Are hedge funds being overlooked by investors?

By Yonela Makwetu

17 Nov 2016

In the words of Alexander Graham Bell, "when one door closes, another opens, but we often look so long and so regretfully upon the closed door that we do not see the one which has opened for us". A similar tendency could become prevalent among investors wanting to invest in South African hedge funds - possibly opting out rather than looking beyond the larger funds that have closed to new investors.

With pooled investment vehicles, the value of the fund increases as the fund performs well. As the return profile becomes enticing to outside investors, the great performance attracts new investors. Although attracting investors is the goal, fund managers do need to keep a close eye on the size of the fund to make sure it remains manageable.

The reality is that portfolio managers may find it difficult to actively manage large portfolios with complex investment strategies. Therefore, hedge fund managers (as well as traditional asset class managers) have a preference to cap, or close, their funds based on the availability of investment opportunities (experience a capacity constraint) to sustain superior performance.

The Financial Services Board allows fund managers to set optimum limits for their funds and effectively close them off to new investors when that level is reached. Therefore, when a fund closes, it is because the manager is acting according to his/her mandate and at times allowing the fund to grow bigger would have an adverse impact on the ability to maintain the investment style. One of the main reason for closing the fund is that managers do not want to get too big that their trades can move the market (granted, there is no local hedge fund big enough to move the market yet).

A manager can either soft close or hard close a fund. A soft close indicates that no additional investors will be allowed into the fund and only current investors will be allowed to make additional contributions. A hard close indicates that the fund will no longer accept any additional investments – not even from existing investors. A fund's capacity, for that matter, should then be higher than the level indicated for a hard close because of the growth which might be experienced through solid performance.

The fund manager can, therefore, close the fund to new investments for an indefinite period or create a “waiting list” in the case of redemptions from existing investors.However, some managers tend to prefer building on relationships with existing investors and giving them preference when there is more capacity. There have even been cases where hedge fund managers have given money back to investors as they noted that the fund has become too big. At the end of the day, performance and quality trump quantity.

The *Novare 2016 Hedge Fund* survey found that 76,3% of the funds polled were open for new investments, signifying that the industry had capacity. Soft closed funds accounted for 7,6%, therefore, only accepting investments from current investors (slightly down from the 9,5% reported last year). There was a sizeable increase in funds which were hard closed from 7,1% to 15,9%, meaning that the fund was not open to new investments. This was prevalent in major hedge fund asset managers not wanting to dilute returns and rather focusing on satisfying existing investors return expectations.

It is clear that capacity does not seem to be an issue in the local industry as of yet as most funds are still open for investments – capacity on the existing hedge funds amount to R118bn. Even though some of the larger hedge funds have been hard/soft closed, a vast amount of hedge funds are available for investment.

The survey found that the South African hedge fund industry’s assets under management grew to R68,6bn, increasing mostly due to solid returns and subsequently showcasing an increase in returns of more than 10% over the last year. In an environment where traditional approaches to investments have underperformed, the advantages that hedge funds offer can no longer be ignored in a well-balanced portfolio.

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