

NAVIGA

Hedge Funds

12 October 2023

WHY ADDING HEDGE FUNDS TO YOUR PORTFOLIO MAKES SENSE

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Over the last 15 years amidst market volatility, the average local balanced fund has achieved the commonly used CPI+5% benchmark only 42% of the time over a three-year investment horizon. Consequently, investors have increasingly turned their attention to alternative investments and return sources, especially in the wake of recent bond market volatility and the uncertain outlook for equities. Hedge funds are an attractive entry point to alternative assets given their increased regulation, liquidity, and transparency. Other alternatives, however, often have little information on underlying instruments, lock-up periods, and high minimum investments. Adding hedge fund exposure to portfolios offers investors a lower correlation with traditional portfolios, diversification benefits, and a means of minimising volatility.

While the average drawdown (peak to trough move) of the FTSE/JSE All Share Index was more than -11% during the past five years, the typical local long-short equity hedge fund limited this drawdown to -4.8%. Fixed-income and market-neutral strategies limited this drawdown even further (to approximately -0.9% and -0.6% respectively). While limiting the downside, these strategies can still participate significantly in market rallies. Over the past 10 years, the typical local long-short equity hedge fund has outperformed traditional local equity funds 71% of the time over a three-year investment horizon.

Hedge funds, like traditional unit trusts, can invest in a wide variety of assets but also make use of additional tools such as leverage, derivatives, and short positions, which gives them the potential to profit from market downturns. Hedge funds can follow different strategies and risk levels that deliver significantly varying performances. Among the most common long-short equity funds available locally, the one-year difference between the best and worst performer can average up to 30%. Therefore, as with any investment, thorough research and due diligence remain crucial.