

The value of hedge funds: Navigating uncertainty with strategic investments

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Hedge funds have become an important tool for retirement funds looking to secure their members' long-term goals while managing risk. As traditional investments face challenges from global economic changes and high volatility, hedge funds offer a unique way for retirement funds to diversify their existing investment strategies and manage risk.

Understanding hedge funds

Hedge funds are investment vehicles designed to deliver absolute performance returns (whatever an asset or portfolio returned over a certain period) regardless of market conditions. Unlike traditional investments, hedge funds use a variety of investment strategies to enhance returns and reduce risk. This flexibility allows hedge fund managers to capture market opportunities that others may not have the strategies or tools to exploit, resulting in steady return profiles.

Key considerations for hedge fund allocations

1. Manager selection and portfolio construction

The success of a hedge fund allocation largely depends on choosing the right manager and constructing a well-balanced portfolio. Different hedge fund managers have unique styles, strategies, and expertise. Often, hedge fund managers may employ all, or some, of the strategies available across the hedge fund toolkit. The dispersion of returns between these managers can be wide, so manager selection is a very important consideration.

Equally important is portfolio construction, which involves assembling a mix of investments and strategies that balance risk and return. Investing with hedge fund managers who have demonstrated a consistent application of their investment philosophy and strategy into their portfolio construction process can help promote repeatable and reliable return streams.

2. Manager diversification

Hedge funds tap into a variety of return drivers that differ from traditional asset classes like stocks and bonds. These strategies target specific market inefficiencies or capture particular risk premiums. For example, hedge funds can make bi-directional investment decisions that profit from both rising and falling stock prices through long and short positions.

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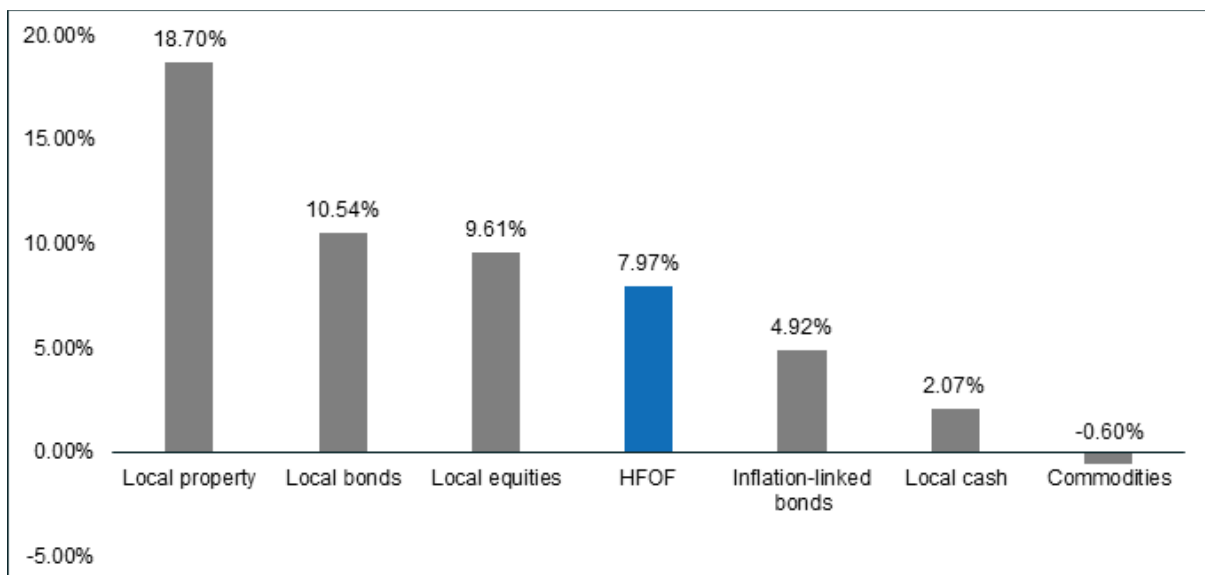
Benefits of hedge funds

The value of hedge funds lies in their flexibility and broad toolkit. Hedge fund managers have greater freedom compared to traditional asset managers, allowing them to employ multiple strategies to capture more opportunities in the market.

1. Defensive during uncertainty

Hedge funds offer defensive capabilities during times of uncertainty, particularly during times of significant broad-based declines across most asset classes as experienced during the 2020 Covid-19 crisis. By employing strategies that are less correlated with traditional asset classes, hedge funds can reduce the extent of participation in market falls.

Chart 1: Asset class returns versus a hedge fund of funds for the three months ending 30 September 2024



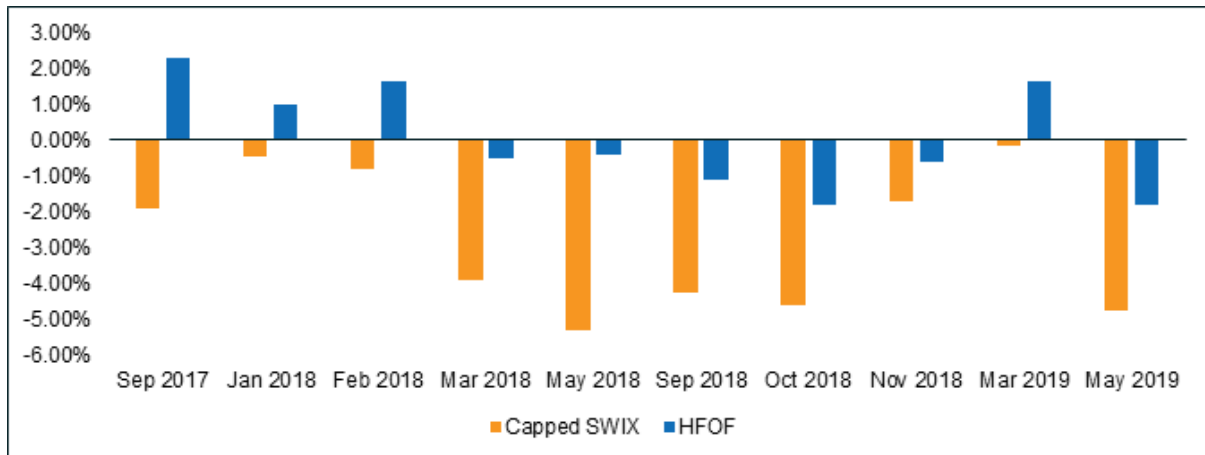
Source: Alexander Forbes Investments. HFOF returns shown net of fees.

2. Protection in down markets

Hedge funds are designed to offer protection by helping to cushion the blow when traditional investments suffer, particularly during sharp market crashes. Their ability to

generate returns independent of broader market movements makes them valuable in a diversified portfolio.

Chart 2: Worst 10 months since 2017 for a typical hedge fund of funds and the Capped SWIX

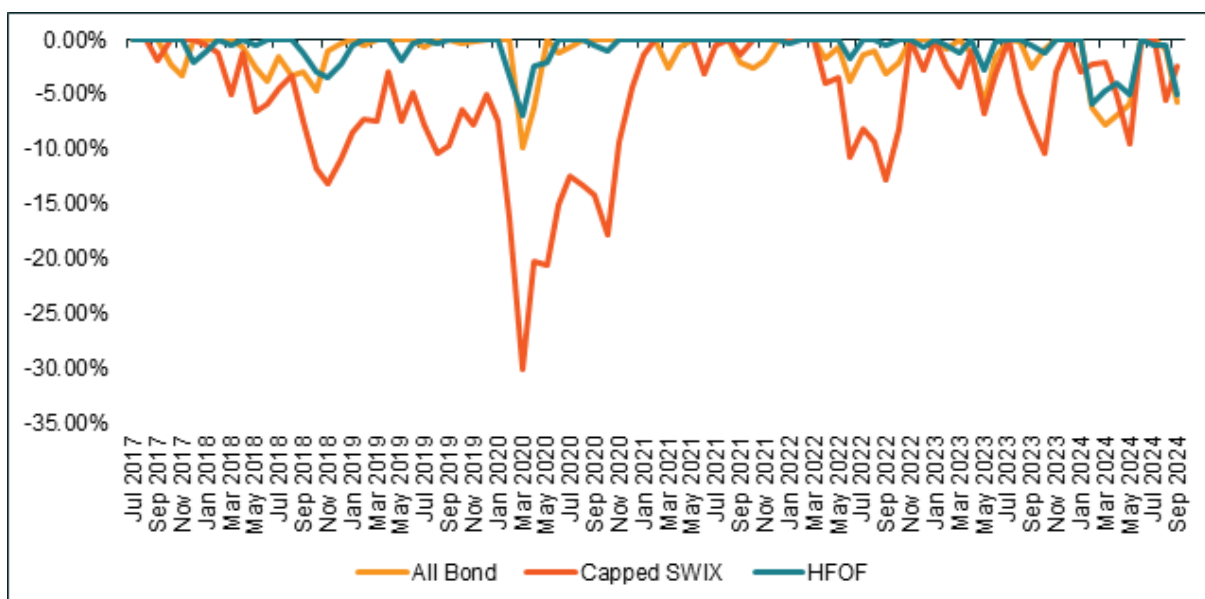


Source: Alexander Forbes Investments. Note: HFOF returns shown net of fees. Capped SWIX: FTSE/JSE Capped SWIX All Share Index

3. Lower market dependence

Hedge funds provide diversification by reducing reliance on traditional markets like stocks and bonds. By employing strategies that are market-neutral or that capture inefficiencies unrelated to market movements, hedge funds can lower the overall risk exposure in a portfolio — particularly drawdowns and downside risk.

Chart 3: Rolling three-year drawdowns of equity (Capped SWIX) and bond market (ALBI) versus a typical hedge fund of funds.



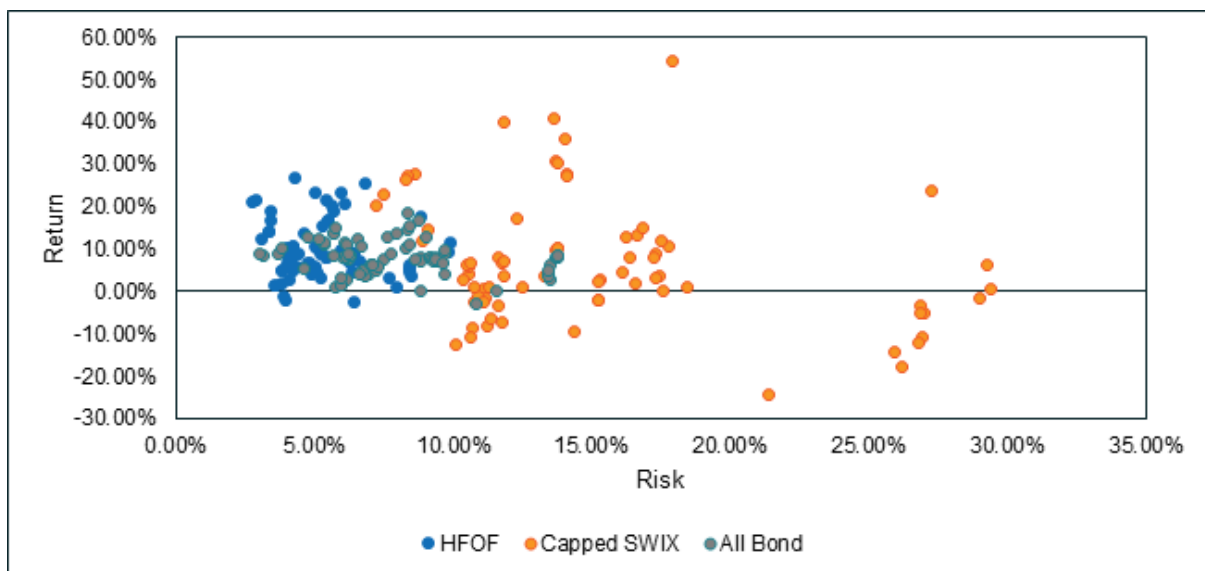
Source: Alexander Forbes Investments. HFOF returns shown net of fees. Capped SWIX: FTSE/JSE Capped SWIX All Share Index. All Bond: FTSE/JSE All Bond Index.

What is meant by a drawdown? A drawdown refers to the decline from a peak value to a trough in the value of an investment or portfolio, measured as a percentage. It shows the drop in value from the highest point before it began falling to the lowest point it reached before recovering.

4. Superior investment performance with less volatility

The risk reduction that hedge funds offer does not necessarily come at the cost of lower returns or growth potential. The ability to provide investment growth with less volatility makes hedge funds a compelling complementary proposition within an overall investment strategy.

Chart 4: Rolling three-year risk and return profile of local equity and bond markets versus a typical hedge fund of funds.



Source: Alexander Forbes Investments. HFOF returns shown net of fees. Capped SWIX: FTSE/JSE Capped SWIX All Share Index. All Bond: FTSE/JSE All Bond Index.

A risk versus return scatter plot visualises how the different investments balance potential returns with associated risks. Points in the top-right quadrant indicate investments with high potential returns but also high risk like, like stocks or emerging market funds, whereas points in the top-left quadrant show more stable investments with good potential returns, like bonds.

Conclusion

Hedge funds play an essential role in modern investment strategies, offering unique benefits for investors seeking to enhance performance while managing risk. By focusing on manager selection, diversification and strategic allocation, hedge funds can boost portfolio performance and provide valuable protection during uncertain times. As the financial landscape continues to evolve, hedge funds remain a key component in achieving long-term investment objectives.

When considering hedge fund investments, it is important to partner with experts who have the knowledge and experience to navigate the complexities of the market. A well-informed partner can help identify and select the best investment opportunities, ensuring that your portfolio is well-positioned to meet your financial goals. With the right guidance, investors can confidently explore the diverse and dynamic world of hedge funds, knowing that their investments are in capable hands.