For those who believe, no explanation is necessary

For those who do not, none will suffice.

A significant amount of progress has been made since hedge funds first became regulated under CISCA in 2015. The regulatory overhaul did not bring about an immediate increase in the popularity of hedge funds, however, especially considering the benefits they can offer investors. At first it was mostly due to their inaccessibility, but nowadays one can choose between a list of leading hedge funds on LISP platforms.

Scepticism among financial advisors remains, with fees and complexity at the top of the list of concerns for those advisors who haven't made an allocation to hedge funds yet. The mere fact that these concerns have been voiced, means that we are at least having the dialogues necessary to get to the next step – debunking the myths and misconceptions regarding hedge funds.

Deciding which hedge fund to invest in is similar to choosing what type of car to buy. Just like you get sedans, SUVs, hatchbacks, trucks, etc., there are many different hedge fund strategies to choose from. Some of the different hedge fund strategies include fixed income arbitrage, macro, event-driven, commodity trading, market neutral and long/short equity. The latter strategy makes up the lion's share of hedge funds, both in South Africa and globally. It is also the most "vanilla" of all hedge fund strategies – long/short equity funds buy the shares they expect to go up in price (like traditional equity funds), and, in addition, short the shares they expect to fall in price.

One misconception that still exists, is that all hedge funds following the same broad strategy are comparable. In practice, even if two funds both follow a long/short equity strategy, there might still be a difference in terms of their risk profile. Some hedge funds will rise more than the market during a bull market cycle but might have deeper drawdowns during a bear market. Others attempt to deliver equity-like returns with lower volatility, participating in most (but not all) of the upside during a bull market, while limiting deep drawdowns in a bear market. In other words, some hedge funds are return enhancers, while others are risk diversifiers. It is therefore imperative to understand what the specific hedge fund's objective and risk profile is before investing, to avoid an expectation gap.

South African hedge funds are arguably the most regulated in the world, which means information regarding FSCA-approved hedge funds is readily available. Minimum disclosure documents for hedge funds are generally available on the hedge fund manager's website and include transparency on fees and performance. Another benefit to financial advisors who want to include hedge funds in their client solutions or model portfolios, is that a LISP platform would have performed additional due diligence on those hedge funds available on the platform.

The South African hedge fund industry passed the R100-billion mark in June 2022, but it is still only a fraction of the size of the traditional unit trust industry. Nonetheless, broader adoption of hedge funds is growing, as investors become more comfortable with the nuances of the industry. By educating themselves about the benefits hedge funds can offer, financial advisors are solidifying the key role they play in ensuring better client outcomes. If you aren't a believer yet, now's the time to take another look at hedge funds – feel free to contact Protea Capital Management if we can assist in this regard. ■

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