

# Funds are healthy despite downturn

Capital inflows expected to increase in second half of the year, writes ANDREW GILLINGHAM

THE South African hedge fund industry has survived the early part of the year's market conditions in a healthy state. Ian Hamilton, chairman of the Alternative Investment Management Association of SA and head of the IDS Group, says none of the South African hedge funds have landed themselves in serious trouble and the industry appears set to continue progressing in the years ahead.

He says offshore hedge funds have had to contend with the US subprime crisis, though some international hedge funds have done very well out of the resulting conditions.

Hamilton says some companies have turned to hedge funds to provide them with liquidity during the credit squeeze, while others have found it more difficult to borrow money to gear up their investments.

"Internationally, the hedge fund segment of the investment industry appears to have had the least direct exposure to the subprime issue. While there has been a slow-down worldwide, they have shown moderate growth."

In the South African market both hedge funds and local banks have been largely unaffected by the subprime crisis. As a result, local hedge funds have not been faced with the liquidity issues that have dogged some of their overseas counterparts.

In addition, domestic hedge funds do not tend to have the same high level of gearing as offshore funds.

"Capital inflows have been slow over the past few months as investors exercise caution

and often choose cash investments rather than equities and equity-related investments.

"There is a flight to safety and there is a general wait-and-see attitude with longer-term investment decisions."

Hamilton expects capital inflows to increase in the second half of the year.

"There is money in the pipeline that will be flowing into hedge funds. Some of the hedge funds are structuring funds that offer a very low level of risk and new types of funds are being introduced."

Emil van Rensburg, an investment strategist at RMB Private Bank, says generally hedge funds are doing extremely well and the industry is enjoying very good growth.

"Over the past three to four years the market has grown exponentially and there has been an influx of new funds as well as strong investment flows into hedge funds."

"This year people are being a little more cautious as we have

**"Capital inflows have been slow over the past few months as investors are exercising caution and often choosing to go into cash investments rather than equities and equity-related investments."**

had a turbulent start to 2008. As the markets have been volatile hedge funds have tended to struggle somewhat."

However, he says the lower level of investor interest is at least partly due to the fact that many investors simply do not understand how hedge funds work and the ways in which they operate. As a result, they often do not know which type of hedge fund to pick to achieve a particular objective.



IAN HAMILTON

"Education remains a key component in developing hedge funds in SA."

He says hedge funds remain very much the province of wholesale investors such as institutions rather than retail investors. Institutions regard hedge funds as an important part of a portfolio but never a main building block. They use hedge funds as an addition to a portfolio to provide a slightly better risk-adjusted return

profile. Hedge funds add diversification and have the ability to make money in bear markets.

"Hedge funds give portfolios an edge when markets go the wrong way. At the same time, hedge funds are not the investors' Holy Grail and they must be seen as a tool. When structuring a portfolio we would not necessarily put more than a 25% allocation of a person's growth assets into hedge funds," he says.

## A good manager should never be at a loss

FUND of hedge funds try to identify exceptional hedge fund managers with whom to invest, and to separate them from those that could be mediocre.

Simone Lowe, portfolio manager at Blue Ink Investments, says there are particular attributes to which fund of hedge fund managers pay attention.

The mindset required is very different to running a long-only portfolio. Capital preservation is the key to any investment decision and the fund is managed to generate the maximum return per unit of absolute risk taken on, rather than trying to generate returns above a benchmark, and accepting the market can go down as well as up.

"For the hedge fund manager, losses of any kind should be loathed. A hedge fund manager needs to have the capacity to take on positions for hedging and capital preservation. There is also a specific mindset when analysing and implementing short positions, especially as these tend to be counter-intuitive to general market

direction," Lowe says.

Hedge fund managers are able to use net and gross exposure to position the fund in line with their view and to manipulate it accordingly. These tools can be used to both enhance return and protect the portfolio.

She says having no benchmark other than cash means that risk on a hedge fund is done on an absolute basis rather than the relative basis often practised in long-only fund management. This, coupled with the extra tools available to the hedge fund manager (shorting, net and gross exposure) mean that a manager needs to be an expert in downside risk management, as a poorly managed portfolio could have significantly more downside than a poorly managed long-only portfolio.

"The manager needs to ensure he understands what could cause him to lose money and the extent of this potential loss and understand how this compares to the upside potential from his positions."

Emil van Rensburg, an

investment strategist at RMB Private Bank, says most hedge fund managers have had good reputations as traders at banks or as long-only fund managers.

"It means we tend to know them from their previous experience in the investment world."

He says the key is ensuring that the manager has a sound understanding of investments.

He says hedge fund managers have more investment arrows in their quivers than long-only managers and can short the market or individual shares to protect portfolios.

"When picking a good manager you want as much experience as possible."

He says while there is not a vast difference in skill levels between long-only and hedge fund managers, good hedge fund managers have a different mindset.

"They have to understand fully the implications of incorporating short options in their portfolios; this does take a different frame of mind," Van Rensburg says.

## Retail market out of bounds for funds

THE registration of hedge fund managers has brought some degree of regulation to the hedge fund industry, though the funds themselves remain unregulated and still face constraints, particularly with regard to addressing the retail market directly.

Ian Hamilton, chairman of the Alternative Investment Management Association of SA, says the registration has gone well and the Financial Services Board (FSB) has been pleased with the industry's response.

"Registration is not completed but so far there have not been any shocks or surprises," Hamilton says.

However, the funds are not regulated and this means, for example, that funds cannot market themselves directly to retail investors and have to focus on wholesale investors such as institutions.

John Gillmer, director at Deneys Reitz, says until August last year hedge funds were unregulated investment vehicles providing investors with exposure to a wide range of products, including derivatives and leveraged positions.

A hedge fund is defined as a portfolio that uses any strategy or takes any position that could result in it incurring losses greater than its aggregate market value.

In August last year the Financial Services Board (FSB) introduced regulations under the Financial Advisory and Intermediary Services Act, 2002, (Fais) governing the managers of hedge funds and funds of hedge funds.

"The regulations require all hedge fund financial services providers to be licensed under Fais."

"They must prove to the FSB that they have a track record of managing particular hedge fund strategies and are able to demonstrate knowledge, skills and competency in managing all instruments in asset classes consisting of a hedge fund portfolio adequately," he says.

## Why and how is still a mystery

INVESTORS need to understand what they are putting their money into and the mechanisms and tools that are used by funds for hedging purposes.

Chris du Toit, an analyst at Allan Gray, says hedging is being used increasingly by asset managers to manage portfolio risk and enhance performance, yet few investors have any idea what hedging is, how it works, or what its benefits are.

"Hedging is often talked about but seldom explained, which is why it remains a mystery to most investors. Also, hedging has developed its own set of terms, which often serve to mystify investors further."

He says hedging is like insurance and can be applied both to physical commodities such as wheat and corn and to financial instruments such as shares. One

of the most common ways to hedge in financial markets is through a futures contract, also known as a derivative because it derives its value from the underlying asset, for example a share.

Essentially a future is a contract between two parties to buy something (known as the long position), or sell something (the short position) at a specified future date for a specified price.

It is a financial instrument bought and sold through the South African Futures Exchange (Safex). A wide range of futures contracts are available through Safex, including futures on single stocks, currencies and indices.

Du Toit says to participate in the futures market it is necessary to open an account, similar to a bank account, with a deposit of at least 10% of the value

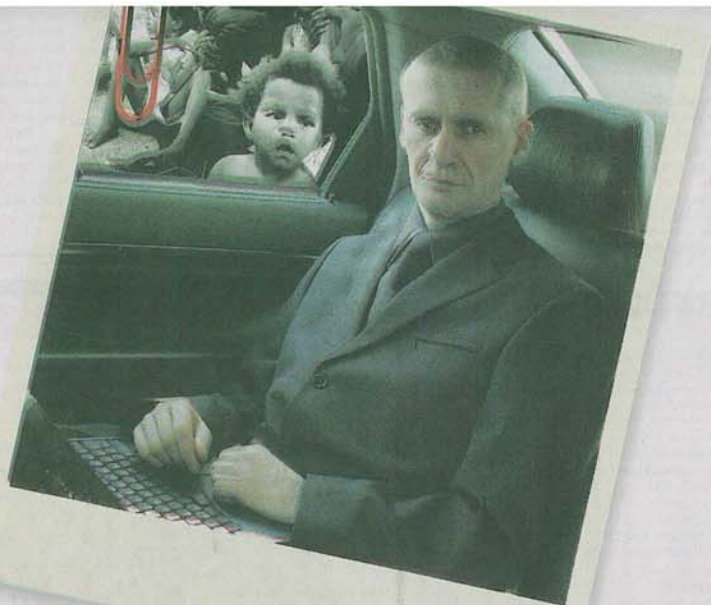
of the futures contract the investor would like to buy or sell. The deposit is known as the margin and earns interest.

As with shares, the price of a futures contract can change daily, and often does because it is linked to the price of the underlying share or basket of shares represented by an index.

Unlike shares, the profit or loss from any change in price of a futures contract is calculated daily and settled daily.

He says Allan Gray sells futures on the basket of shares that make up the all share top 40 index both to reduce share exposure of its portfolios and to enhance performance.

"We hold our shares and sell the market, capturing the difference between the performance of the market and the performance of our shares."



# GET INVOLVED

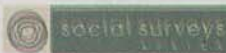
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