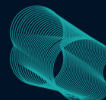


HEDGE FUNDS VS. TRADITIONAL UNIT TRUSTS: KEY DIFFERENCES

For investors, the flexibility and leverage of hedge funds translate to more dynamic and responsive investment strategies. This can result in higher potential returns and more efficient use of capital.

COBUS POTGIETER
SOUTHERNCROSS CAPITAL

WHAT ARE THE KEY DIFFERENCES BETWEEN HEDGE FUNDS AND TRADITIONAL UNIT TRUSTS?

When we look at retail hedge funds in this instance, there is no difference between the two.

Both retail hedge funds and traditional unit trusts share the same legal framework and protections. This includes having a separate custodian, administrator, and management company to safeguard investors' interests.

Both types of investment vehicles offer comparable liquidity. Typically, investors can expect to receive cash within two to five days after giving a 24-hour notice for a redemption at the prevailing unit price.

WHAT ARE THEN, IN THIS INSTANCE, THE REAL DIFFERENCES BETWEEN RETAIL HEDGE FUNDS AND TRADITIONAL UNIT TRUSTS?

The only real differences between traditional unit trusts and retail hedge funds are the tools available to hedge fund managers that are not available to those traditional Unit Trust managers.

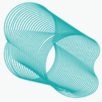
These come down to shorting, derivatives, flexibility, and leverage. Hedge fund managers can short sell, allowing them to profit from a decline in the value of an asset.

For example, if a manager believes Pick ‘n Pay shares at R30 are overvalued, they can borrow these shares, sell them at R30, and later repurchase them at a lower price (e.g., R20), making a profit from the price difference.

WHAT ARE DERIVATIVES USED FOR IN THE INVESTMENT WORLD?

Derivatives are a complex yet powerful subset of the investment universe. Simplistically, a derivative is a financial instrument whose value is derived from the value of an underlying asset. This asset can be anything from stocks, bonds, and commodities to interest rates and currencies.

Derivatives expand the toolkit available to investment managers, enabling them to manage risk, speculate on price movements, and exploit arbitrage opportunities more effectively than with direct investments alone. They allow for more nuanced and strategic views on the market, providing greater flexibility in achieving investment objectives.



WHAT IS FLEXIBILITY AND GEARING USED FOR IN THE INVESTMENT WORLD? HOW DOES IT HELP OR WORK?

Flexibility and gearing are crucial tools for investment managers, allowing them to maximise opportunities and returns.

With flexibility you have the ability to quickly adjust investment strategies in response to market changes.
With gearing, you can use borrowed funds to increase investment capacity and potential returns.

Flexibility and gearing enable investment managers to enhance returns, optimise portfolios, and manage risks effectively by taking advantage of multiple opportunities simultaneously.

FLEXIBILITY AND LEVERAGE - IS IT ALLOWED IN A RETAIL HEDGE FUND?

Flexibility and leverage are closely linked concepts in investment management, particularly in retail hedge funds.

Leverage involves using borrowed capital to increase investment exposure. However, in retail hedge funds, this doesn't mean simply borrowing money to invest, as that level of risk isn't permitted.

Initial Investment:
A manager uses R20 to gain R100 exposure to an undervalued asset.

New Opportunity:
Another asset becomes undervalued. Instead of selling the first asset, the manager uses margin to gain additional exposure to the new opportunity.

In retail hedge funds, leverage doesn't mean borrowing money recklessly but rather using strategies like reinvesting generated capital and trading on margin.

This provides flexibility, enabling managers to seize multiple opportunities simultaneously without having to liquidate existing investments.

WHAT DOES THIS MEAN FOR AN INVESTOR, IF HEDGE FUNDS ARE LESS PRESCRIPTIVE THAN TRADITIONAL MANDATES?

Hedge fund mandates are generally less restrictive compared to traditional mandates, offering several advantages to investors.

Traditional Funds:
Managers must choose between different types of investments (e.g., equities vs. fixed income) based on a predefined allocation strategy.

Hedge Funds:
Managers can pursue a wider range of attractive opportunities across various categories without being constrained by strict allocation rules.

For investors, the less prescriptive nature of hedge fund mandates, combined with the flexibility afforded by leverage, means more dynamic and potentially higher-yielding investment opportunities.

Hedge funds can aggressively pursue the best opportunities across various asset classes, providing the potential for greater returns on each Rand invested.

WHAT DOES THIS MEAN FOR THE INVESTOR?

When comparing traditional investment mandates to hedge fund mandates, the flexibility and leverage inherent in hedge funds offer distinct advantages for investors.
Traditional Investment

A traditional fund manager with R100 might need to split investments according to a set allocation, such as R60 into equities and R40 into fixed income.

When both asset classes are attractive, a hedge fund manager can use leverage to invest R100 into fixed income and another R100 into equity, effectively doubling the exposure with the same initial investment.

When asset classes are unattractive, the manager can scale back significantly, perhaps investing only R40 in fixed income and R20 in equities, preserving capital and reducing risk.

For investors, the flexibility and leverage of hedge funds translate to more dynamic and responsive investment strategies.

This can result in higher potential returns and more efficient use of capital, as hedge fund managers can capitalise on attractive opportunities across different asset classes without being constrained by rigid allocation requirements.