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THE RISK OF INVESTING IN A HEDGE FUND

"Navigating Uncertainty" is a dynamic finance series designed to demystify the complexities of hedge funds. We provide clarity on intricate concepts, ensuring accessibility to readers of all backgrounds.

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WHAT RISKS ARE INVOLVED WHEN INVESTING IN A HEDGE FUND?

When investing in hedge funds, risks can be broadly categorised into investment risk and operational risk. Investment risk involves the potential gains or losses associated with the fund's strategies, where success or failure is tied directly to market performance.

Operational risk, on the other hand, carries a negative asymmetric payoff profile, meaning investors aren't rewarded for assuming this risk. It arises from the internal processes and structures of the fund, which can lead to significant losses if mismanaged. Understanding these classifications is crucial for evaluating the overall risk of hedge fund investments.

WHAT IS MEANT BY INVESTMENT RISK?

Investment risk refers to the potential for gains or losses when investing in the underlying instruments of a hedge fund, similar to any other type of fund. Hedge funds, however, are particularly focused on absolute returns, which can lead to missed opportunities if equity and bond markets experience a strong bull run.

On the flip side, hedge funds are generally better positioned to protect against downturns, potentially benefiting from such conditions over time. Despite this, timing the market and the risk of concentration—failing to maintain a diversified portfolio—are significant investment risks specific to hedge funds.

WHAT ARE THE OPERATIONAL RISKS?

Operational risks in hedge funds are those that do not generate returns, meaning investors are not compensated for assuming them, making it crucial to avoid them entirely.

Before regulatory changes, hedge fund managers often controlled their own cash and administration, leading to significant operational risks.

High-profile failures, such as the Bernie Madoff scandal, highlighted the dangers of this lack of oversight, where hedge funds operated with minimal transparency and managers had excessive control over the fund's legal and financial structures.

In the post-regulatory environment, particularly under the CISCA framework in South Africa, hedge funds now enjoy enhanced protections similar to those of unit trusts. These include independent administrators, custodians, and cash control, ensuring that hedge fund managers focus solely on managing the investment strategy without access to underlying securities or cash.

This shift has significantly reduced operational risks in hedge fund investments compared to the pre-2015 landscape.

WHAT IS THE OPERATIONAL RISK BETWEEN A TRADITIONAL UNIT TRUST AND A HEDGE FUND UNIT TRUST?

The operational risk between a traditional unit trust and a hedge fund unit trust is largely similar, with one key difference: counterparty exposure to the underlying prime broker.

This risk is specific to hedge funds, which often use derivative instruments provided by banks. When hedge fund managers take derivative positions, they are exposed to the counterparty risk of the bank.

Therefore, it is crucial to ensure that your hedge fund manager works with a well-capitalised, reputable bank that can reliably fulfil its obligations in any transaction