



MONEY MARKETING HEDGE FUND SURVEY

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HEDGE FUNDS WEATHER THE STORM

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The sub-prime credit crisis that broke in the US in the second half of 2007 was the tremor that ended in a full-scale financial tsunami that wiped out billions in value across the globe. In keeping with their reason for being, hedge funds fared better than most in helping to protect investors against crashing asset prices.

The global financial crisis has negatively impacted all asset classes. Even large institutions have been forced to their knees, leaving investors with few places to hide as they contemplate the fact that it could take decades for asset prices to return to pre-2007 values.

Hedge funds globally have had to manoeuvre through the storm under conditions never seen before. Several jurisdictions worldwide placed short-selling restrictions on certain shares, even though this proved to be a futile exercise that did not meaningfully reduce market volatility.

To those in the industry, this came as no surprise as hedge funds are a key player in maintaining stability and in making markets more efficient by raising liquidity and reducing mis-pricing in asset values.

Preserving capital

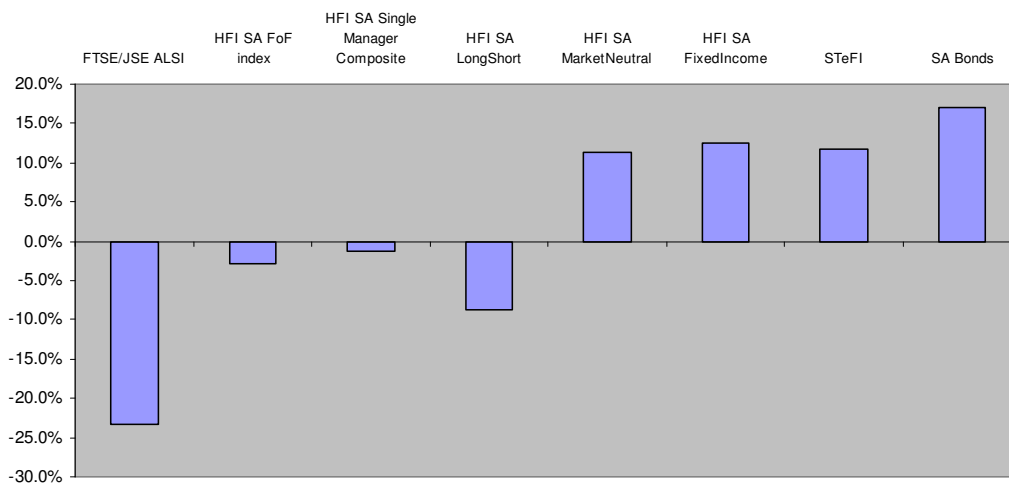
Given that equity prices in developed markets fell by more than 40% in 2008, being invested in hedge funds would have significantly reduced an investor's portfolio losses as global hedge funds were down some 20% over the year.

In South Africa, local equities performed equally poorly, with the FTSE/JSE All Share Index losing more than 23% over the year. However, local hedge funds proved their ability to preserve capital in extremely difficult conditions by falling less than 3% in 2008 (taking the average performance of SA funds of hedge funds as a proxy).

When looking at the performance of different hedge fund strategies, the case for hedge funds becomes even more compelling, as market neutral and fixed income hedge funds managed to produce strong positive and in most cases cash-beating returns for the year.

But even the long/short hedge funds that maintained a long-bias during the year (value-seeking fundamental investors for whom asset prices became cheaper and cheaper) managed to curb losses to a mere fraction of that of the market.

Cumulative return of SA indices for 2008



Source: Hedge Fund Intelligence / Africa Hedge Indices & I-Net

Longer-term performance

When comparing the longer-term performance of hedge funds with that of other asset classes, the value adding properties of hedge funds become clear.

The annual compound return for the FTSE/JSE All Share Index between January 2004 and February 2009 was 15%. South African bonds returned an annualised 9% over the same period. Even though, on average, South African hedge funds' performance over this period was in line with the ALSI (a period when local equities enjoyed a strong bull run), long/short hedge funds on average outperformed local equities and fixed income hedge funds outperformed the ALBI.

More importantly, hedge funds have outperformed other asset classes on a risk-adjusted basis over the past five years – the Sharpe ratio of local hedge funds since January 2004 is roughly twice that of both the ALSI and the ALBI. This implies that, if risk could be measured in "units", for each unit of risk taken, an investor in hedge funds over this period would have earned double the return of an investor in either equities or bonds.

Whereas January 2008 was a particularly bad month for local hedge funds, with most caught too long and exposed to illiquid small caps that retracted by 12%, January and February 2009 are showing the first signs of more stability returning to markets. In February 2009, local hedge funds outperformed local equities by more than 10% for the second time in 12 months (local hedge funds also outperformed the ALSI by a similar margin in September 2008 when the ALSI was down by 13%).

It seems that local hedge fund managers have learned valuable lessons from 2008 and that portfolios are well positioned to preserve capital in a sustained bear market.

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