

Hedge funds Growing up fast

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Institutional investors will ensure that hedge funds become less risky, if a little less exciting

Hedge funds have evolved from being opaque and secretive funds, aimed at rich and sophisticated institutional investors.

But they still have a mysterious and glamorous image as "get-rich" investments, offering high consistent returns.

Domestic SA hedge funds barely existed before the mid-1990s - investors arguably could "get rich" easily enough through the JSE itself, and much of the "get rich" money found its way, legally or not, into international markets.

A few fund managers, disillusioned with the traditional fund management industry's obsession with benchmarks and relative performance, identified a gap in the market for consistent positive returns, which hedge funds provide.

By the time the SA hedge fund industry emerged towards the latter part of the 1990s, the global industry had attracted wider notice from the investment community, in part due to returns, but also because of a low correlation with more traditional asset classes, and the prospect of an improved risk/return profile of the traditional balanced portfolio. Hedge fund volatility is about a third of that of equities and 70% of bonds.

A study by the research centre Edhec shows that an allocation of 10% into the overall allocation of a pension fund leads to a reduction of 25% in the probability that the assets of the fund will fall below 75% of their liabilities.

But Warren Brown, head of hedge funds at SYmmETRY Multi-Managers, says the advent of hedge funds has increased the complexity of developing an investment strategy that is successful and easy to evaluate, monitor and communicate.

Octane Africa MD Duncan Theron says it is an extremely complex task to evaluate the international hedge fund arena - even if pension funds look only at funds of funds they have 1 700 options.

Brown points out that hedge funds carry a number of nonmeasurable risks such as operational and fraud risk - issues which do not concern investors and consultants much when they invest with mainstream asset management houses.

Richard Atkinson, head of alternative investments at RMB Multi-Managers in London, admits that 2005 has been a mixed year for hedge funds.

In general, returns have been considered to be somewhat disappointing, in particular compared with the returns generated by most global equity and commodity markets

But it was hardly an embarrassing performance by the standards of other assets classes. In their worst month they fell 2% but still gave an average return of 7%.

Hedge funds still outperformed bonds, which were down 4%, and though certain markets, such as SA, performed well, the benchmark MSCI World Index was up just 9,5% in dollars - though just sitting in cash would have given 4%.

A significant part of the hedge fund universe was negatively affected by a significant market collapse in the convertible bond market, as well as market shocks to segments of the fixed income market following the downgrade of General Motors (GM) debt.

The convertible market in 2005 became a victim of its own success: at times during the year the majority of participants in the market were hedge funds, all of which were chasing the same investment opportunities.

Combined with a steadily declining level of market volatility in Western markets - and hedge funds need volatility to provide an optimal performance - the market was prone to a setback.

Following significant losses at some funds, they started selling their positions in order to meet redemptions, and as prices started to fall, all hedge funds were forced to liquidate part of their portfolio to cover redemptions and expectations of redemptions.

The resulting sellout in a falling market led to large losses in several convertible arbitrage funds. Atkinson says that though the market has since started to recover, this episode caused considerable pain for investors. At the same time, as GM debt was downgraded, continued concerns in the credit markets led to severe dislocations in the collateralised debt obligations (CDO) markets, as well as increased volatility in the overall fixed income market. Many hedge funds which specialised in the credit markets were hit.

Yet so far there has been limited effect on investor demand for hedge funds. Hedge fund assets worldwide recently surpassed US\$1 trillion.

According to Mustafa Zaidi, a portfolio manager at Octane, a subsidiary of Sanlam, the first institutions to show interest in hedge funds were the endowments of major universities such as Harvard and Yale, as well as Middle Eastern national pension and social security funds in countries such as Kuwait and Abu Dhabi.

Many of the people who run these funds had already invested in hedge funds in their personal capacity.

They were followed by public US pension funds, though this has only just started: at the end of 2005, just five (admittedly huge) funds had invested into hedge funds: the state retirement funds of California, Virginia, Texas, Pennsylvania and Missouri.

Edwin T Burton, a trustee of the Virginia Retirement System, expects that within 36 months a further 100 funds will dip their toe into hedge funds "but it is a pretty big toe".

Burton argues that many pension fund chief investment officers got fed up with having to explain why their fund assets continued to go down from 2000 to 2002 during the equity bear market. "They have sought refuge in the more dependable returns available from hedge funds. It may be true that the US market has rebounded over the past three years - in 2003, hedge funds provided a 14% return compared with 32% from the Standard & Poor's 500 - and they underperformed marginally over the past two years - but the decision-making process by US pension funds is slow and it can take three to four years to introduce a new class of investment.

In comparison, SA pension funds have been much quicker off the mark. From 1994 there were a handful of SA hedge funds promoted to foreign investors, primarily by Dion Friedland, the founder of the Dion chain, who promoted them in much the same way as he promoted vacuum cleaners, damaging the credibility of hedge funds in the process.

But the first serious attempt to set up a sustainable hedge fund business was in the past eight years, with Peregrine Capital and Decillion being the pioneers - and the funds they started are still the market leaders.

It has not been easy for pension funds to invest in hedge funds. Under Regulation 28 of the Pension Fund Act, they fall under the "other" category in which they compete with private equity and unlisted infrastructural investment for just 2,5% of assets. Zaidi says that, in contrast, Middle Eastern funds will invest 8% in hedge funds and a further 12% in private equity.

But last year, there were some significant investments in hedge funds by some of the larger SA funds - Telkom has invested R500m, the Mines Pension Fund R350m and Transnet R100m. The SA industry is already more institutional in nature than the worldwide industry, with 45% of investments in the industry through funds of funds, which are primarily focused on institutions.

According to the Novare SA Hedge Fund Survey, the total assets managed by SA hedge funds have grown from R5,4bn to R8bn but if hedge funds which are "under the radar" and do not participate in industry surveys are included, it could be more than R11 bn.

Internationally, demand is already maturing. Simon Hopkins, MD of the Fortune Group, a London-based hedge fund of funds manager, says that the much-vaunted wall of institutional money was a damp squib in 2005 and there were no landmark allocations in the UK.

Atkinson says there has been a sharp fall in capital inflows to the industry over the past few months, though opportunities still exist.

But he says that investors, including fund of hedge fund managers, will face a more difficult task in trying to discover them.

Perhaps SA hedge funds, which are still producing superior returns by international standards, will be one source of the much sought-after, but increasingly elusive alpha - the industry jargon for excess returns.

But continued growth in Asia combined with increasing volatility in global financial markets will continue to provide hedge funds with investment opportunities.

Atkinson says that institutional investors must be realistic, and look to hedge funds to produce two to three times cash equivalent returns, give a low correlation to other allocations in their portfolio and reduce volatility and downside risk.

The clinching attraction for these funds may well have been the performance of hedge funds during equity downturns. Simon Peile, head of African Harvest Alternative Investments, says that between May 2002 and April 2003, when the equity market lost 30%, the (admittedly small number of) SA hedge funds gained 15%.

But Atkinson says that as with any industry that experiences significant growth over a short time, the opportunities to create outsize returns are reduced. "Hedge funds as an asset class have seen returns slow down over the past few years. Part of the explanation for these lower returns lies with the backdrop in the global financial markets - interest rates until recently were at multiyear lows, the inflow of capital to the industry has significantly reduced the number of investment opportunities for the hedge funds, as well as reducing the profitability of these opportunities, as more capital is chasing the same returns."

The pool of hedge fund managers has increased exponentially, reducing the average quality both in terms of investment skills and ability to develop a sustainable business model.

As the industry has started to accommodate itself to a more institutionalised structure, larger hedge funds are developing an infrastructure, investment process and a corporate

offering closer to that of larger, more traditional investment managers.

The traditional investment managers are also developing hedge fund strategies of their own - in SA, Coronation has been most active in setting up a suite of hedge funds, but others such as Stanlib and RMB are also coming into the fray (see next story).

Atkinson warns that it will in many cases lead to further deterioration of returns as the investment portfolio will adjust to a target audience with a lower appetite for monthly investment volatility - but the absolute returns that hedge funds offer in periods when other asset classes are experiencing falling returns can still provide significant value to investors over a longer investment horizon.

Legae Capital MD Fatima Vawda says there needs to be further separation of funds of hedge funds which are focused on rich speculators and those for institutions. "We have

a new fund of funds, the Cluster fund which will only invest in funds that are prepared to give complete transparency and which we believe are rock-solid from a risk management perspective. Some hedge funds will be happy to stay small garage businesses, preferring to remain opaque, and will not consider an investment in systems, but they cannot expect to receive institutional inflows."

But Vawda says there is negligible risk of a hedge fund blowout along the lines of the notorious Long-Term Capital Management (LTCM). The levels of gearing permitted in the mandates of local hedge funds is far lower than in the likes of LTCM, and most of the riskier investments such as distressed securities and even junk bonds do not exist in SA.

Funds are terminated in SA, but they have always been able to return money back to investors. Novare says that the main reason that funds were closed down was that their performance did not meet investor expectations and so they were unable to attract assets to sustain the business. Investors, understandably, do not like to pay hedge fund fees for poor performance.

Hedge fund fees remain primarily on a "one and 20" formula in which they pay a flat fee of 1% plus 20% of any positive returns - while they can pay 0,1% or less for cash management.

Vawda says that it is not appropriate for pension funds simply to pay for all positive returns and it only makes sense for them to invest in hedge funds if they can outperform cash, but with a lower risk profile than bonds.

She says the appropriate performance hurdle, before funds can start charging performance-based fees, is cash plus 2%.

There is still significant alpha potential in the industry. However, in markets like those we have experienced over the past few years, where most equity markets have been rising, bond yields are falling and commodity prices reach new heights, the alpha generation will disappoint. As hedge funds manage their assets with an absolute return mandate, their risk management and balanced market exposure will ensure that in strong equity markets most funds will fail to match returns from shares. But Atkinson says hedge funds have a much wider range of investment approaches than long-only managers, which enables them to adopt a more dynamic approach to managing portfolio risk in the face of falling markets, and in some cases can even make strong absolute returns by, for example, holding a net short position overall.

Of course, hedge funds will underperform in a sustained bull market. Tony Gibson, head of Coronation International, says a rule of thumb is that investors should look for two thirds of the upside but in return can look for one third of the downside.

In the longer run, Atkinson argues, investing a portion of an institutional balanced portfolio in hedge funds should enable the investor to make considerably higher returns - the lower volatility and the low correlation offered will reduce the overall risk of the portfolio and protect the cumulative returns.

Atkinson says retail investors can also benefit as their portfolios tend to be significantly overweight in equities and real estate.

But the marginal costs of investing in hedge funds, and the potential risks, can be significant. An institutional investor has the choice of either investing in the expertise and infrastructure needed to select and invest in single hedge funds, or, more commonly, using a fund of hedge funds or an investment adviser to manage their hedge fund exposure.

Vawda says that for many pension funds, investing 1% or 2% of their assets in hedge funds may not be deemed worth the extra administrative burden.

Internationally, the diversity of hedge funds also enables the institutional investor to build up exposures to a wider part of the broader investment universe, through targeting particular strategies and specialised hedge funds.

Novare's Derrick Roper says that unfortunately there is still limited strategy diversification in SA hedge funds - 93% of assets is in either long/short equity funds or equity market neutral funds - and very often the funds sit in a grey area in which they could be classified into either camp.

Hedge funds certainly like to show that they take a more maverick approach to investment through the names they choose: they take colourful monikers such as Badger, Ploutos, Centauri, Presidio and Pacific Dunes.

The equity funds run from the Absolute Alpha Fund with a standard deviation of 13,4% down to the Allan Gray Optimal Fund with volatility of just 1,5%. And returns over two years have varied from 43,9% from Peregrine Capital's High Growth Fund down to 6,9% for Allan Gray Optimal.

At opposite extremes are the three fixed interest funds, with volatility of 3,5% and returns of 10% and the six trading strategy funds, in which standard deviation goes as high as 35,3% (for the Badger Quant Strategy Fund) but with one-year returns of 57,8% or 25% for the Trendline Diversified Fund, which had a return of just 5,5% over the past year.