REPORT

SPONSORED EDITORIAL
HEDGE FUNDS

A look at Regulation 28

With the advent of the new Regulation 28 of the Pension Funds Act, Frances Meltzer and Justine Colley, of 27four Investment Managers, analyse the quantitative state of hedge funds in the wake of this

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On 1 July 2011, the new Regulation 28 of the Pension Funds Act (1956) became effective. Regulation 28 is the law governing the South African pension fund industry that prescribes the amount and the extent to which a pension fund may invest in particular assets or in particular kinds or categories of assets.

Under the old regulation, pension funds were restricted to a maximum exposure of 2.5% to hedge funds (called "other assets"). The new regulation is more generous in that it allows for a maximum exposure of 15% to alternative assets (hedge funds and private equity) with a limit of 10% to either.

This study shows the impact and benefits the increased allowance to hedge funds can have in standard retirement fund risk profiled balanced portfolios (CPI+7% and CPI+3% targeted return).

For purposes of this study, an equally weighted fund of hedge funds (FoHF) portfolio was constructed, comprised of 19 multi-strategy South African hedge fund monthly returns for the period October 2003 to October 2011, and represents the building block for the hedge fund exposure in the construction of the balanced CPI+7% and CPI+3% portfolios.

Have hedge funds delivered?

Figure 1 illustrates the performance of the FoHF portfolio, SA equities (SWIX) and cash (STeFI) over an eight-year period. The FoHF portfolio consistently delivered returns in excess of cash and provided a buffer during volatile downward market revisions.

In Figure 2, over the same investment horizon, one can observe the primary benefit of investing in hedge funds; downside risk protection. During the period between November 2007 and February 2009 at the peak of the global financial crisis, equity investors experienced average monthly losses in excess of 7%, while the FoHF portfolio had considerably less significant drawdowns and in some instances delivered healthy gains.

FIGURE 1

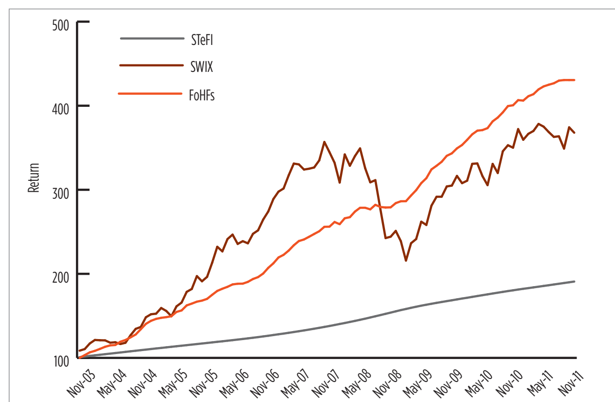


FIGURE 2

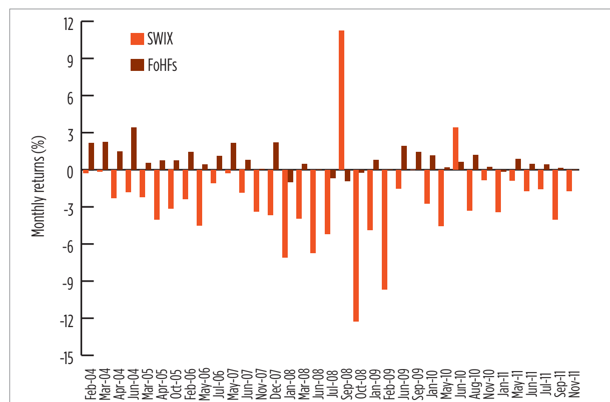


FIGURE 3

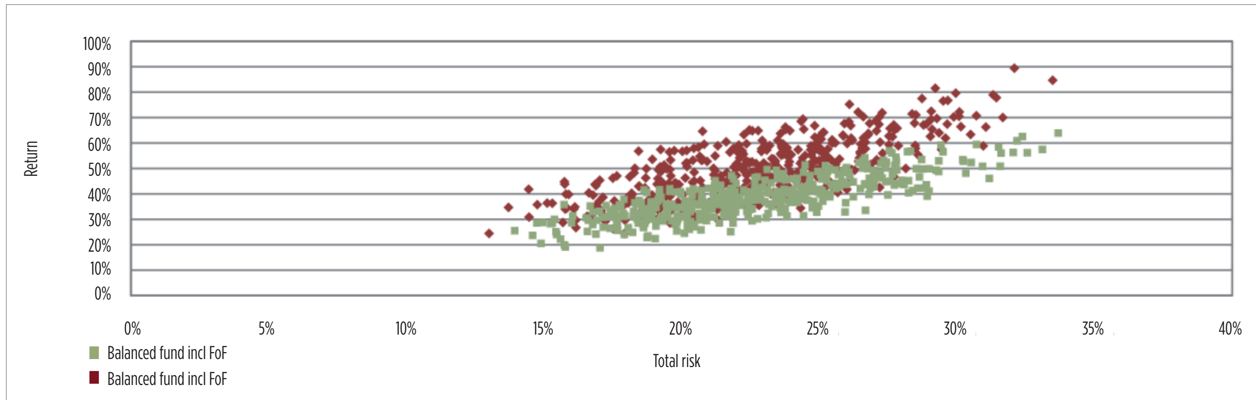


FIGURE 4

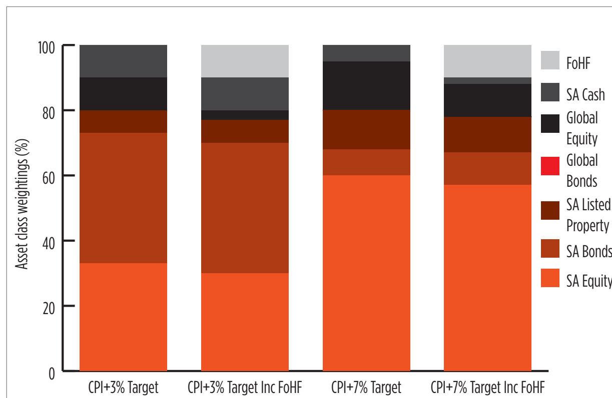
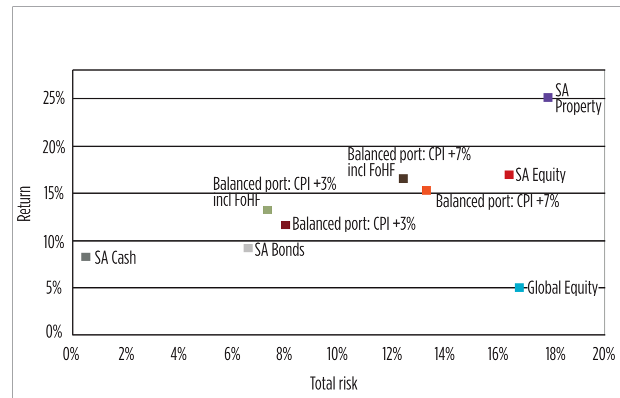


FIGURE 5



Hedge funds as a building block in a balanced portfolio

The study examines the effect of the inclusion of FoHF exposure in an unconstrained balanced portfolio. Two efficient frontiers were generated, one including FoHF as a building block and one without. Figure 3 depicts the attainable sets for a multi-asset class portfolio. Joining the points on the outer most region gives rise to the unconstrained efficient frontier. The addition of hedge fund exposure results in a non-parallel upward shift in the efficient frontier, thereby enhancing returns for the same level of risk.

Targeted return balanced portfolios with constraints

Taking Regulation 28 prescriptive asset class limits into consideration, we construct two risk profiled balanced portfolios, a lower risk portfolio with a target return of CPI+3% and a higher risk portfolio with a target return of CPI+7%. Two risk budgets are generated for each, one including FoHF as a building block and one without. A mean variance optimiser is utilised to generate the optimal blend of asset classes (over a seven- year period).

Figure 4 illustrates the optimal blend of asset classes for the two portfolios including and excluding hedge fund exposure.

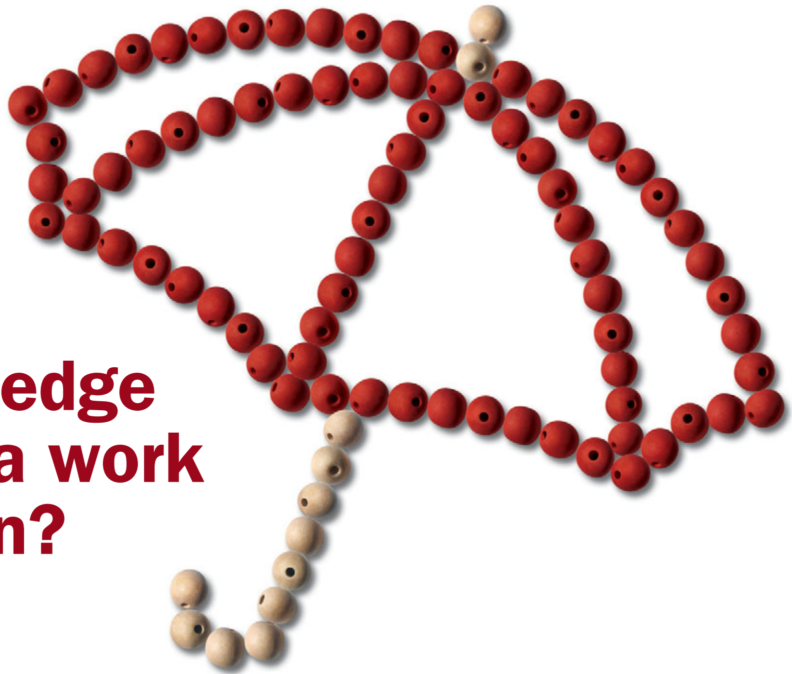
From Figure 5, it is evident that the inclusion of hedge fund exposure to the balanced CPI+3% and CPI+7% portfolios improves the total return per unit of risk. This is also evident from the sharp ratios computed in Table 1.

TABLE 1

Balanced Port CPI +3%	Balanced Port CPI +3%, Incl. FoHF	Balanced Port CPI +7%	Balanced Port CPI +7%, Incl. FoHF
1.46	1.81	1.15	1.33

The outcome of this study is supportive of the role of hedge funds in a balanced portfolio. The new regulation's generous increase in allowance towards hedge funds should be taken up by pension funds in an effort to enhance returns and reduce overall portfolio risk.

Does your Hedge Fund Umbrella work in the rain?



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