PROTEA
CAPITAL MANAGEMENT

Navigating risk in the investment world (September 2019)

What is risk?

Investment risk can be defined as the probability of a permanent loss of capital. Many proponents contrast this definition to the one used in the capital asset pricing model (CAPM), where risk is defined as the beta (volatility) of a share. It is said that one should ignore the shorter-term ups and downs of the stock market and rather invest for the long-term. That's all good and well, but what about the intersection of these two definitions of risk?

While an investment manager might analyse a company from a long-term perspective and try to ignore the short-term noise surrounding a share, outside investors might not have the same level of comfort in this approach. An investment manager might be comfortable to see a favourite share halve in price, taking the view that it is a wonderful opportunity to buy more. The outside investor, on the other hand, would be less enamoured with this course of events, since it would not be clear whether the investment manager is right about the true value of the share (and therefore the market is wrong in the short-term), or whether it is the investment manager who is wrong in his long-term assessment of value.

When outside investors experience high volatility in the value of their investment, it increases the chance that investors lose trust in the investment manager's accurate assessment of value, which can lead to investors permanently withdrawing their investment at an inopportune time. This is how the one definition of risk (volatility) leads to the other (permanent loss). Investment managers who have outside investors therefore do not have the luxury of ignoring volatility altogether, but should actively assist their investors to avoid the hazard of a permanent loss of capital by suppressing volatility as much they can, while giving up as little upside as possible. The traditional way of attempting this is by decreasing the portfolio's exposure to equities (the most volatile asset class) and increasing the exposure to less-volatile bonds and cash. But this isn't the only solution.

The major players in the South African hedge fund industry have enviable track records of both suppressing the volatility of their portfolios and, at the same time, generating above-average long-term returns. This is the holy grail of investing, and the detractors say that it can't be done, but the top hedge fund managers have done it (and continue to do it). While no single hedge fund can *guarantee* that there won't be periods of negative portfolio returns, the responsible use of leverage (short positions) leads to shallower drawdowns than long-only portfolios while still generating above-average long-term returns.

Up until recently, hedge funds have not been accessible to retail investors, but that is changing. Hedge funds are now regulated by the FSCA, just like long-only funds. Monthly hedge fund fact sheets are now readily available, disclosing the strong long-term performance after all fees. Some LISP platforms have added hedge funds, with Momentum and Hollard leading the initiative.

Investors and financial advisers finally have an alternative to navigating risk in the investment world.

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