



## The case for offshore hedge funds remains strong

*"it is not the strongest of the species that survives, nor the most intelligent, but the one most responsive to change"* - Charles Darwin

### Executive Summary

- 2008 was a "tough" year for hedge funds personified by disappointing performance numbers and large redemptions, but institutional investors remain committed towards hedge funds;
- The case for hedge funds to diversify institutional investors portfolios remains convincing. They provide compelling risk-adjusted returns, offers greater protection during markets declines and preserves capital for South African retirement funds in Rand terms during global crises;
- Investment opportunities exist in the current volatile and uncertain markets, with hedge funds ideally placed to take advantage of;
- The likelihood of more stringent registration and regulatory requirements going forward should create a more positive perception for hedge funds and investor allocations.
- However, investors need to be selective with appointment of their fund of hedge fund managers - both in terms of identifying investment skill, as well as investigating wider operational and due diligence arrangements.

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## Introduction

The year 2008 was clearly a difficult year for offshore asset classes, including fund of hedge funds. This should not be surprising given the size of the economic and investment market dislocations, as well as the depth of the systemic crisis.

The disappointing performance of hedge funds was largely attributable to the unique characteristics of the current credit / liquidity crisis - an increase in counterparty risk; arbitrary regulatory changes viz the ban on short selling and the "forced" de-leveraging that was witnessed throughout the year.

However, in a year where there were almost "no places to hide", this does not mean that the case for hedge funds has diminished. Research recently conducted by reputable organisations shows that institutional investors remain committed towards their long-term strategic allocation towards hedge funds.

*"Institutions have been strengthening their commitment to hedge funds investing. Thus far, most institutions are not backing off from their long-term commitment to hedge funds".<sup>1</sup>*

*"63% of institutional investors said alternatives, led by hedge funds, will become as or more important than equities, bonds or mutual funds between now and 2013".<sup>2</sup>*

## Why is the case for hedge funds still compelling?

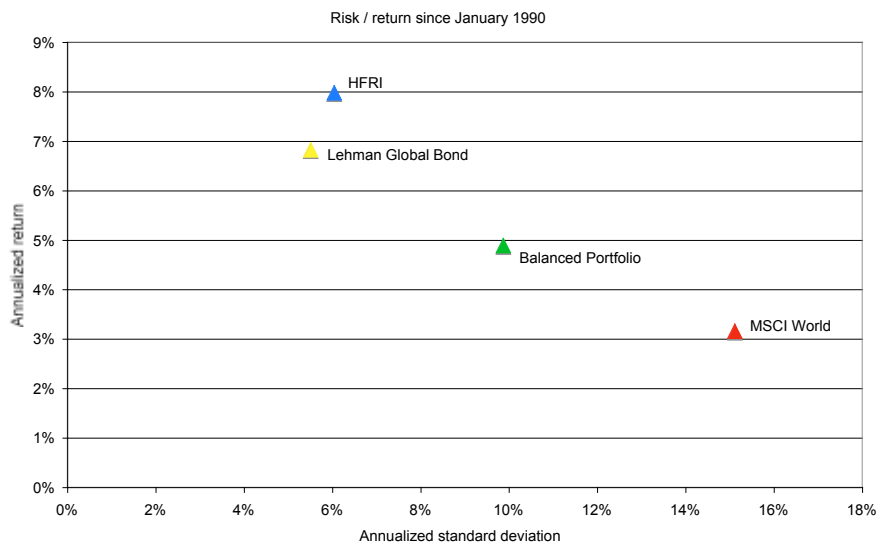
### *Attractive risk-adjusted returns*

Despite many hedge funds losing money in the short-term, a diversified portfolio of hedge funds would still have outperformed global equities during the current credit crisis, as well as a typical balanced portfolio over longer time horizons and at lower volatility (risk) levels. Hedge funds have demonstrated the ability to provide **better risk-adjusted returns** than offshore equities due to hedge fund managers' ability to make use of a more flexible "toolkit" than traditional asset managers. What should be of concern for investors is the fact that global equities (as represented by the MSCI World Index) have not compensated South African investors with returns appropriate to the risk taken not only over the short term, but even over the longer term... food for thought.

At present, most South African institutional investors make use of a balanced portfolio approach offshore. If one compares a diversified portfolio of hedge funds with that of a typical balanced fund (say 60% equities and 40% bonds), the hedge fund portfolio provides better risk-adjusted returns over the long term as demonstrated by the risk / return scatterplot over the page.

*...institutional investors remain committed to hedge funds...*

*...the essence of investment management is the management of risk, not the management of returns....<sup>3</sup>*



*...a compelling case for the inclusion of offshore hedge funds...*

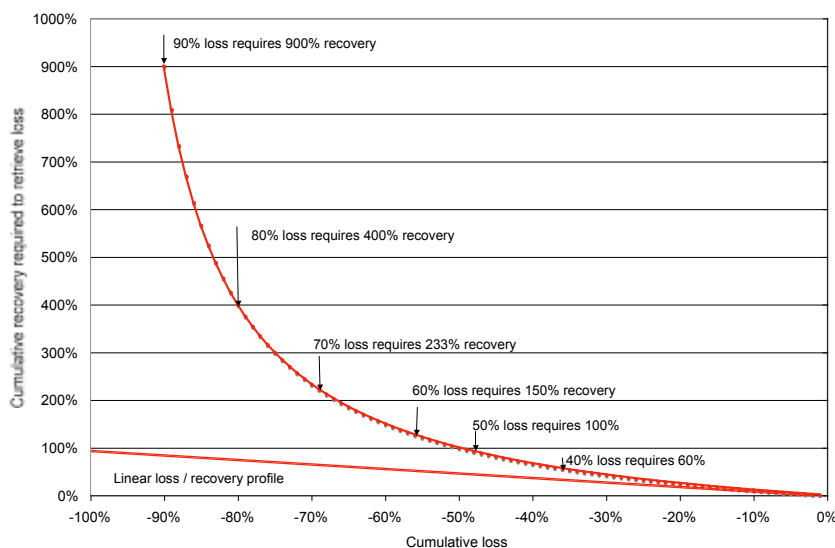
Note - Balanced portfolio composition: 60% MSCI World/40% Lehman Global Aggregate

### *Downside protection*

Another major argument is the ability of hedge funds to provide **better protection on the downside when global equity markets are posting large losses**. From June 2007, when the sub-prime crisis commenced to date, the MSCI World Equity Index (in Dollars) has lost approximately 50% in comparison to the HFRI FoF Index, which is down only 18%, thus demonstrating the typical ability of many funds of hedge funds to protect around 70% on the downside.

*...compounding - the 8th wonder of the world...<sup>4</sup>*

Besides the advantage of smaller losses on the downside, hedge funds also have the ability to recover quicker from drawdowns. The graph over the page shows the “disadvantage” of compounding which requires for example, investors to achieve a return (or recovery) of 100% if their portfolios have lost 50%. This figure increases to a required recovery or return of 150% if the portfolio return decreases by another 10% (i.e. from -50% to -60%). This scenario is typical of the current equity markets. In contrast, hedge funds need less than 25% to recover from their current drawdowns. The question is - how much more can investors “stomach” in the way of losses on their offshore equity portfolios?



...trying to avoid negative compounding is central to the hedge fund concept...

## Capital protection in Rands

The table below shows how the average fund of hedge fund (as represented by the HFRI FoF Index) has performed relative to global equities (as represented by the MSCI World Index) in Rand terms during the “crisis” periods in the current decade.

This represents a definite compelling case for the inclusion of offshore fund of hedge funds in a South African investor’s diversified global portfolio where *Rands are the liability currency* of such investors.

Crisis	Date	MSCI World (ZAR)	HFRI FoF (ZAR)
Technology bubble	Sept '00 - Mar '01	-11.20%	12.95%
World Trade Center (9/11)	Aug '01 - Sept '01	-5.13%	7.78%
Sub-prime	Jun '07 - Feb '09	-31.91%	15.12%

## Current market conditions – “a once in a life-time opportunity”

The current market conditions also offer a *unique* opportunity to invest in fund of hedge funds, however, investors need to ask themselves which are the appropriate hedge fund investment strategies for their portfolios in the current volatile and uncertain markets. Plenty of mis-priced opportunities exist in certain hedge fund strategies such as distressed debt and relative value. It is important for funds of hedge funds to exploit these opportunities, as investors are increasingly looking for opportunities to complement their existing traditional offshore portfolios.

*“Consultants expect institutional investors to reassess how they categorize hedge fund strategies, thinking more in terms of equity and fixed income rather than simply asset allocation”.<sup>5</sup>*

## **Outlook – “with change comes opportunity”**

Hedge funds are likely to face more stringent registration and regulatory requirements going forward, as well as closer monitoring by regulatory bodies. This will be positive for the industry and we believe will create a more positive perception for hedge funds.

*“The perception of investing in hedge funds is often still negative... the quantity of hedge fund bashing is plentiful while the dissemination of high quality hedge fund research is not...”.<sup>6</sup>*

Going forward one should expect a much leaner hedge fund industry that will be better positioned to take advantage of market inefficiencies and thereby provide greater return opportunities for investors. Fewer players with less capital will employ less leverage and generate returns from an opportunity set that is large and still growing.

*“Many ‘surviving’ hedge funds will offer superior risk reward, in particular after the current crisis has helped mop up some of the recent excesses”.<sup>7</sup>*

However, investors will need to continue to be selective, both in terms of identifying investment skill, as well as investigating managers’ wider operational and due diligence arrangements.

*...one should expect a leaner hedge fund industry, better positioned to take advantage of market inefficiencies...*

*...whilst there is still a fair amount of pessimism to go around, hedge fund practitioners are clear on one thing - what hasn't killed them, will make them stronger...<sup>8</sup>*

## ACKNOWLEDGMENTS

<sup>1</sup> *SEI & Greenwich Associates Survey: "Hedge funds under the Microscope" – January 2009.*

<sup>2</sup> *Morningstar / Dow Jones Survey - November 2008.*

<sup>3</sup> *"The essence of investment management is the management of risk, not the management of returns"- Benjamin Graham.*

<sup>4</sup> *"Compounding - 8th wonder of the world"- Albert Einstein.*

<sup>5</sup> *"2009 Consultant Search Forecast"- Casey Quirk, February 2009.*

<sup>6</sup> *"The end of an era – but what lies ahead for hedge funds?"- The Hedge Fund Journal – Alexander Ineichen (UBS & well known investment author).*

<sup>7</sup> *Credit Suisse: "Hedge funds through the storm" - November 2008.*

<sup>8</sup> *"US Hedge Fund Industry - experts predict growth by fourth quarter"- USA Hedgeweek Special Report - February 2009.*

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