OPINION

COBUS CILLIERS: Hedge funds: an underutilised building block for retirement

Retail hedge funds have unique characteristics that other investment vehicles lack

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A lot has been written about the proposed changes to regulation 28 of the Pension Funds Act, which governs allowable asset-class limits.

At a high level, this regulation is meant to protect retail investors, with its key positive aspect the inherent risk management practices it forces upon the investment management industry.

As an example, a regulation 28-compliant fund is not allowed to invest a large portion of the fund capital in an obscure, small-cap, illiquid investment (the limit for a listed company that has a market cap of less than R2bn is 5% of the fund).

Notwithstanding the positive aspects of this regulation, the most controversial topic of late has been the noise around infrastructure as an asset class and the possible introduction of "prescribed assets". Fortunately, these concerns have been put to rest with the latest draft document that has been released for comment by the Treasury.

One positive development in the draft document is the change to the allowable allocation to hedge funds. More specifically, the segment now states that "hedge funds approved and licensed under the Collective Investment Scheme Control Act" have a 5% limit per fund. The total allowable limit for the hedge fund category remains 10%.

Despite retail investors being allowed to invest a portion of one's pension fund or retirement annuity in a hedge fund, most retail investors in SA have little to no exposure to hedge funds. This is understandable, given their nuanced nature.

With the launch and introduction of retail hedge funds in SA, a lot has changed to provide retail investors access to them. The minimum initial required investment has now been reduced from R1m to about R25,000; the amount of risk a retail hedge fund is allowed to take (referred to as leverage) has been reduced; and there has been an improvement in liquidity.

These changes were huge strides in making hedge funds more accessible to the average retail investor, either directly or through their pension fund or retirement annuity.

Retail hedge funds can be exciting and provide unique characteristics that other investment vehicles lack. One such unique characteristic is the ability of a hedge fund to go "short". This is the ability to make money even when the market goes down.

But where should one start the process? Here are some key questions that investors should ask to assess the suitability and appropriateness of the investment:

- What is the performance of the hedge fund over the past one, three and five years? Although this is not an indication of future performance, it does provide some insight into the risk management capacity of each fund, and what risks they have taken;
- What asset classes does the fund invest in, and how concentrated are the investments in the portfolio?
- What experience and qualifications do the people running the fund have?
- How long has the fund been in existence and what are it and the company's assets under management?
- What benchmark does the hedge fund use and how aligned are these to the investor's interest? Most hedge funds have an absolute benchmark which aligns it to investors in that you can't take relative performance to the bank, but rather absolute performance; and
- Are the individuals at the fund registered with the Financial Sector Conduct Authority?

In conclusion, retail hedge funds can provide an excellent building block for a well-diversified retirement portfolio, and a powerful addition to one's retirement planning. The misplaced belief that hedge funds are too risky underscores the misunderstanding of how these investment vehicles work, as most of the SA hedge funds older than three years tend to be lower risk than the average equity unit.

But as with any investment decision, make sure you do your homework before investing to ensure the fund is suitable and appropriate for your risk and return requirement.

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