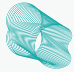

SOUTHERNCROSS
CAPITAL

Investment Strategies within Hedge Funds

"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.

COBUS POTGIETER
SOUTHERNCROSS CAPITAL

Hedge funds employ a variety of strategies, making it challenging to directly compare funds even within the same category. Traditional classifications, such as those by ASISA, are not always effective for identifying directly comparable hedge funds. For instance, while two general equity funds might be comparable as peers, two long-short equity hedge funds might not be comparable due to differing risk and return profiles. One might have a high-risk, high-volatility approach, while another adopts a more cautious strategy.

Hedge funds are generally categorised into three broad types: equity strategies, fixed income strategies, and multi-asset strategies. Multi-asset strategies may include any combination of equities, fixed income, and commodities. Within these broad classes, there are sub-classes. For example, within equity strategies, we have long-short equity and market-neutral classes.

Long-short equity is particularly popular among investors. This strategy allows fund managers to both invest in and short stocks, making it somewhat comparable to traditional equity funds.

Long-short equity hedge funds are the most common type and can range from cautious to aggressive, with varying levels of market exposure. In contrast, market-neutral funds aim to minimise market movements' impact by focusing on the relative differences between long and short positions.

Using broad categories like equity, fixed income, and multi-asset can be imperfect, as funds within these categories may have different risk profiles. To make accurate comparisons, it is crucial to consider both the overall strategy and risk level. Even then, funds can differ significantly, requiring a deep understanding of each fund’s unique strategy to assess its role in an investor’s portfolio.

To illustrate the nuances in risk, consider a manager who believes Shoprite is a strong business while Pick n Pay is overvalued. The riskiest strategy is to invest entirely in Shoprite, leaving full exposure to market movements. A more cautious approach, typical of market-neutral funds, involves owning Shoprite and shorting Pick n Pay, neutralizing market exposure while focusing on the performance differential.

In between these extremes are various combinations of long and short positions. A riskier method might involve only shorting Pick n Pay, which increases market direction risk. Another low-risk strategy is an arbitrage opportunity during corporate actions, such as when Distell was acquired by Heineken. During this period, hedge funds could buy Distell at a discount relative to the acquisition price, a strategy less accessible to long-only managers due to capital constraints.

Hedge funds can exploit opportunities more effectively through derivatives, unavailable to traditional long-only managers. In fixed income, low-risk strategies typically involve high-certainty, short-duration instruments. Riskier strategies might include longer durations, higher credit risk, or betting on interest rate changes.

In multi-asset strategies, both equity and fixed income are present, sometimes alongside commodities. A low-risk commodity trade could involve a long-short approach, like going long on a soybean future in Johannesburg and shorting one in Chicago. High-risk strategies might involve taking a directional bet on local market appreciation without hedging.