By Jaco Visser

A COSTLY ANOMALY IN TROUBLED MARKETS

With the large losses experienced by traditional fund managers over the past couple of weeks, the question is whether a regulatory oddity contributed to investors losing billions of rand.

Hedge funds have historically weathered storms – such as the current coronavirus-induced one ripping through the sails of financial markets across the planet – better than traditional unit trusts.

An anomaly in South Africa's financial regulatory system, however, is hampering traditional unit trusts from protecting their positions against serious losses amid downswings in asset prices through buying into hedge funds.

What makes the situation ever more odd, is that retirement funds are allowed to invest into hedge funds – up to a maximum of 5% in a single fund or a maximum aggregate allocation of 10% into the asset class – and retail investors can put their money into these funds directly. This doesn't make sense.

Jean Pierre Verster
Founder and hedge fund manager at Protea Capital Management

"A traditional, long-only unit trust is not allowed to invest in a hedge fund," says Jean Pierre Verster, founder and hedge fund manager at Protea Capital Management. This doesn't make sense because the general public can invest in a hedge fund directly, but a unit trust fund managed by a professional fund manager – which invests in multiple asset classes – is not allowed to allocate to a hedge fund, he explains.

"Especially in markets like these it is not good to exclude hedge funds," says Jacques Conradie, hedge fund manager at Peregrine Capital, who terms the regulatory anomaly a "headwind".

It's a big mistake to keep unit trusts away from hedge funds as it limits those funds' diversification of asset classes, reduction of risk and their performance, he says.

The newest of them all

This regulatory anomaly goes hand in hand with the relatively recent changes that this industry experienced.

Five years ago, rules pertaining to the financial markets industry were changed to allow for hedge funds to be regulated in the same way as collective investment schemes – traditionally known as unit trust funds.

"There is a very strong and robust regulatory environment pertaining to hedge funds," says Verster.

These include the administration of hedge funds by third-party administrators, the setting of risk limits, and enhanced transparency. In addition, the Association for Savings and Investment SA (Asisa) last year published formal classification guidelines so that investors can compare different hedge funds on a like-for-like basis (see sidebar on p.34). Risk limits were also set for different types of hedge funds.

Even before the 2015 changes, which saw hedge funds being regulated in the same vein as collective investment schemes, hedge fund managers were regulated by the then Financial Services Board since 2007, explains Steven Liptz, co-founder of 36ONE Asset Management.

"Regulation in SA has been happening for a while," he says.

Where are the inflows?

Over the past two years, hedge funds have seen a net outflow of money. This situation isn't likely to change as global equity markets take a beating from panicked investors.

"I don't think that many investors anywhere in the world will be investing," says Liptz. In the current environment, with the coronavirus, Liptz sees very little net inflows. "But we are not seeing substantial inflows into hedge funds. It is not yet an environment for investing," says Liptz.

People sit on the sidelines and wait for better opportunities, for the market to get better and feel confident, he says. "They don't like uncertainty. Bear markets are always full of uncertainty. When you have a bear market together with a disease like coronavirus, uncertainty is heightened and there will likely be little investment into global equity markets for the foreseeable future."

Hedge funds' attractiveness

One of the main attractions to hedge funds – as the name entails – is that it aims to preserve capital for investors. This is done through investment strategies of which short selling is one of the best-known. Typically, a long-short equity fund will buy shares in a company (go long) the manager has analysed and deems to have the ability to appreciate over time. At the same time, the manager will short those stocks that he or she forecasts will experience a large drop in price (see sidebar for explanation). The hedge fund regulations prohibit so-called naked short selling in SA.

"Why wouldn't they invest in hedge funds?" asks Liptz. "The first advantage is that the hedge fund provides equity-like returns after fees, but with lower risk. A very important thing in wealth creation, which is ultimately what investors are trying to do. If you're building wealth, the key to that is solid, consistent returns and capital preservation. That is what the top hedge funds can do and have done

Photos: www.proteacapitalmanagement.com

– consistent returns with lower risk."

They can do that because of the tools at their disposal, which is the second reason for investing in hedge funds. They have more tools to protect capital than a unit trust, says Liptz. "That's what we've done: This past month we're virtually not down in our hedge fund and with unit trusts it's impossible not to be down substantially."

He refers to the longstanding debate on active and passive portfolio management and how hedge fund managers (who fall in the active management category) navigate troubled markets. "People have said for years: 'Look what I'm getting in passive.' That's all good until markets crash. And markets crash and there are no protections in those funds. They get decimated."

Furthermore, across the world the greatest minds with the greatest skillsets are with hedge funds, says Liptz. "In America, which we follow, you had the best long-only managers, in general, becoming hedge fund managers. You have exceptional-quality managers managing the hedge funds."

Another benefit of hedge funds is that they are usually run by fund managers that are small and nimble enough to navigate SA's relatively concentrated and illiquid market, says Liptz. He explains that it's very important for a fund manager to build a position in a certain company's shares at the right price.

"In times of strong bull and bear markets, you want to buy at the correct price," he says. It could take large players – for whom a position could mean billions of rand – months to get their desired position as the purchase of a lot of shares may put upward pressure on the purchase price, distorting it away from what the fund manager views to be the correct price. The inverse is also true when the cutting of a position – and subsequent selling of a company's shares – may put downward pressure on the stock away from the correct selling price. "Being small gives the fund manager the ability to do what you want to do at the right price," says Liptz.

Finally, Liptz sees the fact that many smaller hedge funds are privately-owned and owner-managed as positive for clients.

The lack of outside shareholders gives the fund manager the focus on clients that they deserve, he says. ■

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Short selling

Short selling is the practice where an investor borrows shares from a shareholder with the promise to return them at a future date. After borrowing the shares, the investor immediately sells them on and banks the proceeds. The shareholder who loaned out the shares gets paid a cash interest rate for the duration of the share loan. The investor then waits out the market in the hope that the share's price will drop. If it happens, the investor buys the shares, which are now cheaper, and returns them to the shareholder. The difference in price, minus the cash interest paid, is the investor's profit.

Naked short selling is the selling of a security without being in possession of the security or ensuring that it can be borrowed, according to a definition by the Financial Services Conduct Authority. ■

4 Classification of hedge funds

The Association of Savings and Investment SA (Asisa) introduced a set of classifications for hedge funds in September last year, aiming to make the classification of hedge funds as comprehensible as those of traditional collective investment schemes, or unit trusts.

To this end, the association used the following classification of hedge funds:

Tier 1

Retail hedge funds:
Any investor may invest in this fund.

Qualified investor hedge funds:
Only those investors who can invest R1m or more in a fund, and they themselves or their financial service providers have demonstrable knowledge of "financial and business matters".

Tier 2

South African portfolios:
At least 60% of assets invested in SA.

Worldwide portfolios:
No investment limits are set, and assets can be held in SA and/or the rest of the world.

Global portfolios:
At least 80% of assets are held outside of SA with no limits on regional exposure.

Regional portfolios:
Invests assets in a specific country (for example the UK) or region (for example East Asia).

Tier 3

Long-short equity hedge funds:
Most of their returns are generated from (long or short) positions in the equity market.

Fixed-income hedge funds:
Generate their returns from interest rate sensitivities, thus invest in assets whose "characteristics" are determined by the interest rate market.

Multi-strategy hedge funds:
No single asset class dominates the funds' strategies and these funds consist of a blend of strategies and assets.

Other hedge funds:
Those funds that don't fit into the other three strategy descriptions.

Tier 4

(This tier is only applicable to long-short equity hedge funds.)

Long-bias equity hedge funds:
Portfolios with a net exposure to equities of more than 25% over time.

Market-neutral hedge funds:
Portfolios that have had or expect to have very little "directional exposure" to the equity market; on average over time the net equity exposure should be less than 25% but greater than -25% of the total assets.

Other equity hedge funds:
Portfolios that follow a very specific strategy within the equity market, such as listed property or sector-specific strategies. ■

SOURCE: Association of Savings and Investment SA