshore hedge funds in consultation with their financial advisor.

Investors' experiences and research studies show that offshore hedge funds are a valuable addition to a traditional investment portfolio and a meaningful allocation can cause a significant reduction in portfolio risk. However, offshore hedge funds encompass a wide range of very different strategies and investors need to understand those differences in order to find the appropriate solution that best fit their overall investment strategy.

Simultaneously, the onus rests with the hedge fund fraternity to assist investors to understand how the use of hedge funds can reduce the risk levels of their portfolios. The education process requires skills in making the concepts accessible to investors to better understand. Hedge fund presentations are generally too complex and confusing for investors. Hedge fund managers are too focused on "selling" products instead of trying to understand investor's needs and then explaining how certain hedge fund solutions can help to meet those needs. This is essential because hedge funds should be a mainstream part of any investor's offshore asset allocation!

If offshore hedge funds are included "correctly", by this we mean the selection of the appropriate hedge fund solution and allocation of a meaningfully weighing to the asset allocation mix, they are expected to fulfill a very important role in optimising investors' investment portfolios - especially now that the focus has shifted more towards absolute returns controlling portfolio risk.

HFRI FoF Index vs traditional market indices



MSCI vs. HFRI FoF

