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ALTERNATIVE ASSET CLASSES:
UNDERSTANDING HEDGE FUNDS

VOL.8

ALSO IN THIS ISSUE: AN INTRODUCTION TO ALTERNATIVE ASSETS | DEMYSTIFYING HEDGE FUNDS: COMMON QUESTIONS ANSWERED | KEY TERMS AND DEFINITIONS | REGISTER FOR CPD CREDITS

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INTRODUCTION TO ALTERNATIVE ASSET CLASSES

overview

While investors have a fair understanding of traditional asset classes, it is becoming increasingly important for investors to understand alternative asset classes in order to diversify their portfolios in the current market environment. This article will focus on two main alternative asset classes, namely hedge funds and private equity.

Understanding alternative asset classes

The traditional asset classes available for investment by retirement funds, both locally and in foreign markets, are cash, debt instruments, equities, immovable property and commodities. Whereas there is a fair understanding of these traditional asset classes among investors, the same cannot be said for alternative asset classes.

With returns being under pressure from traditional asset classes over the last years, an increased understanding of alternatives is important to ensure a well-diversified investment portfolio, which can generate returns while protecting retirement fund members' capital.

In addition to financial returns, investing in the right alternative assets can support social and environmental innovation. Investing without an understanding of alternatives can result in negative financial and reputational outcomes for retirement fund investors.

Private equity and hedge funds

Regulation 28 of the Pension Funds Act allows retirement funds to invest up to 15% of their capital in alternative asset classes, with a maximum of 10% in private equity and a maximum of 10% in hedge funds. Other alternative asset classes, limited to 2.5% of capital, can, for example, include private debt, unlisted credit, derivatives and infrastructure funding debt vehicles.

The proposed revision of Regulation 28 will likely see the maximum allowance for private equity funds and hedge funds increase to 15% and 10%, respectively. The accompanying tables provide a high-level overview of private equity and hedge funds.

Focus and structure

	What is it?	How do these funds typically operate?
Private equity funds	A direct or indirect equity or debt investment in one or more privately owned, unlisted companies in pursuit of capital growth that exceeds market returns. In addition to financial returns, some private equity funds also aim to demonstrate social and environmental impact, for example, job creation.	Using the limited liability partnership model (LLP), silent investors (called limited partners) pool funds alongside an active investment manager (called the general partner) for a fixed period (e.g. ten years). During this time, the fund manager invests the pooled funds and actively manages investments to generate targeted returns. Investments are exited towards the end of the fund, after which the fund is typically closed.
Hedge funds	Use an array of investment strategies suited for rising and falling market conditions, and often invest across various asset classes. In addition to traditional buy, hold and sell strategies, hedge funds can include short selling, leverage, arbitrage and derivatives to minimise risk, optimise returns, or both. Fund objectives are best described as pursuing optimal risk-adjusted returns in all market conditions. Often having a low correlation with traditional equity and bond markets, hedge funds sometimes serve as a diversifier in investor portfolios.	Historically, hedge funds in SA followed the LLP model, similar to private equity. SA hedge funds are now regulated under the Collective Investment Schemes (CIS) Act and most have transitioned to a fund model similar to traditional unit trusts, using CIS trust arrangements. These regulated hedge funds, available to retail and institutional investors, are required to have an independent management company that, in turn, appoints a specialist hedge fund investment manager to operate within an agreed mandate. Depending on the type of hedge fund, there might be a lock-up period for investors.

NOTE ON TERMS AND DEFINITIONS

For more detail on some of the terminology referred to in this publication, please refer to p.6 and p.7.

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Risk-adjusted return: a calculation of the profit or potential profit from an investment that considers the degree of risk that must be accepted in order to achieve it. The purpose of risk-adjusted return is to help investors determine whether the risk taken was worth the expected reward. For example: If two investments had the same return over a specific period, the less risky asset would have a better risk-adjusted return.

Returns and fees

	Return expectations	Fees
Private equity funds	**Investors can earn:** • a high return as a result of the fund manager's expertise, skill and judgement; • profit of the fund after expenses, management fees and hurdle rates, which is typically 80%. A hurdle rate is the minimum return that the fund needs to generate before performance fees are charged by the manager. • Returns are not guaranteed, and the risk profile is typically high, due to investing in unlisted equities.	**Typically based on the 2:20 mechanism where the fund manager:** • earns an annual management fee on assets under management (AUM) of between 1% and 2%; • also shares in a portion of the overall profit after expenses, management fees and hurdle rates, typically 20%.
Hedge funds	**Investors can earn:** • better risk-adjusted returns, dependent on the investment strategy deployed by a hedge fund. For example, a market-neutral strategy would have very low correlation with markets and therefore provide diversification benefits to investors with direct market exposure. • Returns are not guaranteed and the risk profile can vary from moderate to high, depending on the investment strategies chosen.	**Typically, a combination of management and performance fees:** • Annual average management fees of 1% of AUM. • Performance fees are typically between 15% and 20%. • In some funds, incentives are paid if the fund exceeds its so-called high-water mark, which is the highest net asset value (NAV) attained in any prior period.

HOW HEDGE FUNDS OPERATE

overview

In support of the maxim 'you should not invest in something you don't understand', the aim of this article is to explain how hedge funds operate, and in the process make it easier for retirement funds to decide how best to consider hedge funds for their portfolios.

Hedge funds have been around since the 1950s, with the first hedge funds in South Africa appearing in the 1990s. Although initially reserved for high-net-worth individuals, private clients and certain institutional investors *(see sidebar on next page)*, South African retirement funds and retail investors now have access to hedge funds.

Generally, hedge funds are not well understood. Proponents view hedge funds as opportunities to gain exceptional returns, even in falling markets. They also view hedge funds as aiding the financial market in discovering the real prices of overvalued assets. Detractors view hedge funds as carrying excessive risks for investors, as well as the economy. This view is based on hedge funds' ability to enter into leveraged positions and betting against macroeconomic trends. Often these opinions from both proponents and detractors are formed without a clear understanding of how hedge funds operate.

The global rise of hedge funds

In the early years of the industry, hedge funds and commodity trading advisers (CTAs) had attracted money mainly from wealthy individuals and clients of private banks (which formed many of the early funds of hedge funds), plus like-minded family offices. Over time, more money had also started to come in from investors with tax-exempt status, such as endowments and foundations, and corporate sources, such as insurance companies. After hedge funds outperformed so clearly during the dotcom era, the investor base started to become increasingly institutional, with corporate and public retirement funds and sovereign wealth funds becoming more and more significant allocators. Hence a more 'institutional' type of hedge fund industry started to emerge — one that needed to cater to the 'institutional standards' in money management required by those investors.

Source: Alternative Investment Management Association (AIMA)

Hedge fund structure and strategy

In South Africa, as is the case globally, the hedge fund manager typically consists of a team of licenced specialist investment professionals that – in accordance with the rules and methods of the fund agreement – manages the fund.

As most South African hedge funds now operate under CIS trust arrangements, similar to traditional unit trusts regulated under CISCA, the hedge fund manager is typically appointed by the hedge fund management company (Manco). The Manco also appoints other key service providers, such as brokers and auditors. The Manco, although adding costs, plays an important role in the governance, valuation and risk management of the hedge fund.

Hedge funds can vary greatly in the investment strategies they employ. The chosen strategy will determine how the fund is managed and forms the basis on which investors make their decision to invest. These strategies typically enable hedge funds to:

- **Take positions against a certain expectation in a market in order to optimise risk-adjusted returns.** Most hedge funds in South Africa operate a combination of long positions (buy, hold and sell) and short positions. Short positions are achieved through "short selling" or buying put options. Short positions are taken where fund managers expect that asset prices will decrease in future. An example is where a hedge fund short sells a particular share because its research on the company leads to the view that the future price will fall below its current price, thereby enabling the fund to profit from market price movement.
- **Use leverage to amplify the position it takes in the market.** In practice this means that the fund utilises debt to take a position size in excess of its current available capital.
- **Hedge funds don't solely take short positions.** Some hedge funds operate a combination of long positions (buy, hold and sell) and a combination of long and short positions) as well as short positions. In South Africa, the combination of long and short equity strategies is prevalent.

(See p.6 for more detail on the different types of hedge fund strategies that can be employed.)

Useful distinctions for hedge funds:

- Asset class the hedge fund focuses on. For example, fixed income, equities, commodities, or a combination.
- The investment strategy the hedge fund adopts i.e. long-short, market-neutral, event-driven, arbitrage etc.
- Whether the hedge fund targets retail or institutional investors. Until recently, only qualified investors were allowed to invest in hedge funds, but South African regulation now allows retail hedge funds (RIHFs) to accept investments from anyone. A distinction is typically made between RIHFs and qualified investor hedge funds (QIHFs).
- Whether the hedge fund invests only in South Africa or in broader geographic regions. For example, a South African-focused portfolio, a worldwide portfolio (including South Africa), a global portfolio (mostly outside of South Africa) or a regional portfolio (mostly in a specific region outside of South Africa).

How a hedge fund management team operates

After setting up a hedge fund with a specific objective and mandate, the hedge fund managers need to find ways to ensure expected returns are realised. They need to do this while staying within the risk profile agreed upon with investors. This implies that fund managers are typically required to:

- Formulate views on the macroeconomic environment and the potential impact on financial markets and asset classes.
- Perform detailed bottom-up research on listed equities, bonds and financial instruments across the relevant investment markets.
- Construct and monitor a portfolio that consists of the securities and instruments that represent the fund manager's best view of how to achieve the portfolio's investment objective, given the prevailing market conditions.
- Monitor the risk metrics of the portfolio to ensure that at all times the risk is acceptable and falls within the mandate and regulatory limits.
- Monitor and reconcile daily and monthly cashflows and trade accordingly.

On a day-to-day basis, hedge fund managers and their teams will thus be involved in:

1. Accessing and doing research.
2. Talking to analysts and experts in relevant asset classes (within their teams and externally).
3. Making decisions on what to buy and sell, and how best to execute such transactions. For example, deciding how much leverage to use, and giving instructions to trade.
4. Maintaining processes and systems that can provide up-to-date views of their exposure in the markets. This includes giving instructions to rebalance portfolios that carry too much risk.
5. Working with qualified partners to execute trades, do valuations and administration.
6. Reporting to and engaging with various stakeholders, including regulators, Mancos and investors to meet legal and mandatory requirements.

Comparison with other collective investment schemes

To explain how hedge funds operate, it is also useful to compare them to other collective investment schemes (CIS), such as equity and balanced unit trust funds, which are generally more well-known to investors.

The major difference between a hedge fund and equity-based CIS: Whereas these funds only buy, hold and sell, hedge funds have more flexible strategies at their disposal. In addition to buying, holding and selling, they can also sell short or use put options. Very few hedge funds elect to only sell short or use put options.

"Hedge funds can vary greatly in the investment strategies they employ. The chosen strategy will determine how the fund is managed and forms the basis on which investors make their decision to invest."

Comparison of hedge funds to traditional multi-asset and equity unit trusts in terms of operations:

	Hedge funds	Traditional multi-asset and equity unit trusts
Targeted investors	• Historically high-net-worth individuals and institutions allowed to invest • Recently, with limitations, also retirement funds and retail investors; other CIS can't invest	• With some limitations, the full range of institutional, corporate and retail investors
Region	• Depends on the fund, but can have a country, regional or global focus	• Depends on the fund, but can have a country, regional or global focus
Investment strategies	• Can buy, hold and sell • Flexible • Able to short sell and buy put options to earn returns in falling markets • Can use leverage, arbitrage and derivatives • Strategies often limited by legislation and mandate, e.g. maximum leverage	• Buy, hold and sell • Cannot hold more than 5% of its assets in one security. There are certain exceptions to this rule. For example, the limit is 10% if the market cap of a company is more than R2bn.
Return expectations	• Moderate to high returns in all markets • Hedge funds expected to outperform traditional long-only funds in bear markets due to the ability to adopt short positions	• Moderate to high returns in bull markets
Risk	• Moderate to high risk. Generally, don't aim to correlate to the market, so returns can be volatile. Not being correlated to the market can, however, drive risk down in bear markets. • Hedge funds can also take leveraged positions, which would increase liquidity or solvency risk. • In cases where hedge funds are aggressively leveraged, this can potentially cause big losses for investors.	• Moderate to high risk
Management style	• Mostly actively managed	• Actively or passively managed
Fee structure	• Varies between funds, often using a combination of management fees based on AUM (between 1% and 2%), and a 15% share in returns above a base return rate.	• Typically, % of AUM. However, a number of long-only and multi-asset equity funds adopt a combination of base fees on AUM and incentive-based fees.

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KEY DEFINITIONS AND TERMINOLOGY

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Hedge funds

Hedge funds manage capital with the objective of achieving optimal risk-adjusted returns. In addition to traditional long investment strategies, hedge funds can invest in a variety of asset classes and use non-traditional investment strategies, including, among others, short selling, leverage, derivatives and arbitrage. While hedge funds typically invest in the same asset classes as traditional unit trust funds, they can take advantage of a broader range of investment tools and thereby generate other sources of return.

Different types of hedge fund strategies

- **Long and short equity:** Funds aim to generate positive returns by being simultaneously long and short in the equity market. The objective is to reduce market risk and retain company-specific risk. The majority of local equity long-short funds tend to be long biased. An investment strategy is to take long positions in stocks that are expected to increase in value and short positions in stocks that are expected to decline in value. A long-short equity strategy seeks to minimise market exposure, while profiting from stock gains in the long positions and price declines in the short positions.
- **Market neutral:** In a market-neutral equity strategy, funds take similar-sized long and short positions in related equity sectors with the effect that directional market risk is offset. The aim is to profit from both increasing and decreasing prices. Market-neutral strategies are often attained by taking matching long and short positions in different stocks to benefit from mispricing and delivering positive returns from both the long and short stock selections and reducing risk from movements in the broad market.
- **Fixed income:** An investment strategy that attempts to profit from arbitrage opportunities in interest rate securities. When using a fixed- income arbitrage strategy, the investor assumes opposing positions in the market to take advantage of small price discrepancies while limiting interest rate risk. This general strategy type includes basis (e.g. cash vs. futures), yield-curve and credit spread trading, as well as volatility arbitrage.
- **Statistical arbitrage:** Quantitative models are used to identify market opportunities and establish short-term positions involving a large number of securities.
- **Volatility arbitrage:** Funds aim to exploit mispricing between similar instruments where the mispricing is the result of different volatility assumptions by price makers.
- **Multi-strategy:** An investment philosophy allocating investment capital to a variety of investment strategies and potentially across several asset classes.
- **Commodities:** Funds that predominantly invest in soft or hard commodities. These funds can follow a number of different strategies to obtain alpha from this asset class, including trend following or non-directional market neutral strategies.

SOURCE: Novare Hedge Fund Survey 2019

Glossary

- **Alpha:** A measure of excess return generated by an investment (security) relative to a benchmark index
- **Arbitrage:** The exploitation of pricing anomalies in financial markets to generate risk-free or low-risk profits
- **AUM: Assets under management** represent the total market value of the investments that a person or entity manages on behalf of clients
- **Bond:** A debt instrument that promises that the issuer (the borrower) will pay the holder (the investor) interest over a certain period of time and repay the face value at maturity
- **Debt instruments:** Securities representing the debt borrower. Examples are government bonds, Treasury Bills, bankers' acceptances and negotiable certificates of deposit
- **Derivatives:** Financial instruments that derive their value from underlying securities and other variables, such as indexes or reference rates, have either no or small initial investment and allow firms to speculate or hedge risks that arise from factors outside their control, such as foreign currency rates.
- **Financial instruments** are assets that can be traded, or they can also be seen as packages of capital that may be traded. Most types of financial instruments provide efficient flow and transfer of capital all throughout the world's investors. These assets can be cash, a contractual right to deliver or receive cash or another type of financial instrument, or evidence of one's ownership of an entity.
- **Financial market:** The institutional arrangements, mechanisms and conventions that exist for the issuing and trading (i.e. buying and selling) of financial instruments
- **Fixed-income market:** The money and bond markets and their derivatives. Also called the **interest-bearing market.**
- **Futures:** An exchange-traded contract for delivery of a standard equity of a specific underlying asset at a predetermined price and date in future
- **Leverage:** Gaining an economic exposure that is larger than available capital resources
- **Liquidity:** The extent to which an instrument can be readily acquired or disposed of at prevailing market prices
- **Lock-up period:** A lock-up period is a window of time when investors are not allowed to redeem or sell shares of a particular investment
- **Long hedge:** Buying a futures contract (e.g. by a commodity consumer) to hedge against a rise in the price of the underlying asset
- **Long position:** A dealer that has purchased a security is said to be "long" that security
- **Manco:** A **management company** or CIS manager performs collective portfolio management services of a CIS and/or alternative investment funds
- **Naked short selling:** Not permitted in South Africa. Naked shorting is the illegal practice of short selling shares that have not been affirmatively determined to exist. Ordinarily, traders must borrow a stock or determine that it can be borrowed before they sell it short.
- **NAV: Net asset value** means the total market value of all assets in a portfolio including any income accruals and less any deductible expenses, such as audit fees, brokerage and service fees
- **Net exposure:** Net exposure is the difference between a hedge fund's long positions and its short positions. Expressed as a percentage, this number is a measure of the extent to which a fund's trading book is exposed to market fluctuations. Net exposure can be contrasted with a fund's gross exposure. A fund has a **net long exposure** if the percentage amount invested in long positions exceeds the percentage amount invested in short positions, and has a **net short position** if short positions exceed long positions. If the percentage invested in long positions equals the amount invested in short positions, the **net exposure is zero**.
- **Option:** A contract that gives the holder the right, but not the obligation, to buy or sell and underlying instrument at an agreed price
- **Put option:** An option that permits the holder the right, but not the obligation, to sell an underlying asset at an agreed price
- **Securities:** Paper certificates (definitive securities) or electronic records (book entry securities) evidencing ownership of equity (stocks), debt obligations (bonds) or related instruments
- **Scrip:** An abbreviation for securities receipt/ A term used by financial market participants for securities of all kinds
- **Scrip borrowing/lending:** The borrowing and lending of underlying shares and other instruments, usually for a fee. Also referred to as stock lending or securities lending.
- **Short hedge:** Selling a futures contract (e.g. by a commodity producer) to hedge against a fall in the price of the underlying asset
- **Short position:** A dealer who has sold a security, which they do not own, has a short position in that security
- **Short selling:** The act of selling securities that are not owned by that seller
- **"Stranded" assets:** Assets that have suffered from unanticipated or premature write-downs, devaluation or conversion to liabilities.
- **Valuing shares:** Equity valuation attempts to estimate the intrinsic (or economic or fair) value of a share. This is compared to the prevailing market price of the share to ascertain if the share is a buy or not – in other words, if the estimated intrinsic value is greater than the share price, the share is a buy.

Regulation & Classification

FSCA: The Financial Sector Conduct Authority is South Africa's financial regulator responsible for market conduct regulation of the financial sector in South Africa. For example, hedge funds are regulated by the FSCA.

FAIS: The Financial Advisory and Intermediary Service Act (No 32 of 2002) promotes consumer protection through the regulation of certain advisory and intermediary services to clients by financial firms, including hedge funds.

FSP: FAIS requires that persons that provide advice or intermediary services (any act performed by a person on behalf of a client with a view to buying, selling or otherwise dealing in a financial product), with respect to financial products, register as a **financial services provider**. Under FAIS, hedge fund funds are to be registered as hedge fund FSPs.

CISCA: The Collect Investment Schemes Control Act. South Africa became the first country in the world to put in place comprehensive regulation for hedge fund products in April 2015. The regulations provide for two categories of hedge funds, namely **qualified investor hedge funds** and **retail investor hedge funds.** In order to comply with the regulations, hedge funds had to convert to legal structures that conform with the provisions of CISCA. Although a hedge fund can be registered as a CIS, they are given distinct treatment from other unit trusts regulated by CISCA in that as a designated scheme they are permitted to enter into certain transactions and employ certain strategies that unit trusts may not enter into.

Regulation 28: Regulation 28 of the Pension Funds Act applies to pension, provident and retirement annuity funds, and essentially limits asset managers' allocations of retirements savings to certain assets classes. As of 2015, a hedge fund can be formally registered as a CIS alongside traditional Regulation 28 funds.

Collective investment scheme: A scheme where funds from various investors are pooled together for investment purposes, with each investor entitled to a proportional share of the net benefits of ownership of the underlying assets.

ASISA: The Association for Savings and Investment South Africa represents the collective interests of the country's asset managers, collective investment scheme management companies, linked investment service providers, multi-managers and life insurance companies. **The ASISA Hedge Fund Classification Standard**, which was adopted in 2020, applies to hedge funds registered as collective investment schemes.

Oversight

Management companies (Mancos)
A key requirement that all hedge funds must adhere to in this new regulatory landscape is to appoint a management company (Manco) for all administrative, operational and risk monitoring duties and to ensure that the appointed Manco is approved by the FSCA. This procedure is similar to the set-up of a unit trust fund. Due to this development, the operational risk associated with hedge funds has been reduced.
Under section 5 of CISCA, both QIHFs and RIHFs must operate under a Manco.

Hedge fund risk management

- The funds are compelled to appoint an independent trustee. The trustee is usually a bank that is not affiliated with the unit trust company or asset manager;
- Additional risk management and compliance monitoring of hedge funds are performed independently from the asset manager;
- The FCSA conducts ongoing supervision, ensuring that hedge fund regulation is aligned with the local unit trust industry;
- Industry integrity is promoted;
- Investors enjoy enhanced transparency on matters such as fees, and portfolio turnover ratios are disclosed more frequently.

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DEMYSTIFYING HEDGE FUNDS: COMMON QUESTIONS ANSWERED

overview

Hedge funds have tended to get bad press over the years. While in some cases there has been justified cause for concern around the management of certain hedge funds, diversifying into this alternative asset class is gaining increasing attention. This article takes a closer look at the perceptions around hedge funds, as well as their risk and return factors.

Short selling. Betting against companies. Lack of transparency. Operating unregulated and high risk. Existing within a world of their own, separate from the "traditional" investment management industry. These perceptions – and some of the well-reported investment scandals that have involved hedge funds – leave investors with many concerns about investing in this alternative asset class.

Perhaps a good starting point is to refer to the term "hedging", which, at its core, is taking action to prevent the risk of an adverse outcome. While some overly aggressive hedge funds have indeed made unscrupulous investments and caused damage to companies and investors, there are those hedge funds that do seek to reduce risk for their investors through proper management, market research and analysis. Hedge funds make use of strategies such as shorting, leveraging and arbitrage, which is often where doubts creep in about the transparency around how they seek to achieve their investment mandates. There's no such thing as a free lunch, and while hedge funds can provide portfolio diversification, the strategies they employ can also be risky, with high costs of investment.

Given this backdrop, it is important to address some of the key concerns around hedge funds, including how they are managed and regulated, in order to get a clearer picture of the suitability of hedge funds as an investment.

1 Are all hedge funds high-risk investments?

The fact that hedge funds often take leveraged positions on future markets could result in higher risk. It is, however, not a given that hedge funds are higher-risk investments than long-only funds. For example, hedge funds that combine long and short positions may reduce volatility or exposure to downside risk. In South Africa, the prevalent hedge fund investment strategy is long-short, aimed at reducing risk.

For some South African hedge fund managers the purpose is actually to reduce risk, whether it's through short selling or diversification into various asset classes. There are, of course, exceptions, where hedge funds manage very concentrated, highly geared portfolios, but these are not the 'norm.'

While there are still a number of highly aggressive hedge funds in South Africa, these are typically single mandates run for clients that can tolerate that type of risk. Leveraging lucrative positions can actually provide geared exposure, which can be attractive from an investor perspective. This feature is unique to hedge funds, seeing that traditional long-only portfolios do not employ leverage.

"Although the current maximum allocation to hedge funds under Regulation 28 of the Pension Funds Act is 10%, hedge funds can still play an important diversification role."

2 Are hedge funds only short sellers?

The stigma that hedge funds are simply short sellers that feed on bad news in order to push a stock's price down – or simply short poor or bad stocks – is one that has tended to stick. Hedge funds can employ a wide range of investment strategies. Although most hedge funds take short positions, certain hedge funds combine long positions, where rising markets can generate outperformance, and short positions, which reduces risk in falling markets.

South Africa's economy is going through a tough period currently. This has resulted in additional equity market volatility and pressure on equity valuations. Hedge funds can still profit from falling equity markets by utilising short positions. Investors that are positioned in long-only funds are more vulnerable to these negative movements. Should markets go down, these funds can move to cash, except if this is not part of the investment fund's mandate – then the investor will just have to ride it out, take the hits and hope that these hits are less than the market is taking.

The prevalent long-short strategy in South African hedge funds is to research the entire market in order to identify both outperforming and underperforming shares. This allows investors to position their portfolios to be long the outperforming shares and short the underperfoming shares. An example would be the concept of "pairing", whereby two shares in the same industry are identified and classified based on a number of key factors to determine which is thought to be able to outperform the other. The fund manager would then buy the share they expect to outperform, and short the share they expect to underperform. The market-neutral approach is more conservative, whereby long positions are equally offset by short positions, resulting in zero-net market exposure. These strategies require a deep understanding of the markets and is not a case of directional speculation.

Another important element is that hedge funds provide diversification through exposure to different asset classes, thereby providing an additional and differentiated risk-return profile to portfolios that are not available to traditional long-only equity portfolios **(see sidebar on p.10).**

3 Are hedge fund management fees fair?

Hedge funds often come under fire for the high fees they charge, compared to traditional long-only funds. A counter-argument for this is the level of market exposure an investor can get based on the size of their investment. For example, by using leverage in a fund, a hedge fund manager can extract more value or return on the same amount of capital invested when compared to a long-only portfolio strategy. This can justify the higher fees charged by a hedge fund. This is on the assumption that the hedge fund identified by the investor, based on their risk appetite, performs to the investor's needs.

However, considering that hedge funds often use the 1%:15% model (flat 1% management fee and variable 15% performance-based fee), the total fee as a percentage of AUM will be high if the hedge fund is underperforming. Especially if compared to passive long-only equity funds, which typically charge management fees lower than 1%. Whether it is fair that the manager shares in the upside return in the form of a performance fee, would depend on the investor's philosophy. It must be noted that the charging structure of hedge funds is similar to many long-only equity funds, where incentive fees are also prevalent. In addition, with most hedge funds, hurdle rates are also implemented in the performance fee structure. This is where a performance fee is only charged when returns are above a specified hurdle rate. An additional performance measure to protect an investor is the principle of a high-water mark. A high-water mark is where the investor only pays performance fees that cover the point of entry into the fund and the highest point in terms of the value of the fund.

4 Are hedge funds unregulated?

Hedge funds are often regarded as "dangerous investments" due to them historically being unregulated – particularly globally.

From 1 April 2015 hedge funds were included in the ambit of collective investments schemes and are now regulated by the Collective Investment Schemes Control Act in South Africa. Furthermore, as of 2020, hedge funds need to be classified according to the ASISA Hedge Fund Classification Standard and must be run by qualified investors, if they are to be made available as collective investment schemes. The Financial Services Conduct Authority's (FSCA – formerly FSB) FAIS Act also includes hedge fund regulation, including the licensing requirement, codes of conduct and amended fit and proper conditions **(see article on p.11).**

The increased transparency and governance requirements that form part of these regulations can provide investors with more confidence when it comes to investing in hedge funds. Previously, investors had to do their own research into hedge funds and it was difficult to compare them in terms of risk profiles. For example, it wasn't easy to identify all the long-short equity hedge funds that invest in Africa, and to decide which are the better investments. The ASISA classification system, which is now underway, is making this easier, whereby hedge funds that have similar mandates or are in the same category can be compared.

Although it is still an ongoing process, the hedge fund industry believes this will improve over time, particularly as the FSCA provides more clarification with regard to this.

5 Are hedge funds suited to institutional investors?

Although the current maximum allocation to hedge funds under Regulation 28 of the Pension Funds Act is 10%, hedge funds can still play an important diversification role. This is due to the lower correlation with traditional asset classes, which allows diversification benefits and enhanced risk-adjusted returns on a portfolio level.

6 Can hedge funds damage financial markets?

Hedge funds often operate below the radar, only featuring in the news because of the massive profits or losses they make. However, large hedge funds with highly leveraged positions can potentially cause systemic damage (for example, if large positions need to be liquidated in a short period of time). Unscrupulous hedge funds can also aim to influence market prices to profit from their short positions. There are, however, few funds large enough to significantly move markets. Some hedge funds take positions on macroeconomic trends (for example that Asian markets will fall on the back of increased regulation). This creates the perception that they are betting against growth and development. Proponents of hedge funds will argue that they are contributing to price discovery in markets **(see box).**

Hedge funds can wreak havoc on certain smaller industries as well. There have been instances where, in certain smaller stocks, a large position can create pressure on the share price. This has added to the sensational view of hedge funds that simply short stocks.

TO INVEST OR NOT TO INVEST?

As with any actively managed alternative asset class, there will be a significant difference in the performance of your best and worst hedge funds. Therefore, when considering hedge funds, make sure that you take note of the following:

1. Compliance of the hedge fund to the ASISA classification;
2. Experience of the hedge fund manager;
3. Consider the fund's historical performance compared to long-only funds;
4. Consider the fund's performance in exceptionally good as well as in exceptionally bad years against the performance of the market (e.g. how did the fund perform during the financial crisis?);
5. Consider its volatility compared to other equity and balanced funds.
6. Consider the hedge fund's asset class diversification. For example, exposure to alternative asset classes, such as soft commodities (e.g. wheat and soya beans), which are not available in long-only funds.

THE ALTERNATIVE TOOLBOX

Hedge funds can also provide access to alternative asset classes, such as commodities, which can benefit a broader diversified portfolio, rather than serving as a standalone investment. With the right hedge fund management team, equipped with the knowledge and expertise in these respective markets, this additional exposure to alternative asset classes over and above a traditional portfolio can provide investors with good returns in a market downswing.

But, like any other investment, alternative investments come with pros and cons.

Pro: Diversification. The two big reasons to include alternative investments, namely, portfolio diversification and to enhance returns, must be considered carefully. Alternative investments should have low correlation to traditional markets, but that doesn't necessarily imply negative correlation, which is a common mistake.

Con: Long lock-ups. While alternative investments like private equity can enhance returns, it can mean locking in your investment capital for a number of years, and that's why investors need to seriously consider how much of a return premium they may get over more liquid public markets.

Pro: Exposure to unique investments. Alternative investments allow people to access markets they won't be able to otherwise access, such as land, or being an early investor in a start-up fund, which can pay large returns for patient investors.

Con: Complexity. These are very complex investments that take serious due diligence. Professional investors will spend a great deal of time researching strategies and interviewing managers.

SOURCE: U.S. NEWS & WORLD REPORT, MONEY. A beginner's guide to alternative investments. Available at: https://tinyurl.com/yux4etnc

Price discovery

The process of ascertaining the correct economic value of assets. It is vital for efficient markets that free or low-cost information reaches as many markets participants as possible, so that security prices accurately indicate the economic value of the securities.

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HEDGE FUND REGULATION IN SOUTH AFRICA

overview

In 2015, new regulations in South Africa allowed for hedge funds to fall under the CISCA (Collective Investments Schemes Control Act) and be formally registered as collective investment schemes alongside traditional Regulation 28 funds. The new regulation has allowed for greater transparency, liquidity, and risk control measures than was required in the past.

One of the main concerns around hedge funds and how they operate is that regulation of this asset class has not been strict, with this unregulated nature of hedge funds often cited as a contributor to failure and unscrupulous investments. This perception has created problems for investors and reputable hedge funds, and often causes this asset class to be misunderstood.

When it comes to the regulation of hedge funds, South Africa is rather unique. This article provides an overview of the regulatory environment of this industry. Regulatory oversight plays an important role in providing investors with greater comfort to invest in hedge funds, and has also made this asset class more accessible to investors.

The regulatory timeline

Prior to May 2015, the hedge fund industry in South Africa was self-regulated and every manager had to have a Category IIA FAIS licence. Since 2015, the Minister of Finance declared the business of a hedge fund as a collective investment scheme in terms of Section 63 of the Collective Investments Schemes Control Act (CISCA). The adoption of this progressive legislation, supported by voluntary industry initiatives can ensure that South African hedge funds strengthen the financial system over time.

The legislation includes registration requirements and oversight by the Financial Sector Conduct Authority (FSCA), mandatory management companies (Mancos) and other compliance requirements, which will be explained. This makes it possible for retirement funds, under Regulation 28 of the Pension Funds Act, to consider investing up to 10% of their portfolios in regulated hedge funds. A maximum of 5% can be invested in fund of hedge funds and a maximum of 2.5% in single hedge funds.

Lead fund categories and compliance

Central to hedge fund legislation in South Africa is that any person managing a "hedge fund" or "fund of hedge funds", is seen as a financial services provider under the FAIS Act. Therefore, if the person managing the hedge fund wants to attract "members of the public" to invest in the hedge fund, it has to register the hedge fund with the FSCA.

Hedge funds are registered in accordance with the hedge fund categories set out in CISCA, Board Notice 52 of 2015 as either:

1. **Retail investor hedge funds (RIHFs)**, aimed at the general public as per CISCA classification. These are typically hedge funds with a less risky investment strategy; or a
2. **Qualified investor hedge funds (QIHFs)**, aimed at experienced or institutional investors who have R1m or more to invest. In addition, the investor, or their appointed financial adviser, requires demonstrable experience and understanding to make an informed investment decision when it comes to hedge fund investing.

Retirement funds can invest in both RIHFs and QIHFs

In practice, retirement funds will invest as qualified investors, either through investment into an existing registered hedge fund or through a segregated mandate specifically developed for the retirement fund.

Continues on p.14

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THE HEDGE FUND INVESTMENT MANAGEMENT PROCESS

Retail investors

Retirement funds

Other institutional investors

High-net-worth individuals, trusts and private companies

Collective investment schemes not allowed to invest

Retail investor hedge fund (RIHF)

- Can market
- External management company (Manco) required
- Strategy: varies, but often combines long and short equity positions with limited leverage
- Assets: often include liquid assets e.g. fixed income and listed equity
- Leverage limits regulated
- Liquid – easy for investors to exit
- Fee structure: resembles CIS – assets under management (AUM)

Qualified investor hedge fund (QIHF)

- Can market
- External Manco required
- Strategy: varies, usually includes leveraged short positions, but long positions not uncommon
- Assets: vary from fund to fund
- Leverage limits can be typically higher than RIHF as they are not prescribed in regulations, but still have to be approved by the regulator as part of the investment deed when the fund is launched
- Often less liquid than RIHF, e.g. exit within one month
- Fee structure: annual AUM based management fee and share in outperformance (e.g. 1%:15%)

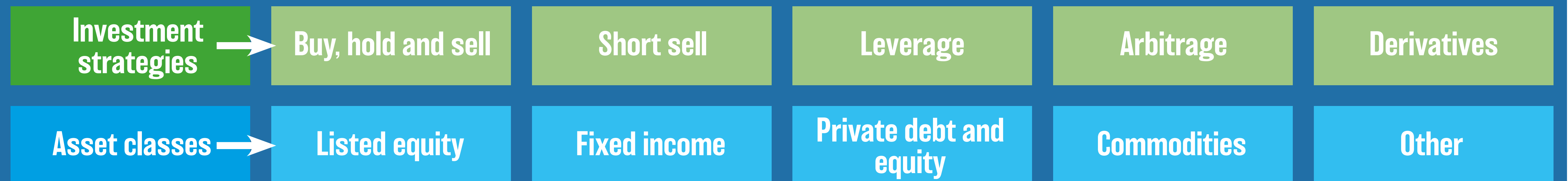
Unregulated hedge fund

- Cannot market
- External Manco not required
- Strategy: varies from fund to fund
- Assets: vary from fund to fund
- Can be highly leveraged
- Can be illiquid if underlying positions are not often traded
- Fee structure: same as QIHF but higher fees might be found
- An unregulated hedge fund is only possible if there is one investor; once there are more investors, the hedge fund must be regulated

Hedge fund manager

- Requires a Category IIA FSCA financial services provider license
- Executes mandate based on investment management agreement (IMA)
- Provides regulatory seed capital and co-invests with investors
- Develops investment strategy
- Conducts in-depth market research
- Rebalances risk
- Instructs trades and contracts
- Under section 5 of CISCA, both QIHFs and RIHFs must operate under a Manco

Building blocks from which to construct hedge fund portfolios



continues from p.11

In managing a hedge fund, the hedge fund manager needs to comply with a range of requirements that include, but are not limited to:

1. Fund founding documents must be submitted and will be scrutinised by the FSCA as regulator.
2. The FSCA needs to be satisfied that appropriate systems and controls are in place and maintained.
3. A risk management function (separate from its investment management and fund administration functions), including regular reporting to the FSCA on risk-related matters needs to be in place.
4. Alignment of interests needs to be established between investors and managers through, for example, the remuneration policy.
5. Leverage limits: Should a South African hedge fund employ leveraging, there are strict regulatory requirements in place to monitor the risk in this regard. For example, in RIHFs a fund manager cannot go beyond prescribed leverage limits. Managers of QIHFs will be allowed to set their own maximum leverage levels for each underlying portfolio of the QIHF, but the leverage levels must be disclosed to the regulator at registration and investors prior to entering into a transaction.
6. Engagement in physical short selling and derivatives that create short positions are allowed, but not naked short selling (selling of a security without being in possession of the security or ensuring that it can be borrowed).
7. Fund administrators and brokers need to be duly registered before being appointed.
8. A binding valuation policy and independent review of valuations needs to be in place.
9. Transparency through an annual independent external audit is required, as well as an annual report.
10. Wide-ranging disclosure and reporting requirements to investors are required.

Mancos and monitoring risk

Mancos appoint their own external risk managers to monitor risk in accordance with legal and fund mandates. The key strength for the Mancos from an investor perspective is that they consist of members that generally understand hedge fund strategies and instruments.

ASISA Hedge Fund Classification Standard

In addition to the legislation and regulation already discussed, the investment industry has also introduced standard classifications of hedge funds. This is known as the ASISA Hedge Fund Classification Standard, which was adopted in 2020. The standard applies to hedge funds registered as Collective Investment Schemes in Board Notice 52 of 2015 of the Collective Investment Schemes Control Act, 2002. Although still in an early stage of adoption, the standard will:

- Allow investors to better understand and analyse different hedge fund types;
- Make it easier to compare funds and fund performance;
- Allow for better assessment of potential risks associated with investing in a hedge fund;
- Support action that sees to it that hedge funds don't change classification regularly.

A high-level overview of the ASISA classification:

Tier 1 Describes the investor type that is invested in the hedge fund	**Tier 2** Describes the geographic focus of the hedge fund	**Tier 3** Describes the dominant investment strategies used by the fund manager	**Tier 4** Is only applicable to long-short equity funds, and further describes the investment strategy of the applicable fund
Retail investor hedge funds (RIHFs) **Qualified investor hedge funds (QIHFs)**	**South African portfolios** with at least 60% of assets in SA **Worldwide portfolios** investing in both SA and rest of the world **Global portfolios** that invest at least 80% outside of South Africa **Regional portfolios** that invest at least 80% in a specific region (e.g. Africa) or country (e.g. China)	**Long-short equity hedge funds** that generate returns from mostly investing in equities **Fixed-income hedge funds** that earn returns from interest rate securities **Multi-strategy hedge funds** that blend a variety of strategies with no single asset class dominating **Other hedge funds** that do not fit into any of the other strategies	**Long-bias equity hedge funds** are funds that will have more than 25% net exposure to traditional long-equity investments **Market-neutral hedge funds** that will have very little directional exposure to the equity market **Other equity hedge funds** invest in very specific equity types or sectors

Notes on hedge fund investing

1. It is important to note that "members of the public" does not automatically exclude institutional investors, so hedge funds marketed to retirement funds need to be registered.
2. A retirement fund cannot gain exposure to a hedge fund through another registered CIS, as these are still prohibited from investing in hedge funds.
3. It is important to note the onshore hedge funds can be marketed, but offshore hedge funds not registered under Section 65 may not be marketed to the public by any person.

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HEDGE FUNDS AND RESPONSIBLE INVESTING

overview

With regard to the adoption of environmental, social and governance factors as part of responsible investment practices, hedge funds should not ignore ESG integration. Smart hedge funds can actually benefit from the rise in ESG investing.

Considering market impact

It is true that investors, the financial markets and even the real economy can be hurt by unscrupulous and/or overly aggressive hedge funds. Examples include the Bernie Madoff investment scandal and Long-Term Capital Management in the United States of America. In South Africa, it is unlikely that South African hedge funds can destabilise the financial system. Unscrupulous or overly aggressive activities can, however, unduly damage investors, companies and even smaller industries.

Hedge funds therefore need to consider their responsibility as influencers in the financial markets and the economy. In this vein, hedge funds should take care as to how they communicate their hedging positions, especially with regard to assets that they have shorted. By communicating their research and positions with integrity – and by adhering to South Africa's progressive hedge fund regulations – they can be positive contributors to financial markets and the economy as a whole.

One area where hedge funds can seize opportunities to create positive impact, while still serving their investors, is through integrating environmental, social and governance (ESG) factors in their investment strategies. ESG matters are top of mind for institutional investors around the world. Globally, significant institutional investments are flowing to so-called ESG assets. This includes green bonds, renewable energy and ESG-indexed funds.

Global institutional investors that have adopted responsible investment practices are placing pressure on hedge funds in this regard. When investing and monitoring hedge funds, South African retirement funds should understand how the hedge fund managers are dealing with ESG matters.

ESG as an opportunity

Hedge funds are uniquely positioned to benefit from a period of increased ESG-focused investing. It is plausible that the combination of depressed equity markets – and increased global environmental and social pressure – will require active management with a wider range of investment strategies, especially during periods of increased market volatility. Some ESG-related opportunities that hedge fund managers can consider, include:

- **ESG arbitrage and risk management:** Hedge funds that have a proper understanding of assets that will perform well in an era of environmental and social innovation, could develop strategies that could either reduce portfolio risk related to ESG, or take advantage of ESG- related arbitrage. This could occur where a long equity position is taken on a company with strong ESG credentials, while short positions are taken on equities that rank poorly on ESG metrics. An example could be in the energy sector, where a hedge fund can take a long position on a renewable energy share, while selling short a coal energy share, based on research that suggests the increasing move towards clean energy will result in coal energy becoming a "stranded" asset.
- **Price discovery on ESG assets:** It should also be considered that during the rise of ESG investing, where more capital is pursuing ESG investments, there will likely be "ESG fakes" or ESG assets that are overpriced. Hedge funds can play an important role in price discovery by employing their quality research, market insights, and using investment strategies, such as shorting, to highlight ESG fakes or to ensure that overvalued ESG assets are repriced.

How can hedge funds adopt ESG policies and practices?

Notwithstanding their unique investment strategies, hedge funds that accept investment from the public need to articulate their philosophy, policy and approach to ESG matters in a manner consistent with best practice.

1. Adopt ESG policies and practices aligned to global and South African best practice, guided by the United Nations' Principles for Responsible Investment (UNPRI) and the Code for Responsible Investing in South Africa (CRISA).
2. Since a significant number of South African hedge funds take long equity positions, they should give consideration to ESG in their investment process and stewardship. For example, hedge funds could utilise their equity-based voting power on ESG matters and report on their voting practices as it relates to important matters, such as climate disclosure and executive remuneration.
3. Hedge funds could also show how they are building ESG expertise within their investment and analyst teams.
4. Hedge funds should report on their responsible investment activities to investors.

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Example question: Please choose the correct answer.

True or false? Hedge funds in South Africa can register as collective investment schemes.

- [x] True
- [ ] False

1. Fill in the missing amount. Regulation 28 of the Pension Funds Act allows retirement funds to invest up to _____% of their capital in alternative asset classes.

2. True or false? Most hedge funds in South Africa operate as collective investments.

- [ ] True
- [ ] False

3. True or false? Retirement funds can invest in both RIHFs and QIHFs.

- [ ] True
- [ ] False

4. What does CISCA stand for?

____

5. Choose the correct answers by ticking the relevant boxes. Which of the following hedge funds, as classified by South African regulation, require the establishment of a management company (Manco)?

- [ ] Qualified investor hedge fund (QIHF)
- [ ] Retail investor hedge fund (RIHF)
- [ ] Unregulated hedge funds
- [ ] All of the above

6. True or false? A collective investment scheme cannot invest directly into a hedge fund.

- [ ] True
- [ ] False

7. Choose the correct answer. Which of the non-traditional investment strategies/instruments are hedge funds not permitted to use in South Africa?

- [ ] Leveraging
- [ ] Arbitrage
- [ ] Derivates
- [ ] Naked short selling

8. True or false? Exposure to alternative asset classes, such as soft commodities (e.g. wheat and soya beans), are not available in long-only funds.

- [ ] True
- [ ] False

9. What is the minimum investment amount required in a qualified investor hedge fund (QIHF)?

- [ ] R20 000
- [ ] R30 000
- [ ] R50 000
- [ ] R1 million

10. True or false? Hedge funds with a geographic focus in South Africa (known as South African portfolios) require an asset allocation of at least 80% within South Africa.

- [ ] True
- [ ] False