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You and Your Money

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Guest(s): Vawda, De Waal

Summit TV personal finance expert Bryan Hirsch speaks to Fatima Vawda managing director 27Four Investment Managers and Carla de Waal portfolio manager Novare Investments about whether hedge funds protect investors from the downside in volatile markets

Bryan Hirsch: Welcome to You and Your Money. Hedge funds are designed to be uncorrelated with other asset classes but there are many sceptics who don't believe that's the case and international hedge funds lost a great deal of credibility when they showed huge losses in 2008 when investor expectations was they would provide protection against a falling market. However, in South Africa hedge funds have come through with much more credibility. Hedge funds are probably the least understood form of investment although we've dealt with this asset class regularly on You and Your Money. Fatima, what exactly is a hedge fund?

Fatima Vawda: Basically every fund manager has a tool box comprising of a set of tools used to generate returns - in its simplest form a hedge fund manager has more tools available than a traditional fund manager. A hedge fund manager can use things like leverage, they can go short of the market, they can make extensive use of derivatives, etcetera. The tools available to a hedge fund manager to generate returns are much wider and broader than what's available to a traditional fund manager. Having said that there's a number of characteristics that very closely define hedge funds in their purest form - in its simplest form hedge funds are meant to be uncorrelated to traditional asset classes, so when traditional asset classes either go up or down they're not meant to pick up any of that beta risk. Hedge funds in the purest form are again meant to be very low risk investments - they are meant to offer you downside protection during periods of extreme volatility. Those are some of the characteristics that define the hedge fund...

Bryan Hirsch: Then why did the American hedge funds - and I'm not saying everyone did - but why did American and hedge funds worldwide disappoint investors? Why in 2008 didn't they maintain their value, and why have South African hedge funds done so well?

Carla de Waal: I think it's important to understand South African hedge funds - it's probably not fair to compare them to offshore hedge funds. Most of the US and global hedge funds that did suffer significantly during 2008 was as a direct result of credit exposure and being caught in that whole credit down cycle - they couldn't get out of that and as a result they had huge downside risk where the South African hedge funds did not have that type of exposure. The type of strategies that you find in South Africa is still very much vanilla-type strategies - most of them are still equity-centric so you find equity long, short and equity market neutral being hedge funds that invest using listed equities. Fixed interest hedge funds use bonds to invest with - but the way they go about investing makes them quite different from traditional funds. As Fatima has said for me the crux of that difference is being able to use short selling. When look at the mandates that hedge fund managers would have as opposed to the mandates long only managers would have they would differ significantly - a long only manager's mandate might allow them to take between let's say 15% to a maximum 75% equity exposure so if they're bearish on the market they can only drop their equity content to 50%. A typical long short hedge fund manager - a typical mandate for a long short manager would be let's say minus 50% to plus 100% so when they're

bearish on the market they might actually go to minus 50% exposure and as a result if the market falls they can actually make money in that falling market. That's the big difference. Why South African hedge funds held up reasonably well over 2008 is that many of the managers were able being in the listed equity space to take short asset exposure and protect the portfolios against a falling market and not be exposed to the credit type scenarios that had the big draw down.

Bryan Hirsch: Fatima, you're a unique manager because you've run successful hedge funds for some years - and now you've moved into portfolio managing enormous assets. That's an unusual animal to have in the industry because most hedge fund managers are very different to long only managers. How are you finding the market and how you determining now what to buy? Look at the volatility we've had in the last week...

Fatima Vawda: The volatility in the last week has been very unnerving. I think the proper way to look at things is to have a long term view on your asset allocation - your asset allocation really is the long term driver of investment performance. We basically run multi-manager portfolios and multi-manager portfolios are driven on two elements - that is asset allocation and fund manager selection. We believe that 95% of your returns are driven by asset allocation so having the composition of the different asset classes in your portfolios optimised is really where you are going to generate your long term return. It's really very difficult to call direction in the markets at the moment - what's happening in European markets is extremely worrying with the Euro and also the quantitative easing and when the US markets will finally withdraw the plan they put in place last year. There's the weakness of the euro, the British elections, the weakness of the rand at the moment - so there's a lot of elements playing in the markets at the moment that are really worrying and not only that it just makes it very difficult to seek direction.

Bryan Hirsch: So you're sitting on the fence or are you going short? If you're a hedge fund manager now would you be shorting this market?

Fatima Vawda: Diversification is a good way of protecting yourself during a period like this - making sure that you keep your portfolio at its lowest risk possible so low volatility exposure in the market, but really asset class diversification and making sure that in the short book you're not short of small cap stocks so you prevent a short squeeze in the market. If you are going to go short of the market make sure that you're short of large cap stocks that you can cover quite quickly and employ protective strategies, derivatives, maybe buy a couple of puts, etcetera. There's a lot of opportunities available that hedge fund managers can use to protect themselves during periods like this...

Bryan Hirsch: After the break I want to talk about the growth in the industry because I think at the moment it's a bit stifled. We have caller Sam on the line...

Sam: I'm a trustee of a pension fund and our investment advisors have suggested that we invest some of the funds in hedge funds - is this sound advice?

Bryan Hirsch: I'm going to answer that question in the second segment.

commercial break

Bryan Hirsch: Sam's question leads into where is the industry going and is the industry growing in South Africa? As the trustee of a pension fund they've obviously had recommendations from the investment managers to put some money into hedge funds. It sounds as if Sam was saying "I'm not even sure what a hedge fund is all about yet I have a responsibility as a trustee..."

Carla de Waal: If you look at the current pension fund legislation Regulation 28 deals with how much a pension fund can invest in which asset classes. It's difficult because hedge funds invest in asset classes that traditional managers can also invest with - so you can't say hedge funds are a

different asset class. When that pension fund regulation was put into place - at that stage hedge funds didn't exist - so obviously the current legislation doesn't really deal with hedge funds as an alternative investment strategy that may be followed. In February 2010 a draft amendment was released - the Treasury and the Financial Services Board (FSB) are currently looking at amending current legislation with respect to pension funds and how much they can invest in different asset classes and the hedge fund industry has been in close negotiations with the FSB and Treasury to help with this issue of how much exposure should a pension fund have to a hedge fund. In terms of when you want to invest in a hedge fund it's such a wide term - you will find hedge funds that cover the full risk return spectrum, there are hedge funds that will outperform equities but with more risk than the equity market. You will also find hedge funds that can protect against equity downside so that the pension fund trustee must really look at where this portfolio needs to fit into his full portfolio - and that needs to be done with asset liability matching obviously to ensure that the end objectives of the portfolio are met. Only then can you determine what percentage that pension fund can invest in hedge funds.

Bryan Hirsch: We've got caller Darryn on the line.

Darryn: Bryan, I'd like to know how you measure the performance of one hedge fund against another when they have very different strategies?

Bryan Hirsch: A great question because that's really what Carla was pointing to. Carla, has the industry grown?

Carla de Waal: It has reached a bit of a plateau. We still think it's about R30billion in size but given the amendments to the pension fund legislation and general cautiousness about how the regulatory landscape could evolve I think people have been sitting on the side lines and taking a "wait and see" approach so we haven't seen new fresh inflows into the industry this year.

Bryan Hirsch: Fatima, it's a small industry if you think about unit trusts and collective investment schemes at about R780billion if we are talking about R30billion in pension funds that's small. Darryn's question was how do you actually measure the performance of one hedge fund against another when you've got so many different strategies?

Fatima Vawda: Carla alluded to that earlier. In South Africa we have very few strategies - we don't have the number of strategies that people use in the US or Europe, etcetera. In the equity market we make use of one strategy and we have permutations of that one strategy. In the equity market the predominant strategy that one uses is an equity long short type of strategy and market neutral is basically a permutation of how long or short you can go relative to that strategy - market neutral for example is you don't have any directionality so you're neutral on the long side and the short. It's very easy to compare similar strategy hedge fund managers because based on their risk profile and the underlying strategy that they assume - where we've already said they can fall into one of three or four buckets in South Africa - peer group analysis is very easy to undertake performing a scenario analysis, stress testing and computing risk statistics on each of the funds and the peer groups is very simple. That's already been done - there are several hedge fund surveys available in South Africa where similar strategy managers are already bucketed within peer group profiles and compared as a result thereof.

Bryan Hirsch: So there's true comparison in South Africa because of the limited strategies but internationally it's very different...

Fatima Vawda: Internationally it's very difficult. There is something called the hedge fund index globally and they have tried to bucket similar strategies together but it's difficult offshore because of currency risk and because of the vastness of the underlying landscape. In South Africa we play on the JSE 400 stocks and we play in the liquid counters 100 stocks and that makes it smaller. Globally they're playing across several indices and markets so it's much more difficult.

Bryan Hirsch: Carla, how regulated is the South African industry?

Carla de Waal: It's actually more regulated than many people think. I think South Africa was one of the pioneering countries to implement manager legislation - that was already in late 2007 - so hedge fund managers in South Africa are pretty well regulated by the FSB. There's a special category that licenses them as an authorised financial services provider - they look at qualifications and experience. Only now are the G20 countries are looking at implementing similar type of manager legislation. Also, if you look at the type of structures through which hedge funds may be offered - if it's through a debenture it needs to comply with the Companies Act, and if it's through a life license it needs to comply with the Life Companies Act - so there are different levels of legislation already being implemented. Another thing besides being a regulated industry the South African industry has very much been self regulated in the sense that allocators such as funds of hedge funds are driving this process in terms of the type of transparency that we want and the type of disclosure that we want. It's this type of transparency that helps us to be able to compare the different risk profiles because can actually then see the underlying holdings of a fund and see how that interacts with a full portfolio and see how that actually mitigates the risks. I think in that sense South Africa is streets ahead of global hedge funds...

Bryan Hirsch: Fatima, how do individuals invest in hedge funds? We've spoken a bit about pension funds and regulation - but how about an individual? You believe that a hedge fund does play some part in an overall asset allocation...

Fatima Vawda: Hedge funds by their very nature are not regulated instruments - and they're not governed by the collective investment schemes model which is where unit trusts are regulated. I also want to make the point that hedge funds are not a debit order type of instrument - and they will never be a monthly debit order small amount type of investment instrument. Hedge funds really focus on serving very high net worth individuals and investors and focus on serving institutional pension fund type investors. That's really where this fund is focused on. I think the minimum investment size for high net worth individuals would be nothing less than R1million in our South African market. Anything below that is quite difficult to implement. Basically they can source service providers entering through a fund of funds vehicle through their financial advisor. The best route for a high net worth investor wanting exposure to a suite of top performing hedge funds in South Africa would be to go the fund of funds route because the fund of funds route provides the comfort that an external party is responsible for picking those managers and for weighting those managers in the portfolio.

Bryan Hirsch: We have caller Clive on the line.

Clive: I've invested in international hedge funds and I can't get my money out - what do you suggest I do?

Bryan Hirsch: That's a major problem. We will talk about lock-ins and the different strategies after the break and we've got emails from David, Malcolm, Justin and Sydney.

commercial break

Bryan Hirsch: I have an email from Justin in Hoedspruit "how are hedge funds going to survive if they charge high profit shares and they're all so far down? Aren't they just going to have more hidden charges and probably just close and open up somewhere else?" There are two questions. Carla, maybe you can deal with Clive's question about the lock-in? Are South Africans simply being locked in and can't get their money out of hedge funds as international hedge funds put up these gates?

Carla de Waal: I think given the underlying strategies that the South African hedge funds followed

mostly in the listed space - they didn't have the same type of lock-ins that the offshore investors would have been exposed to - so the experience for the local investor was a bit different from offshore investors. I think that's also why it's so important to do your homework upfront and make sure you really understand all the terms and conditions of investing with the specific fund you're investing with. Also, continuously monitoring that the underlying investments - that the liquidity of those investments really does offer the type of liquidity that the manager is offering. You can't invest with an investment opportunity that unlocks value in six months if you offer your investors a monthly liquidity term - you need a risk manager to make sure that they understand that there is no mismatch between the liquidity of the underlying holdings and the liquidity offered to investors in the investment fund prospectus.

Bryan Hirsch: That's where you came in firstly with the fund of funds as compared to a single strategy. Lets' just talk about the question about hedge funds taking profit shares - they're now down so they can't get their profit shares - how are they going to charge? Are these hidden costs, and lastly are they just going to close up shop and open up again?

Fatima Vawda: Hedge fund fees are very simple. I think people have this notion that hedge funds are charging excessive fees, etcetera. Transparent hedge fund managers in South Africa fees are basically a 1% management fee that's fixed and a 20% outperformance fee if they meet their hurdle rate that's supposedly a targeted rate of return. The nice thing about hedge fund fee structures is there's always a high water mark in place - that means performance fees cannot be charged if the high water mark is not met. What's happened in the US and in offshore markets because hedge funds dropped so much - particularly in the mortgaged backed securities market which is where the credit crisis originated - a lot of those hedge fund managers will never ever get back to their original high water mark. What they decided to do is let's close and sit back for six months and let's re-open and see who can attract capital again. The South African market is very small - the hedge fund industry is tiny and people say there's about 100 managers but there's about 50 good hedge fund managers out there and we all know each other so it's very difficult for the hedge fund manager to not meet its high water mark and then close shop and then re-open so the integrity of the manager will be permanently damaged. Basically the high water mark protects the underlying investor and the fees the investor is paying is 1% and 20%. What the investor needs to very clearly see is that if the net of fees performance that is being generated is what the manager has set out to deliver in terms of his objectives - if he meets those objectives saying he is going to deliver cash plus 10% per annum and he delivers cash plus 10% per annum net of fees - where's the problem paying the one and twenty? If he protects you as in 2008 when the markets fell by 40% in South Africa and the hedge fund universe in South Africa delivered flat returns or up - and some were in fact positive returns - if the manager pulled fees at that point what's the problem? I think investors must also be quite clear they are buying into skill and talent...

Bryan Hirsch: I've got an email from Malcolm in Ballito "I don't agree with you - I think that the hedge fund industry failed investors creating false expectations of absolute returns, non-correlation to the markets and higher fees for better returns." We have debated that but at least we've got someone who says he doesn't agree. Maybe just give me an example - what happened this last week? I know you can't look at everything in a week but did hedge funds take the same sort of drop last week and then recover today like the markets?

Carla de Waal: I think most of the managers that we invest with were still very conservatively positioned so they did protect on the downside last week - but they didn't keep up on a day like today.

Fatima Vawda: We actually did a valuation this morning - for the first week in May the markets were down about 7.5% and our hedge fund managers in the worst case scenario was down 1.5% or 2%. Again the strategy defined market neutral guys were all up for the first week - those that picked up beta in the market the long short equity managers would have picked up the fall last week and were negatively affected but not to the level at which the markets were affected.

Bryan Hirsch: Fatima, you're wearing red tonight - is this danger?

Fatima Vawda: The danger zone...

Bryan Hirsch: Do we know anything about what's going to be happening?

Fatima Vawda: It's a really tough market. Every day you're sitting there reading the research, you read about investment strategy and you look at what's happening in the emerging markets - you read and listen to the professionals - but it's really difficult to call the markets. The best way is to sit tight and not change your investment process or change your investment strategy when things get tough.

Bryan Hirsch: Hedge funds are under intense regulatory scrutiny - even our Finance Minister has joined his global counterparts in getting tough on these instruments making a firm commitment to bring hedge funds and other alternative investments firmly into the regulatory fold after the financial crisis. South African hedge funds are proving their metal providing investors with cash returns at significantly lower volatility than the equity market. Hedge funds have the ability to offer good upside participation with low downside helping to shield investors from the worst of market downturns.