comment

Why don't **South African pension funds** invest in hedge funds like their developed market peers?

By André Steyn, founder and portfolio manager at Steyn Capital Management

According to a 2020 Mercer study of Europe's largest pension funds, which covered assets of €1.1 trillion, 38% of these funds have an allocation to hedge funds, with the average size of allocations varying between 5% and 20% of fund assets. Our own analysis of the largest 200 pension funds in South Africa suggests that less than one in 20 local funds have allocations to hedge funds, with these allocations on average being far below the regulatory allowance of 10% of plan assets.

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Our view is that South African pension funds are missing out, given the strong returns that hedge funds have delivered versus balanced funds, the potential of downside protection offered by hedge funds, alpha generation on the short side which long-only funds can't provide, and the fact that hedge funds are now regulated by the FSCA, reducing risk for investors.

The graph below sets out the return streams of our longest-running hedge fund's long book (blue line), which has outperformed the market by more than six percentage points per annum over 13 years, and our short book (red line), which has outperformed the inverse of the market by over 17 percentage points a year over the same timeframe. Short selling can be regarded as a type of market insurance, and it is particularly pleasing when your insurance is paying you each year, as our own short book has done by generating a meaningful positive return. The combined performance has allowed our qualified investor hedge fund to outperform the stock market by almost three percentage points a year after fees, while taking on less than half of the market's risk.

The importance of this posture is best illustrated by the graph on the next page, which shows our hedge fund's performance after fees in the 10 most significant monthly market declines over the past 13 years. Our fund has outperformed the market in nine out of the 10 drawdowns, and generated positive performance in seven of those market dislocations. It took a once-in-a-hundred-years pandemic, together with a large long allocation to casino and hotel businesses, to cause a break from our usual pattern of substantially outperforming in weak markets. While we are still not satisfied with this loss, we strongly believe that this is the outlier rather than the norm, and we would still expect to be able to offer strong downside protection during future market turbulence.

Given the obvious self-interest, we turned to several pension fund consultants, to garner their views.

Claire Rentzke from Sukha & Associates, an independent asset consultancy, says that local pension funds have been avoiding hedge funds due to a perception of high fees, and the fact that high interest rates over

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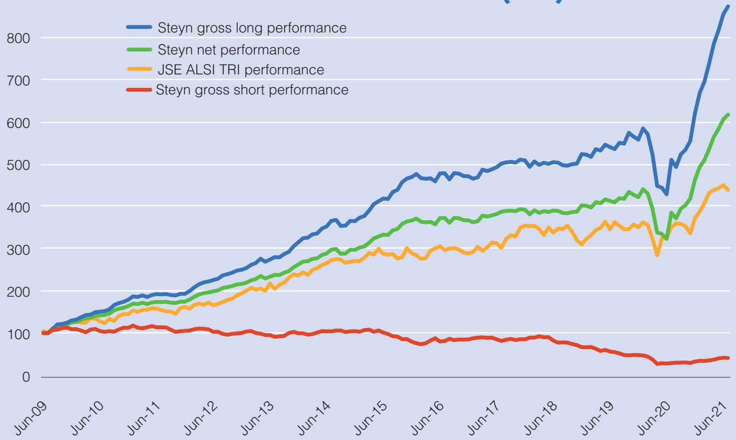
STEYN CAPITAL QUALIFIED INVESTOR HEDGE FUND VERSUS THE JSE ALL SHARE TOTAL RETURN INDEX (ZAR)



Source: Steyn Capital

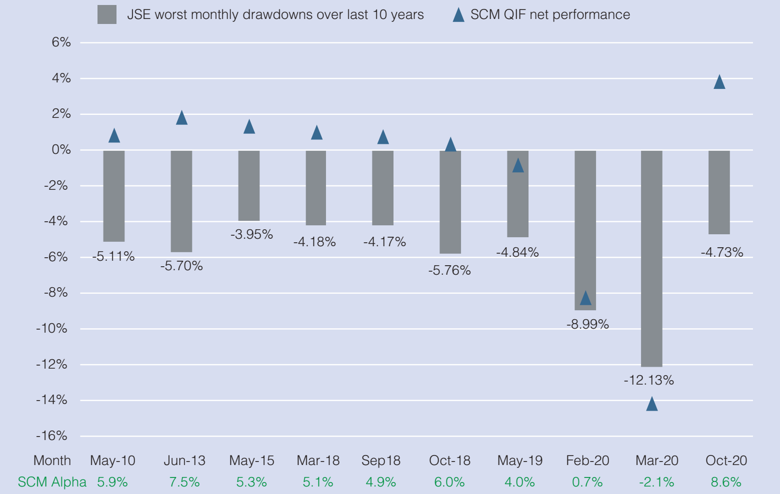
the past few years have reduced the attractiveness of hedge fund returns. Rentzke agrees that average fee levels have declined over the past few years. Our research suggests that our own fee levels at Steyn Capital are approximately a quarter lower than industry norms. Rentzke further agrees that the reduction in fixed income yields certainly makes hedge funds more attractive on a forward basis.

Danny Streicher from Mentenova, a pension consultant and multi-manager, says that pension funds have been avoiding hedge funds due to returns being weaker than expected, issues of complexity and poor perception, and a lack of liquidity. Streicher agrees that several of these issues have been addressed by the regulation of hedge funds by the FSCA in 2015. Regulation of hedge funds has increased transparency and liquidity, and has reduced risk. In fact, many of the well-publicised "hedge fund" blow-ups like Madoff weren't hedge funds at all, but were frauds masquerading as hedge funds. It is instructive to note that there has never been a blow-up of an FSCA-regulated hedge fund, which should provide much comfort for pension fund trustees.

The disappointing returns question is an interesting one. It seems that in years gone by, hedge funds were uniformly sold as investments whose returns were not affected by market movements. This of course can only be true for market-neutral funds or fixed income funds. Directional long/short equity funds do take on some level of market risk, and are helped or hurt by changes in equity markets. A skilled hedge fund manager who is able to generate excess returns on both the long and short sides can deliver market-beating returns with much less market risk than a traditional long-only fund. It is therefore important to select hedge funds that are appropriate for the investor's risk profile and investment portfolio. The recently introduced ASISA Hedge Fund Classification Standards have made this selection a lot easier by grouping hedge funds into different categories with comparable investment objectives and investment universes. Our own hedge fund is classified as a Long Bias SA Equity Hedge Fund, which aims to better the return of the stock market over time, while taking on less than half of market risk.

While hedge funds can be more complex than traditional funds, there is a strong case that pension fund consultants should guide clients here, given the obvious benefits.

SCM HEDGE FUND PERFORMANCE IN JSE MARKET DRAWDOWNS



Source: Steyn Capital