

Octane Oracle

In this issue of Oracle, we briefly explain what an offshore hedge fund is, discuss some of the main characteristics and lastly, address the confusion surrounding the use of the term “hedge”.

Executive summary

- The term hedge fund is a generic name or description used to classify offshore hedge funds and does not reveal how offshore hedge funds are managed or how they actually invest their investors' assets;
- Hedge funds invest in an opportunity set that is much broader than that of the typical traditional equity, bond, property or cash investment manager or fund;
- Hedge funds have a number of characteristics that differentiate themselves from other more traditional offshore investment approaches;
- Investors need to recognize that the range of offshore hedge fund strategies that offshore hedge fund managers apply, varies materially and that these strategies do not necessarily aim to guarantee or protect investors 100% against short-term market downturns. Over the short to medium term, i.e. 12 months, offshore hedge funds have shown that they can protect capital while still producing returns in excess of offshore cash and bonds. Over the longer term i.e. 15 to 20 years, offshore hedge funds have managed to outperform offshore equities at much lower risk.

History of hedge funds

The hedge fund industry was “born” back in 1949, when Alfred Winslow Jones established the first hedge fund in the United States. Jones

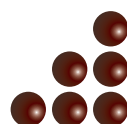


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used short selling to protect (“hedge”) his long-only portfolio from a declining market combined with a leveraged long equity position.

Since then, the scope of the term “hedge fund” has expanded beyond Jones’s strategy to describe funds engaging in a range of other alternative investment strategies, but not necessarily with the aim of protecting the investor’s assets. Jones’s success at the time resulted in several investment managers setting up other funds, which traded different strategies. For example, in the 1980’s, hedge fund managers such as Julian Robertson and George Soros posted extraordinary returns over long periods of time making use of macro strategies. These macro funds were not set up with the main objective of protecting their investors’ assets during market downturns, but were also “labeled” under the generic “hedge fund” name.

With the proliferation of the offshore hedge fund industry and with more underlying offshore hedge fund strategies being introduced, classifying the wide range of offshore hedge fund investments all under the name “hedge fund” has created an expectation amongst investors that hedge funds not only provide investors with different sources of return but also protection from capital losses. Investors need to understand that of the 15 broad offshore hedge fund strategies, which offshore hedge fund managers apply, only one or two of these are not correlated to offshore stock and bond market returns and aim to protect or “hedge”



investors' assets over shorter time horizons.

What is a hedge fund?

The term hedge fund is a generic description for a wide variety of hedge fund strategies that are implemented by hedge fund managers. There are now more than 10,000 offshore hedge funds and more than 2,300 offshore fund of hedge funds and this universe keeps growing.

A hedge fund invests in almost any opportunity in any regulated market. This may sound too broad to describe a hedge fund, but this is precisely what a hedge fund is. A traditional offshore investment manager only invests in conventional equity, bond, property and cash strategies, whereas an offshore "hedge fund"

generally combines traditional investment strategies such as buying equities, bonds, commodities, currencies and listed property, with alternative 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.

One way to identify an offshore hedge fund is the typical charge of a management and a performance fee, as well as the investment manager having his or her own capital invested alongside third party investors'. In addition, and possibly the main differentiator, is that offshore hedge funds typically pursue absolute return strategies rather than seeking relative out-performance of a specific market benchmark such as the MSCI World Equity Index or Lehman Global Bond benchmark.

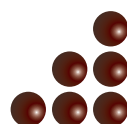
Short selling

Investors may ask the question how is it possible for a hedge fund manager who buys and sell shares to achieve positive returns when the stock exchange as well as the specific share in which the manager invests, performs negatively. The process of short selling is briefly explained as follows:

The hedge fund manager is of the view that the share is overvalued, "too expensive", at R100 and wishes to take advantage of a price decline when the share price drops closer to its fair market value. The investment manager then borrows the share from a third party such as a bank or prime broker and sells the share in the market for R100. To enable the investment manager to borrow the share, the investment manager has to pay a borrowing fee of R2. Hopefully, the manager has made the right call on the share price and the share drops to R80.

The manager eventually repurchases the share at R80 in the open market in order to return the borrowed share back to the third party lender. The manager therefore has made a profit of R18 (R20 less the cost to borrow the share i.e. R2).

Offshore hedge funds have access to a broader set of "tools" than traditional investment managers.



Main characteristics of offshore hedge funds

Legal structure:

Offshore hedge funds are typically private investment vehicles and are not regulated. This means they do not have to be registered with a regulatory agency such as the Securities Exchange Commission (SEC) in the US. Many offshore hedge fund managers do however, voluntarily register themselves with the relevant bodies such as the SEC and FSA (Financial Services Authority) in the UK.

Investment approach:

Offshore hedge funds utilise a wide range of different investment strategies. The strategies all make use of a variety of financial instruments to produce returns that are less correlated to traditional asset classes.

Manager compensation:

Offshore hedge fund fees are predominantly structured on a management fee plus an incentive or performance fee basis.

Alignment of interests:

Hedge fund managers generally have substantial amounts of their own money invested in their own funds, and thus align their own interests that of their investors.

Reporting & transparency:

The offshore hedge fund industry generally provides monthly performance results, with returns being quoted net of all fees. Showing returns on a net of fees basis is a more accurate way of reflecting the value that has been added to the portfolio by the hedge fund manager. Traditional investment managers report gross of fees. The initial monthly returns are typically estimates with the final asset values only made available five to six weeks after month end. Portfolio exposure informa-

tion varies. Although some offshore hedge fund solutions provide full transparency at the transaction level, the majority of hedge funds are typically less transparent than traditional investment manager mandates.

Lockup & liquidity:

Liquidity refers to the timing i.e. trade date and notice period required for investors to redeem their investment and have their money returned from the hedge fund. A lock-up period is the length of time that investors must remain invested before the initial investment can be redeemed. Offshore hedge funds typically have some form of liquidity constraint i.e. a notice period of 90 days must be provided and the hedge fund trades quarterly. An initial lock-up period of up to one year may apply.

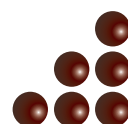
However, not all offshore hedge funds implement a lock up period and notice periods range from 30 days to 120 days, with trade dates being monthly, quarterly, bi-annual or annual.

Why the name "hedge" fund creates confusion

A popular misconception among investors is that all hedge funds "hedge", guarantee or protect their investors assets even during short-term market fluctuations. The reality is that not all hedge funds "hedge" or protect investors assets against short-term market downturns. As noted before, 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.

Hedge fund strategies can be classified in a number of ways. At Octane, we classify offshore hedge fund strategies in the following four broad categories i.e. –

- **Relative value** - this strategy typically refers to non-directional strategies such as arbitrage and market neutral. Market





exposure and market risk are typically reduced in these transactions.

- **Event driven** - these strategies focus on investing in securities of companies facing major corporate events such as mergers, acquisitions and spin-offs. These strategies typically are higher risk than relative value strategies and take on some level of market risk.
- **Long/ short equity** - this is an equity-type strategy whereby managers will hold some combination of both long and short positions that could at least partly reduce the impact of a market decline.
- **Trading strategies.** These are typically "non-hedging" strategies and are usually directionally biased (i.e. the manager takes a view) and opportunistic in nature. These strategies on average present higher levels of potential risk relative to the other categories. Tactical trading includes strategies such as global macro and managed futures.

Not all hedge fund strategies "hedge" market risk over short-term investment periods. The generic description originated from the days of Alfred Jones's hedge fund strategy and has since been used to encompass all the different investment strategies. Over longer term periods i.e. one year and longer, offshore hedge funds have shown that they can protect capital and still produce returns in excess of cash and bonds.

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